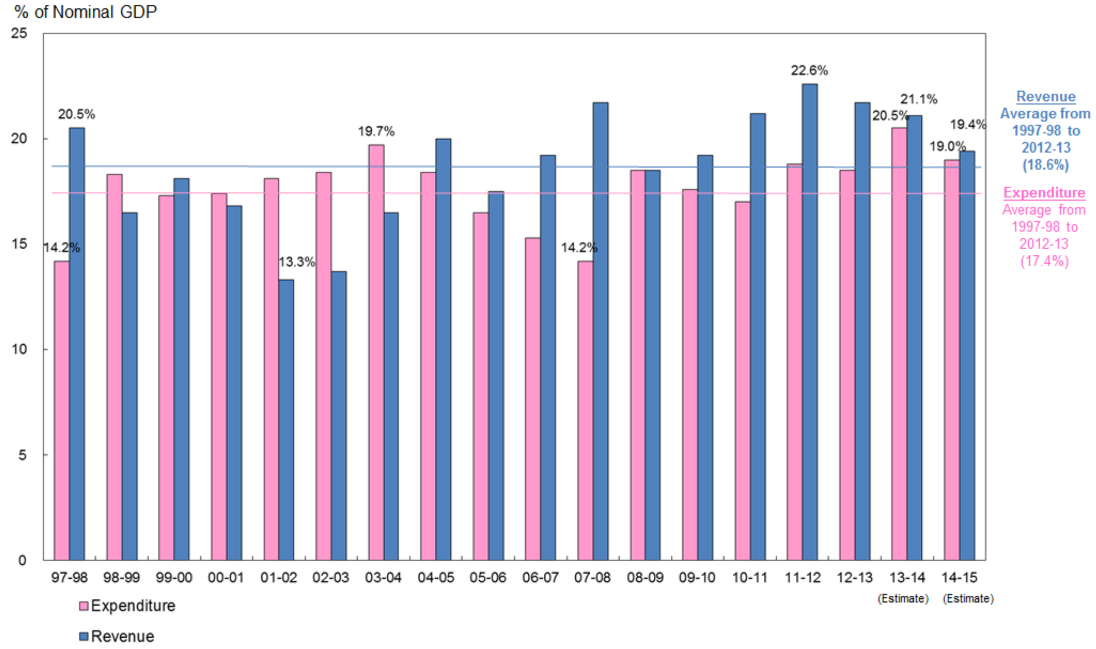
Chapter 1 – Fiscal Health Check

Overview

1.1 The current state of Hong Kong's public finances is healthy. Since 1997-98 –

(a) we have adhered to the "*principle of keeping expenditure within the limits of revenues*", as required under Article 107 of the Basic Law (BL 107). Government expenditure was on average 17.4%[1] of the Gross Domestic Product (GDP) from 1997-98 to 2012-13, and government revenue was 18.6%[2] *(Chart 1.1)*;

Chart 1.1 – Government revenue and expenditure since 1997-98



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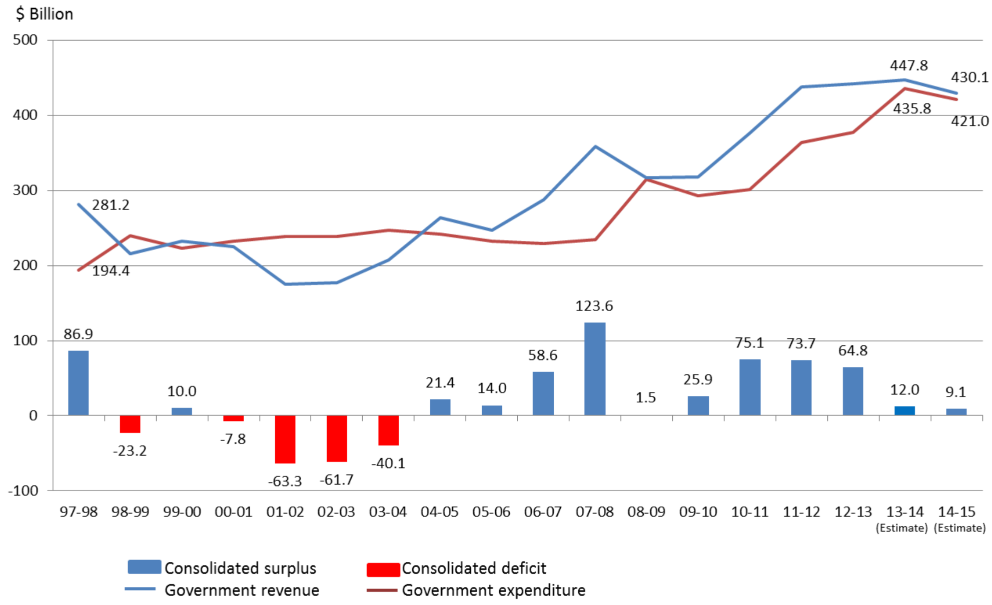
1 Taking into account the expenditure of the Housing Authority and Trading Funds, public expenditure was on average 19.3% of GDP. Unless otherwise stated, this report deals with government expenditure only which also includes repayment of government bonds and notes in 2006-07, 2008-09 and 2009-10.

2 Including proceeds received from the issuance of government bonds and notes in 2004-05.

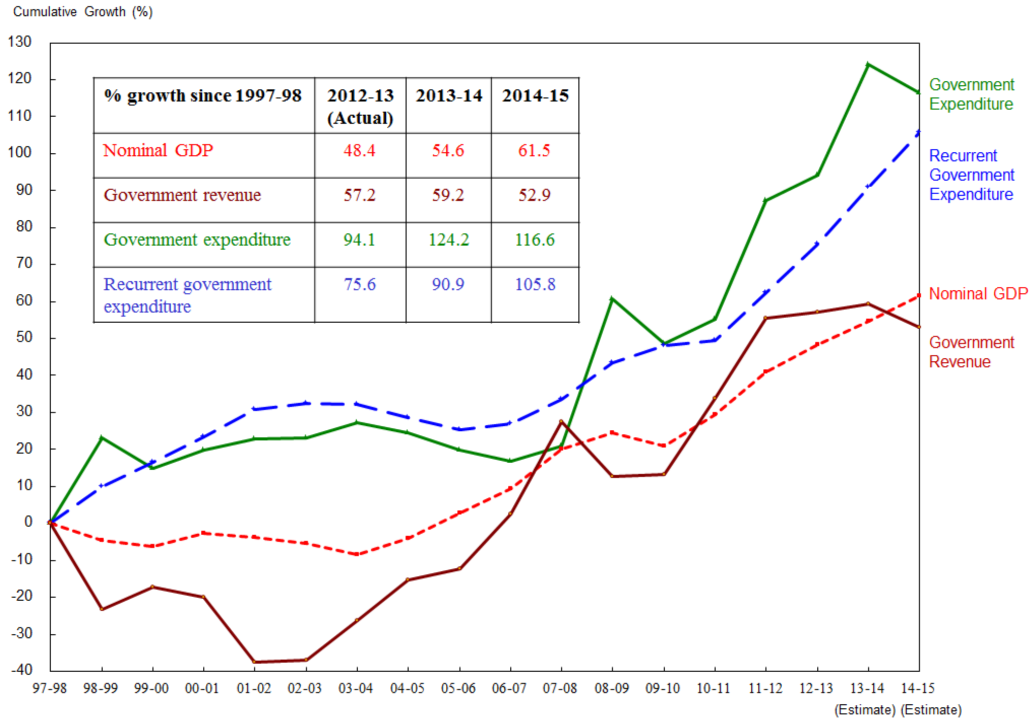
(b) we have achieved 11 years of budget surplus and five years of deficit from 1997-98 to 2012-13 *(Chart 1.2)*, again in line with the BL 107 requirement for the Hong Kong Special Administrative Region to "*strive to achieve fiscal balance, avoid deficits*"; and

Chart 1.2 – Financial highlights since 1997-98



(c) government expenditure has grown on a cumulative basis to 2012-13 by 94.1% while the corresponding growth in government revenue and GDP was 57.2% and 48.4% respectively *(Chart 1.3)*. Recognising the BL 107 requirement for the Hong Kong Special Administrative Region to "*keep the budget commensurate with the growth rate of its gross domestic product*", the Government will continue to closely monitor the rate of growth in government expenditure.

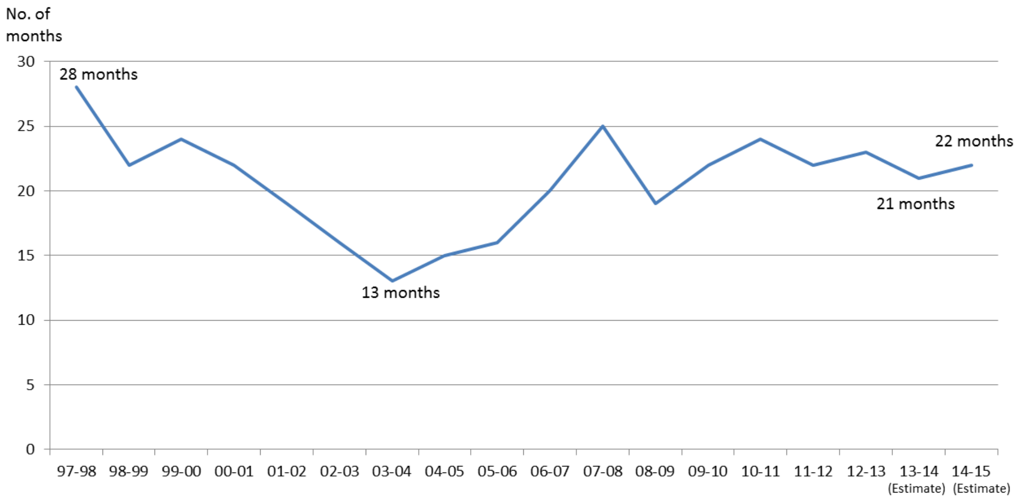
Chart 1.3 – Growth since 1997-98



% growth since 1997-98	2012-13 (Actual)	2013-14	2014-15
Nominal GDP	48.4	54.6	61.5
Government revenue	57.2	59.2	52.9
Government expenditure	94.1	124.2	116.6
Recurrent government expenditure	75.6	90.9	105.8

1.2 The fiscal reserves of Hong Kong are estimated to reach $745.9 billion as at the end of 2013-14. Though high in absolute dollar terms, the balance of the fiscal reserves is estimated to be about 21 months of government expenditure. The level is just about mid-way between the 13-month-equivalent trough by end 2003-04 and the 28-month-equivalent peak by end 1997-98.

Chart 1.4 – Fiscal reserves in terms of number of months of government expenditure



1.3 The fiscal reserves represent all the cash balances held by the Government in various accounts. They are needed to meet the day-to-day cash requirements for all bureaux/departments and subvented bodies, serve as a cushion in economic downturns, generate investment returns, help stabilise the Hong Kong dollar, and help meet the longer term financial commitments of the Government.

1.4 With the Government running successive years of budget surplus since 2004-05 and with the fiscal reserves reaching some $750 billion, is there real cause for concern, even though the Government has been spending faster than it earns in recent years? With so many pressing demands from different sectors of the community, should short-term immediate needs not prevail over medium or long-term concerns?

1.5 The Working Group sees a need to rise above immediate concerns and to also pay greater regard to longer term affordability and fiscal sustainability. The following indicators should shed light on the need for caution and the exercise of fiscal prudence –

(a) **Our society is ageing fast**. This exerts pressure on government expenditure and undermines economic and revenue growth. The proportion of elders at and above 65 is forecast to increase from 13.7% of the total population in 2012 to 30.2% in 2041. During the same period, the working population aged between 15 and 64 will decrease from 74.9% to 60.8% of the total population. This means that by 2041, every two persons of working age will have to support one dependent elderly person, instead of five supporting one today. Coping with demographic changes requires substantial investments and financial commitments. At the same time, economic growth potential will be undermined as the labour force dwindles, thereby also reducing revenue growth in the years to come.

(b) **Government has been spending faster than it earns in recent years**. During the period from 1997-98 to 2012-13, government expenditure has grown on a cumulative basis by 94.1% while the corresponding growth in government revenue was 57.2%.

(c) **Government expenditure is inelastic**. Over 10% of the Government's recurrent expenditure relates to social security payments and another 60% relates to personal emoluments and related expenditure for the Government (30%) and subvented sector (30%). It is difficult to scale back on these expenditure. Experience during the economic downturn in the early 2000s shows clearly that arresting the growth in government expenditure required strenuous efforts and tough measures like downsizing the Government through voluntary retirement, imposing successive annual pay cuts, reducing subventions, and imposing government-wide austerity programmes, etc.

(d) **Government revenue is narrow-based and volatile**. As *Chart 1.3* illustrates, government revenue could hit a far lower trough during an economic downturn and a far higher peak during an economic boom, compared with the ebbs and flows of the economy. Besides, our revenue sources are not diversified. The Government is increasingly reliant on profits tax, salaries tax and land premium to finance its expenditure.

(e) **Fiscal reserves can be depleted faster than one might expect**. In the six years from 1998-99, we used up some $200 billion of the fiscal reserves. We currently have a list of known commitments. Outstanding commitments from capital works amount to $340 billion. Statutory pension liabilities amount to $700 billion. Debt guarantees stand at $80 billion. Before committing to new recurrent initiatives, there is a clear need for the Government and the community to consider long-term affordability. How best to optimise the use of the fiscal reserves is an issue that merits serious consideration. We need to take early and pragmatic actions to carry out a fiscal consolidation process with a view to providing a healthy and sustainable fiscal system for our next generation.

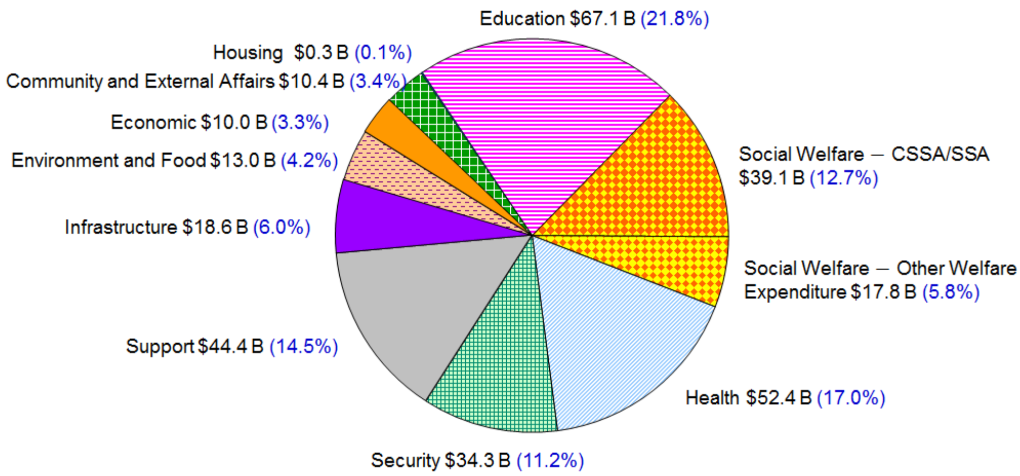
1.6 The following sections will analyse in greater detail the current state of the Government's expenditure, revenue and fiscal balances, alongside the challenges ahead.

Government expenditure

Recurrent expenditure

1.7 Total government expenditure is estimated to be $421 billion (including repayment of $9.8 billion in bonds and notes) for 2014-15. Recurrent government expenditure accounts for about 73% ($307.4 billion) and is broken down as follows –

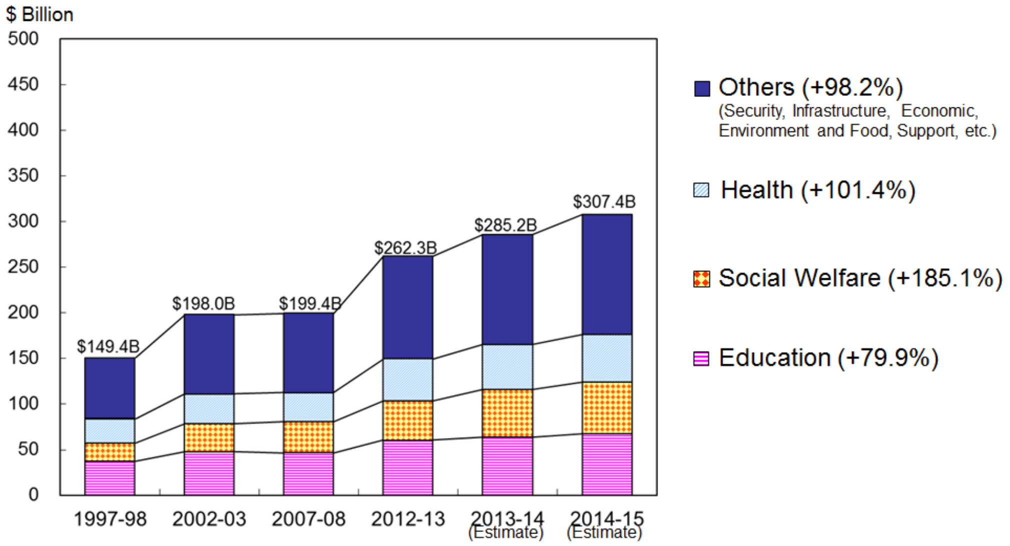
Chart 1.5 – Estimated recurrent expenditure for 2014-15 ($307.4 billion)



1.8 As is evident, education, social welfare and health are the key policy area groups that together consume about 60% of Government's total recurrent expenditure.

1.9 On the basis of the 2014-15 original estimates, the Government's recurrent expenditure would have doubled since 1997-98. As *Chart 1.6* illustrates, social welfare is forecast to record a cumulative increase of over 180%, health over 100% and education some 80% since 1997-98.

Chart 1.6 – Recurrent expenditure growth since 1997-98



Challenges

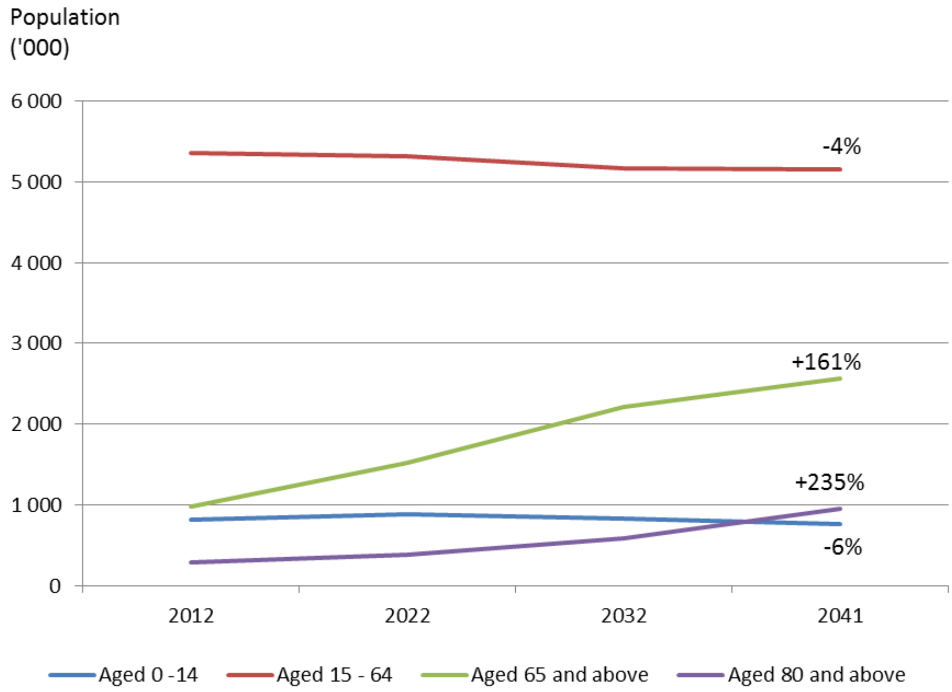
1.10 Despite rapid increases in expenditure to date, pressure for the Government to incur more resources to improve public services and to meet the rising aspirations of the community will continue to mount. Expectations are hard to be managed within the resources available.

1.11 Meanwhile, longer term fiscal pressures on health and social welfare spending given an ageing population must not be overlooked.

1.12 Between 2012 and 2041 –

(a) the **total population** in Hong Kong is forecast to increase by about 19%, from 7.1 million to 8.5 million;

Chart 1.7 – Population changes by age groups



(b) the age group of 65 and above is forecast to increase by 1.6 times, from 13.7% of the total population (980 000) to 30.2% (2.56 million). Within this group, those aged 80 and above is forecast to increase by 2.3 times, from 4.0% of the total population (286 000) to 11.3% (957 000);

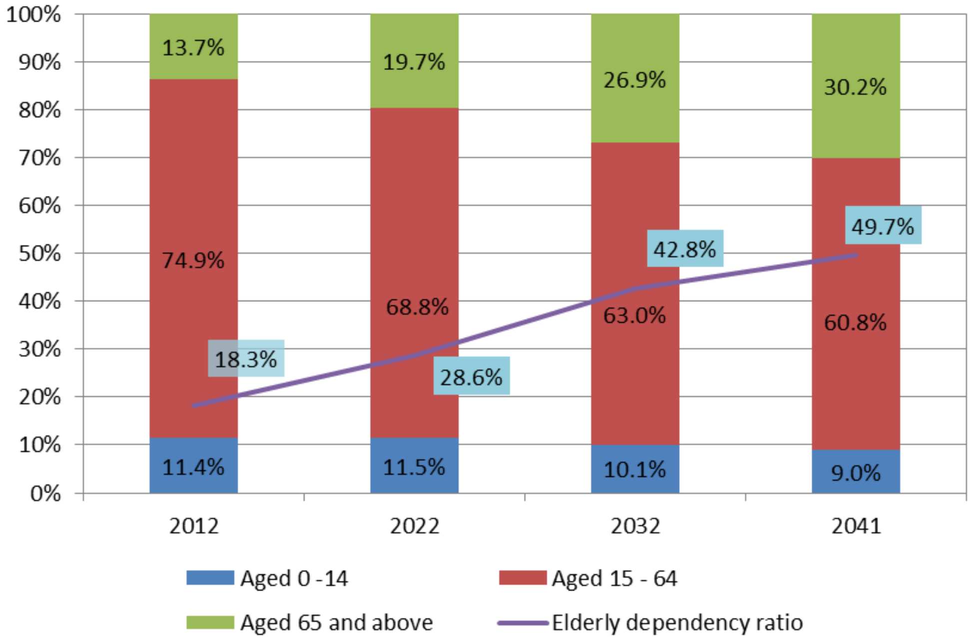
(c) the age group between 15 and 64 is forecast to drop by 4%, from 74.9% of the total population to 60.8%;

(d) the age group up to 14 is forecast to drop by 6%, from 11.4% of the total population to 9%;

(e) the median age is forecast to increase from 42.8 to 51.8; and

(f) the life expectancy for male is forecast to grow from 80.7 to 84.4 and that for female from 86.4 to 90.8.

Chart 1.8 – Proportion of different age groups to total population and elderly dependency ratio



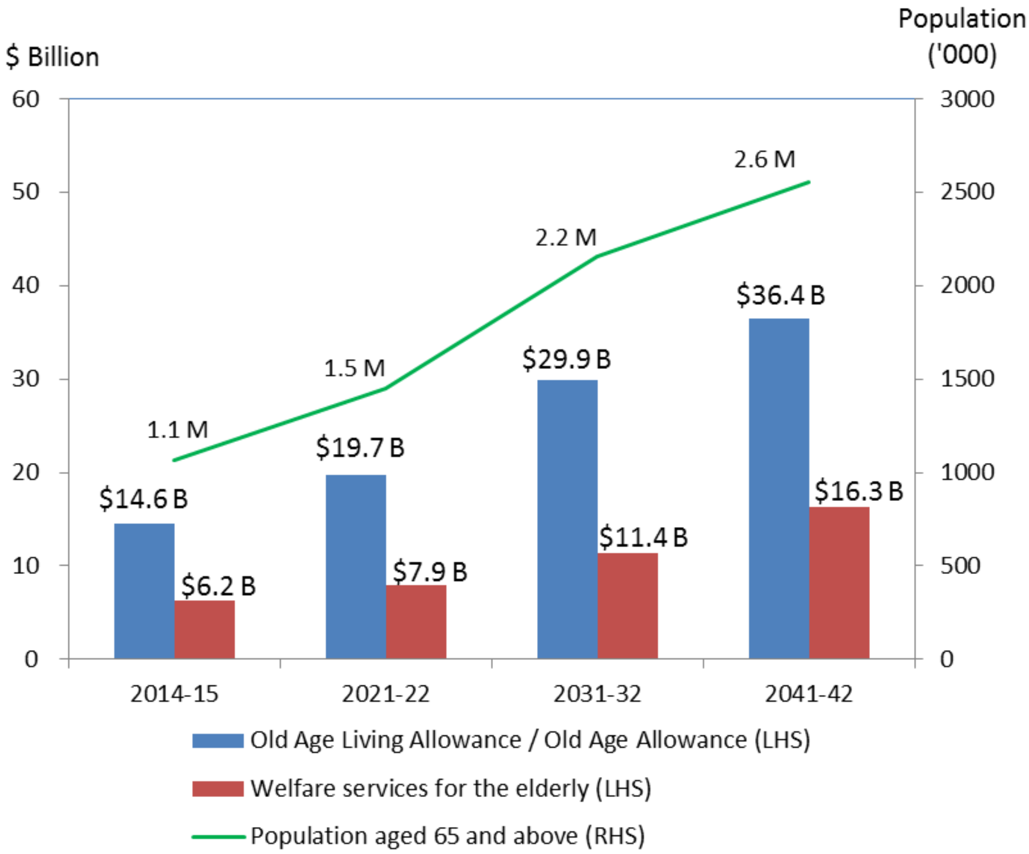
1.13 With the population ageing, the size of the labour force is set to decline, posing a threat, if not drag, on economic growth in the longer term. Resources that can be set aside for new or improved services would logically be constrained.

1.14 At the same time, an expanding and ageing population will put pressure on social welfare and health services expenditure, even if we assume no inflation and no service enhancement over time. By way of illustration, during the period from 2014-15 to 2041-42 –

(a) expenditure on Old Age Living Allowance and Old Age Allowance would increase from $14.6 billion by 1.5 times to $36.4 billion a year;

(b) expenditure on welfare services for the elderly would increase from $6.2 billion by 1.6 times to $16.3 billion a year;

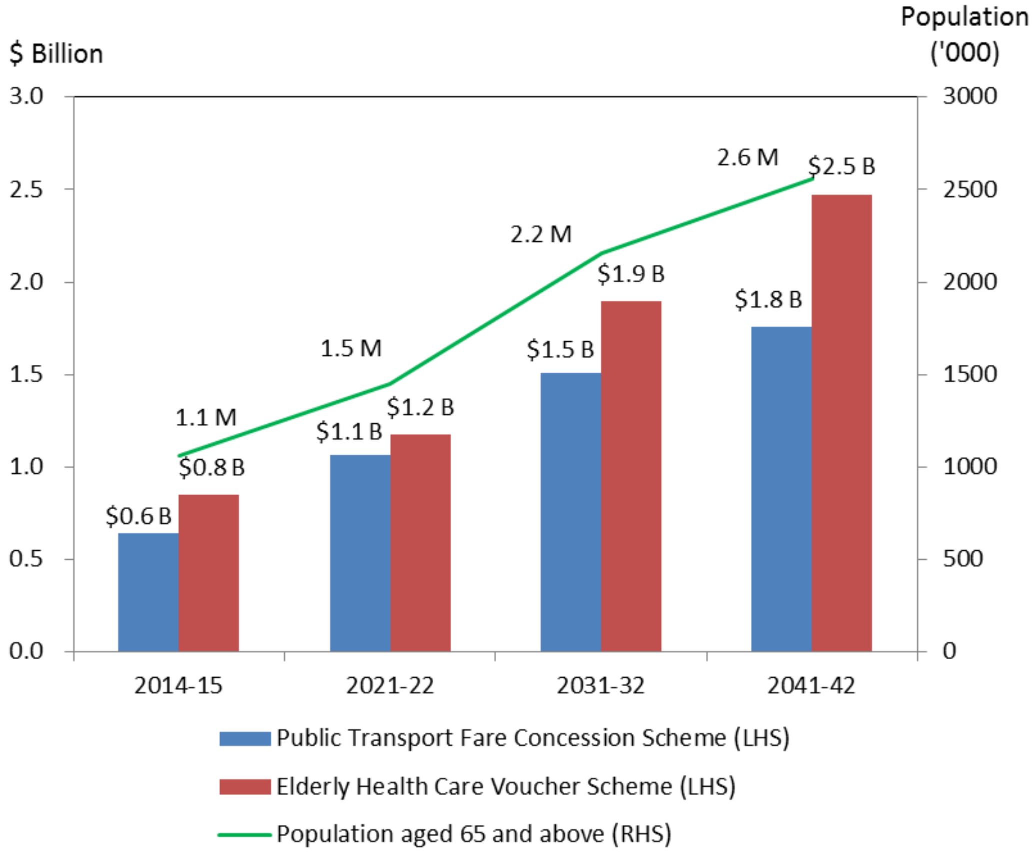
Chart 1.9 – Annual expenditure on Old Age Living Allowance / Old Age Allowance and welfare services for the elderly (in 2013 constant prices)



(c) expenditure on the Public Transport Fare Concession Scheme for the Elderly and Eligible Persons with Disabilities would triple from $0.6 billion to $1.8 billion a year;

(d) expenditure on the Elderly Health Care Voucher Scheme would more than triple from $0.8 billion to $2.5 billion a year; and

Chart 1.10 – Annual expenditure on Public Transport Fare Concession Scheme and Elderly Health Care Voucher Scheme (in 2013 constant prices)



(e) as the elderly has greater demand for healthcare services (e.g. the hospitalisation rate for the elderly is higher and their average length of stay in hospital is longer), population ageing would drive up the recurrent subvention requirements of the Hospital Authority from $47.2 billion by 81% to $85.6 billion a year.

Chart 1.11 – Hospitalisation rates by age group in 2012-13

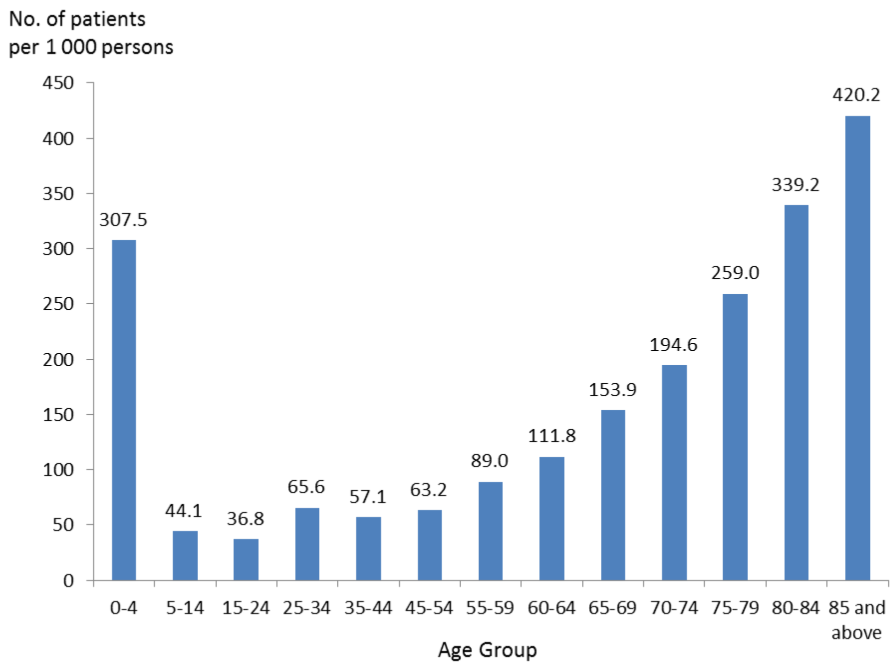


Chart 1.12 – Average length of stay (days) by age group in 2012-13

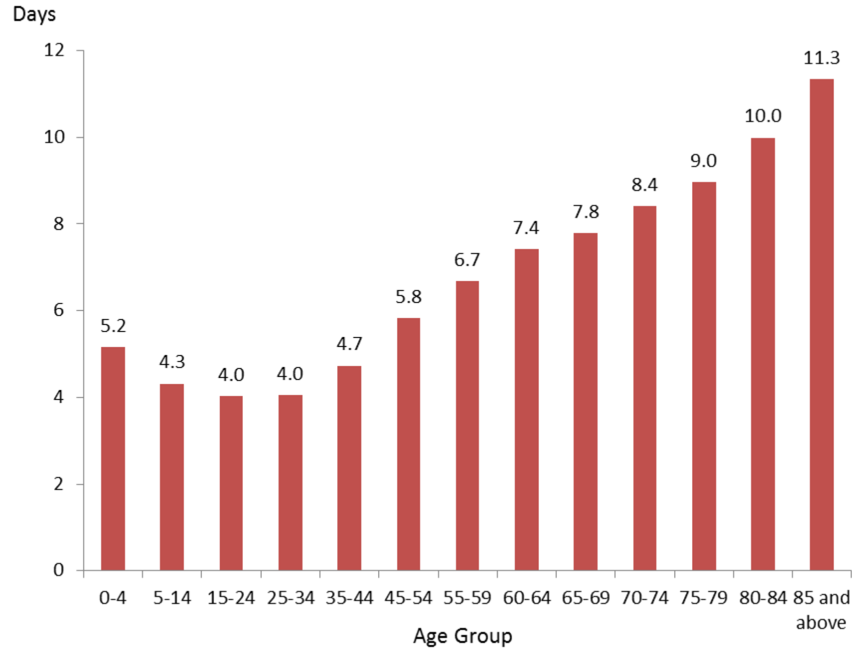
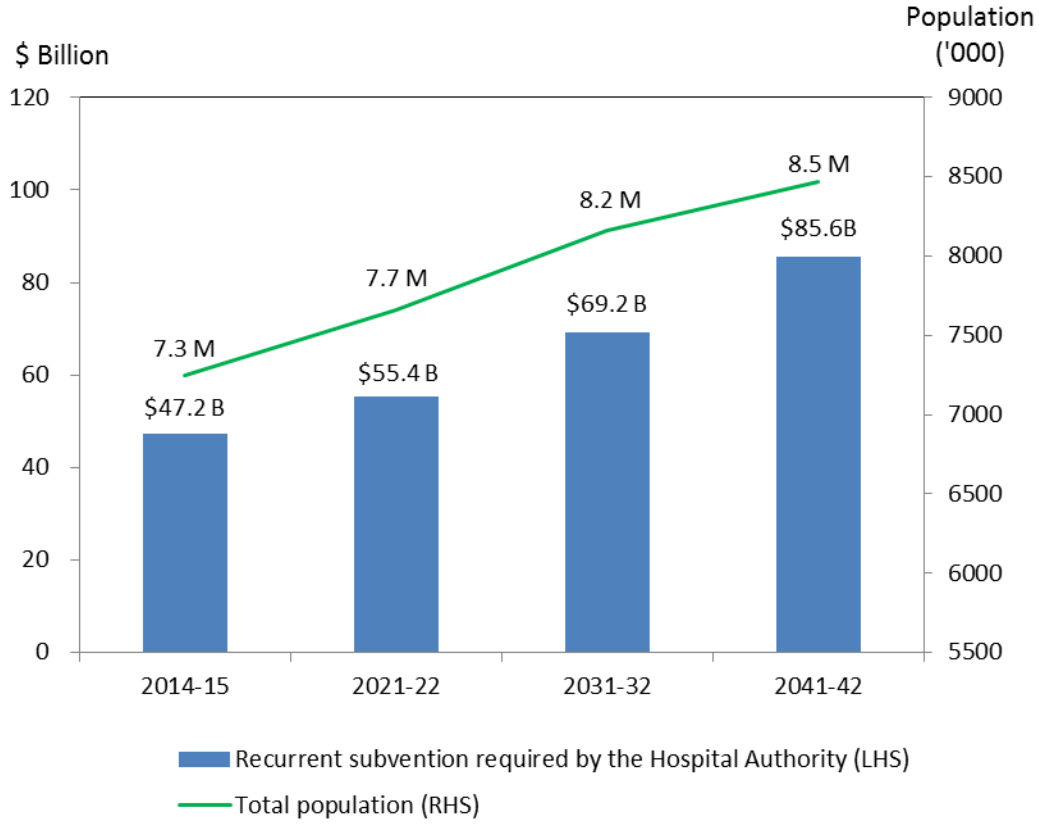


Chart 1.13 – Annual recurrent subvention required by the Hospital Authority (in 2013 constant prices)



1.15 Worth noting is also the fact that there are inherent inelasticities in government expenditure. Over 10% of the Government's recurrent expenditure relates to social security payments; another 30% relates to personal emoluments and related expenditure for the Government and 30% relates to payouts of similar nature for the subvented sector. As revealed by the past trends, these payments tend to go up more frequently and quickly than going down.

Capital expenditure

1.16 Government investment in infrastructure has been on the rise. The Finance Committee of the Legislative Council approved 137 projects under the Capital Works Reserve Fund (CWRF) with a total commitment of $281 billion in the last three legislative sessions from 2010-11 to 2012-13. It is estimated that there will be over 400 approved works projects (excluding minor works projects funded under CWRF block allocations) as at end March 2014 and the total unfunded commitment of these approved projects is some $340 billion.

1.17 The cash flow requirement of capital works projects under the CWRF is about $71 billion for 2014-15, higher than the average of some $60 billion for the preceding five years. The cash flow is expected to be on the rise given the peaking of the construction programme for many railway infrastructure projects, cross-boundary facilities and other mega projects from 2016 to 2018.

1.18 Other than projects under the CWRF, there are social welfare related works projects funded under the Lotteries Fund. Taken together, these CWRF and Lotteries Fund works projects are estimated to have a substantial cash flow requirement of some 3.2% of GDP in 2014-15.

1.19 The Government's accounts are distinct from that of the Housing Authority which is a statutory body established under the Housing Ordinance (Cap. 283). Although it is the requirements of the Housing Authority to balance its recurrent expenditure on its estates, the Government will have to support the public housing programme where necessary. The public housing production programme of the Housing Authority is too substantial to be overlooked.

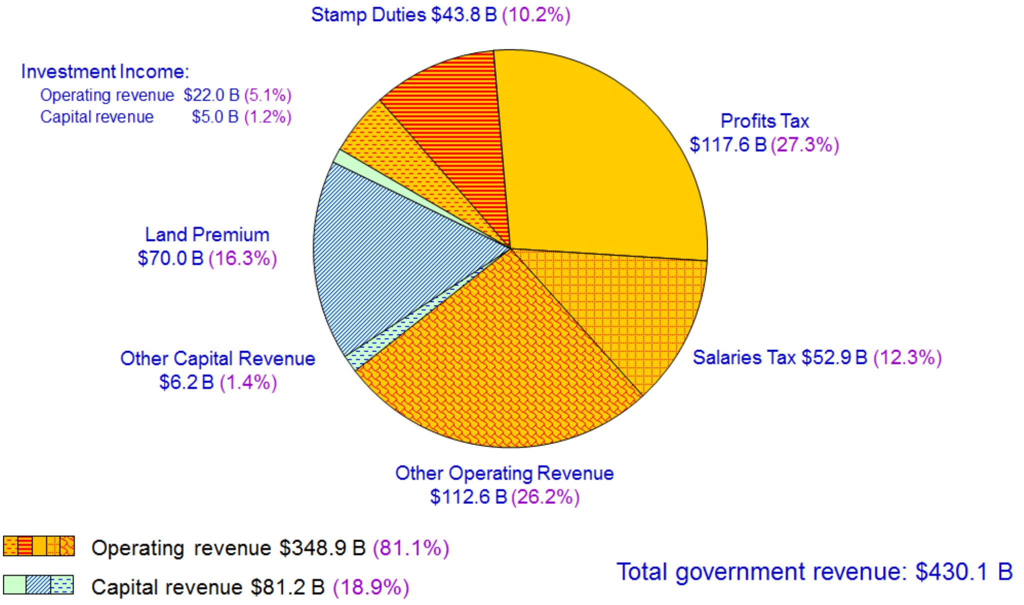
Challenges

1.20 The cash flow requirements of the Government's capital works programme, along with those under the Lotteries Fund, are reaching record peak levels. Whether the construction sector has capacity and resources enough to cope with the works programme is an issue that needs to be addressed. The Government's potential liability arising from supporting the public housing programme under the Housing Authority should also be kept in mind.

Government revenue

1.21 Total government revenue is estimated to be $430.1 billion for 2014-15, broken down as follows –

Chart 1.14 – Estimated government revenue for 2014-15 ($430.1 billion)



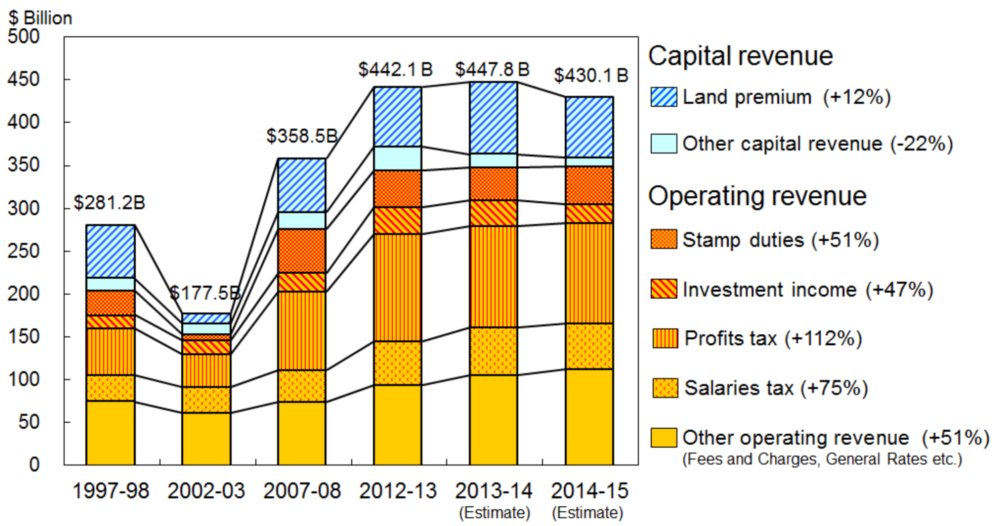
Note: Major items under Other Operating Revenue include General Rates, Bets and Sweeps Tax, Motor Vehicle Tax, and Fees and Charges.

1.22 Profits tax, salaries tax, land premium, stamp duties and investment income are the major revenue sources of the Government, contributing about 72% of the total estimated revenue in 2014-15.

1.23 For the **17 years from 1997-98**, government revenue would increase by a cumulative 52.9% from $281.2 billion in 1997-98 to $430.1 billion in 2014-15. This represents an average **growth of 2.5% per annum**, which is comparable to the average nominal GDP growth rate of 2.9% per annum during the same period. In other words, the growth in government revenue has been broadly commensurate with the growth of the economy in the long run when the effects of economic cycles smoothen out.

1.24 For the **five years from 2009-10**, total government revenue would grow at an average of **6.2% per annum**, from $318.4 billion in 2009-10 to $430.1 billion in 2014-15. This growth rate also follows closely the 6.0% per annum growth in nominal GDP for the same period.

Chart 1.15 – Government revenue growth since 1997-98



Challenges

1.25 Whilst government revenues have tended to fare better than expected in recent years, there are underlying concerns that our revenue sources are not diversified enough, that the tax base for profits and salaries tax remains narrow, that our key revenue sources also tend to be very volatile, and that an ageing population would add to the burden of the next generation of taxpayers and the community at large.

1.26 The Government is increasingly reliant on direct tax revenue (from profits tax, salaries tax and property tax), land premium and investment income to finance its expenditure. Contributions from more stable revenue items, such as fees and charges, have dropped. The following is a summary –

Chart 1.16 – Ratio between direct tax and indirect tax since 1997-98

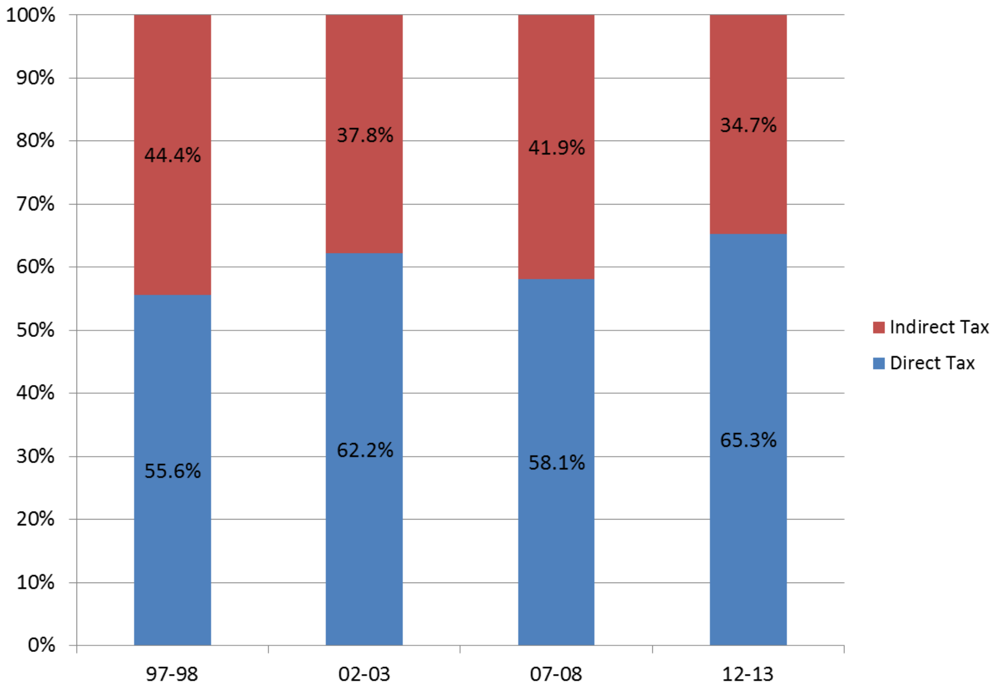
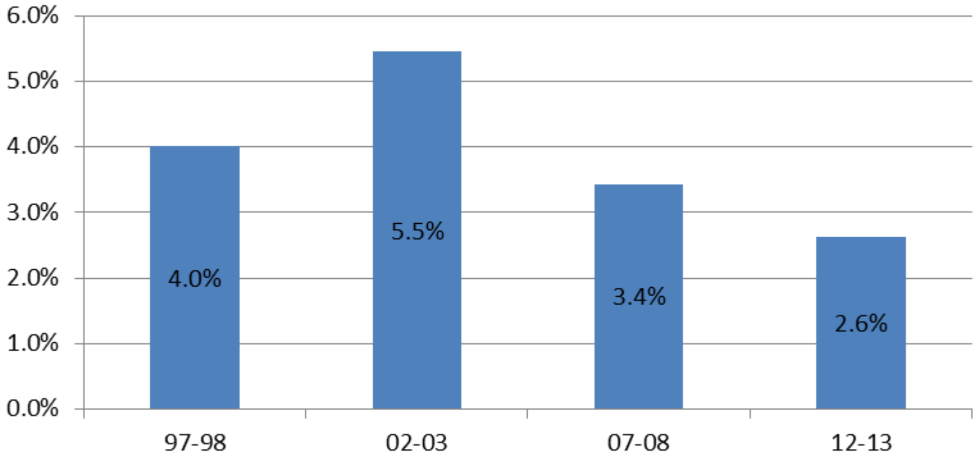


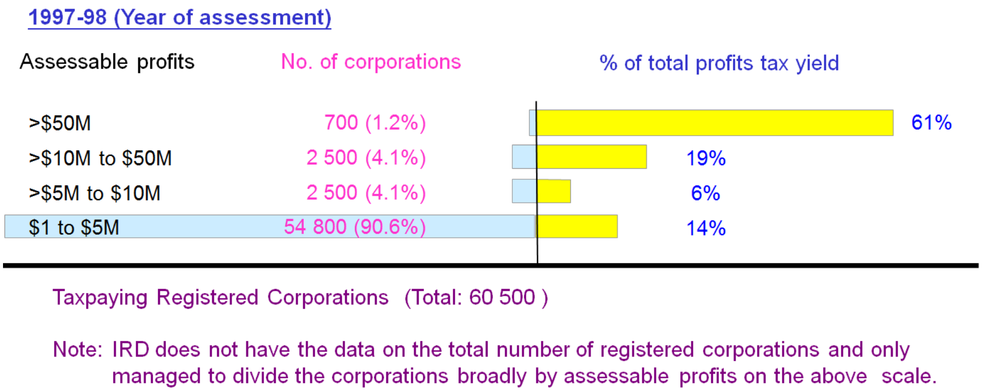
Chart 1.17 – Fees and charges as a percentage of total revenue since 1997-98

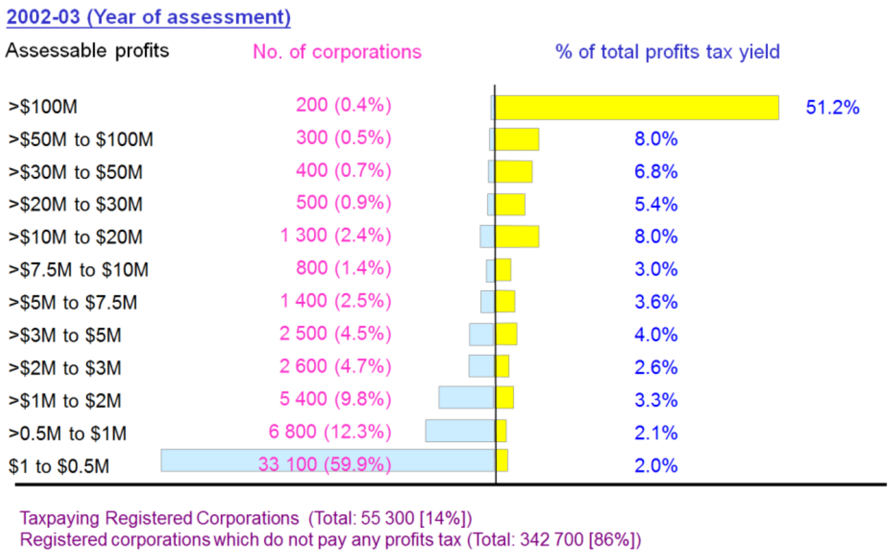


1.27 The tax base of profits tax has remained low, with only 11% of registered corporations (or 94 900) paying profits tax for the 2011-12 tax year, compared with 14% for 2007-08 and 2002-03. The top-paying 700 to 800 corporations contributed 64.4% of the overall profit tax revenue for the 2011-12 tax year, compared with 61% for the 1997-98 tax year.

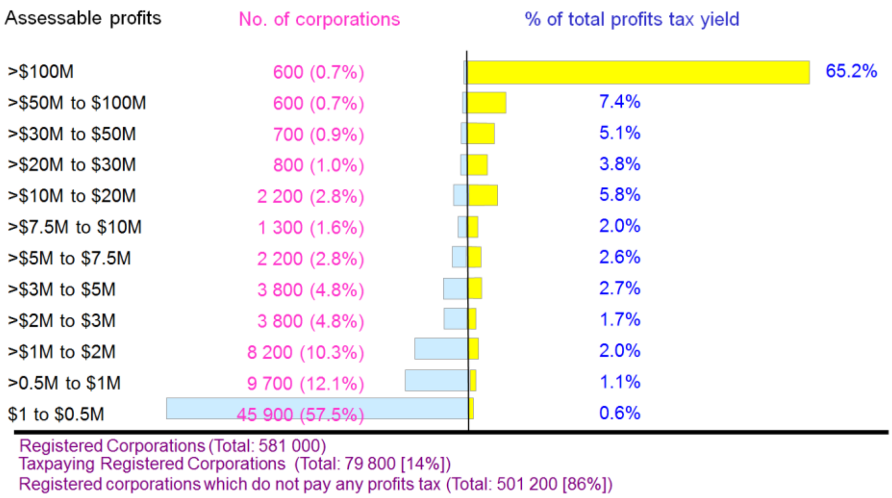
1.28 As is, the profitability of these corporations would have a direct bearing on how much revenue the Government receives, and how much the Government can spend. To ensure the stability of government revenue, Government should avoid increasing or excessive reliance on the top 1% of the registered corporations.

Chart 1.18 – Distribution of profits taxpayers for the 1997-98 2002-03, 2007-08 and 2011-12 tax years

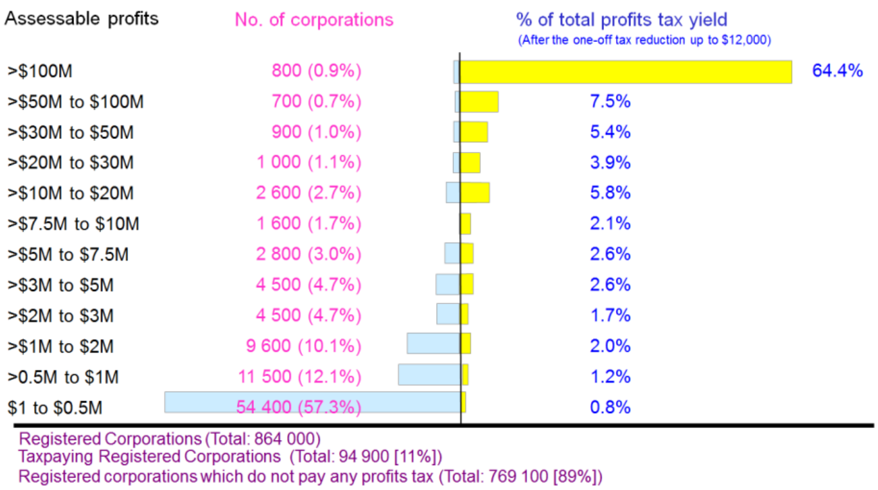




2007-08 (Year of assessment)

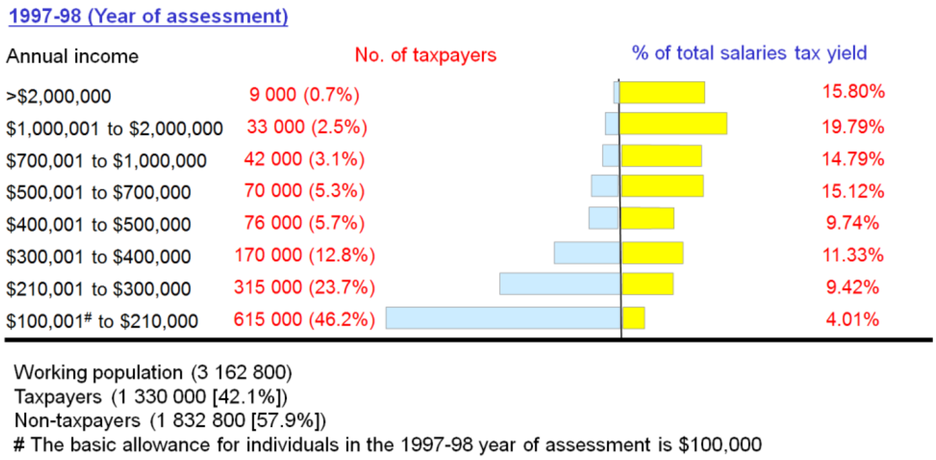


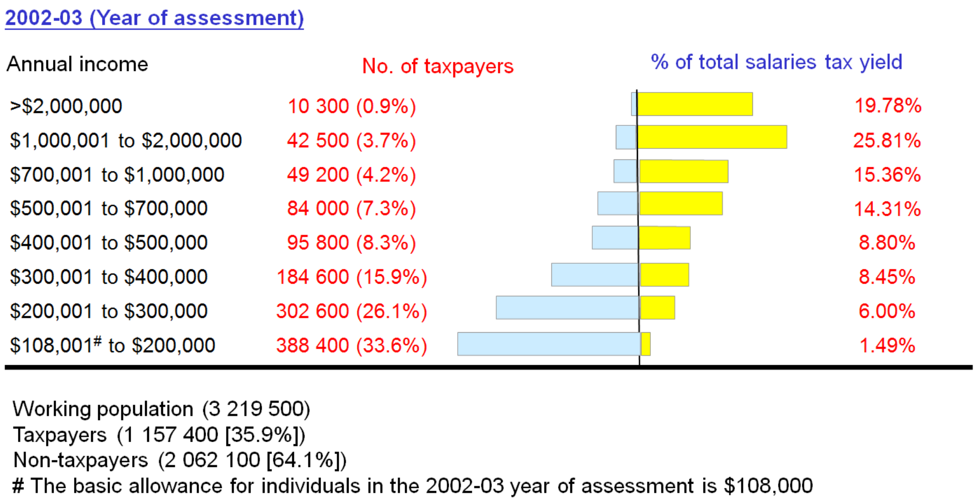
2011-12 (Year of assessment)



1.29 As for salaries tax, only 45% of the working population paid salaries tax for the 2011-12 tax year. Reliance on the high-income individuals is also on the rise. In 2011-12, the top 200 000 salaries taxpayers contributed 81.7% of the salaries tax; in 1997-98, they contributed 71.6%.

Chart 1.19 – Distribution of salaries taxpayers for the 1997-98. 2002-03, 2007-08 and 2011-12 tax years





2007-08 (Year of assessment)

Annual income	No. of taxpayers	% of total salaries tax* yield
>$2,000,000	25 000 (1.7%)	52.69%
$1,000,001 to $2,000,000	56 000 (4.0%)	22.13%
$700,001 to $1,000,000	66 000 (4.6%)	10.85%
$500,001 to $700,000	112 000 (7.9%)	7.44%
$400,001 to $500,000	120 000 (8.5%)	2.90%
$300,001 to $400,000	213 000 (15.1%)	2.12%
$200,001 to $300,000	353 000 (24.9%)	1.47%
$100,001# to $200,000	471 000 (33.3%)	0.40%

Working population (3 493 400)
Taxpayers (1 416 000 [40.5%])
Non-taxpayers (2 077 400 [59.5%])
* After the one-off tax reduction up to $25,000
# The basic allowance for individuals in the 2007-08 year of assessment is $100,000

2011-12 (Year of assessment)

Annual income	No. of taxpayers	% of total salaries tax* yield
>$2,000,000	32 000 (2.0%)	42.79%
$1,000,001 to $2,000,000	75 000 (4.6%)	24.26%
$700,001 to $1,000,000	89 000 (5.5.%)	13.29%
$500,001 to $700,000	158 000 (9.7%)	10.73%
$400,001 to $500,000	159 000 (9.7%)	4.54%
$300,001 to $400,000	257 000 (15.7%)	2.91%
$200,001 to $300,000	394 000 (24.0%)	1.22%
$108,001# to $200,000	470 000 (28.8%)	0.26%

Working population (3 600 000)
Taxpayers (1 634 000 [45.4%])
Non-taxpayers (1 966 000 [54.6%])
* After the one-off tax reduction up to $12,000
# The basic allowance for individuals in the 2011-12 year of assessment is $108,000

1.30 Income from our major revenue sources tends to be very volatile, fluctuating widely with economic conditions or changes in policy. As *Table 1.1* illustrates –

(a) profits tax revenue ranged between 2.9% of GDP in 1999-2000 ($37.7 billion) and 6.2% in 2012-13 ($125.6 billion);

(b) land premium ranged between 0.4% of GDP in 2003-04 ($5.4 billion) and 4.6% of GDP in 1997-98 ($62.5 billion);

(c) stamp duties ranged between 0.6% of GDP in 2002-03 ($7.5 billion) and 3.1% of GDP in 2007-08 ($51.5 billion); and

(d) salaries tax revenue – though relatively less volatile, still fluctuated between 1.9% of GDP in 1998-99 ($25.1 billion) and 2.7% in 2011-12 ($51.8 billion).

Table 1.1 – Volatility of key revenue sources

Revenue item	Range from 1997-98 to 2013-14		Estimated revenue in 2014-15	
	% of GDP	equivalent $ Billion	% of GDP	equivalent $ Billion
Profits tax	2.9% - 6.2%	37.7 - 125.6	5.3%	117.6
Salaries tax	1.9% - 2.7%	25.1 - 51.8	2.4%	52.9
Stamp duties	0.6% - 3.1%	7.5 - 51.5	2.0%	43.8
Land premium	0.4% - 4.6%	5.4 - 62.5	3.2%	70.0
Investment income	0.1% - 3.3%	0.9 - 41.9	1.2%	27.0
Other revenue	4.6% - 7.0%	77.7 - 88.0	5.3%	118.8
Total revenue	13.3% - 22.6%	175.6 - 437.7	19.4%	430.1

1.31 With an ageing population, the local labour force is projected to reach its peak in 2018 and dwindle throughout the 2020s, as the retirement of baby-boomers outweighs the new entrants from the younger generations. There will be pressure on salaries tax and other operating revenues. Besides, the elderly dependency ratio will worsen – by 2041, two persons of working age (people aged 15 to 64) would support one dependent elderly person, instead of five supporting one today.

Fiscal reserves

1.32 In the light of successive years of budget surplus, our fiscal reserves is forecast to stand at $745.9 billion as at end March 2014. This is equivalent to 35.1% of the GDP or 21 months of government expenditure. Enviably high, the level of fiscal reserves has induced demands for service improvements on many fronts. However, fiscal reserves can be exhausted. Within the fiscal reserves, only the portion held in the General Revenue Account (about $394 billion) is for meeting the day-to-day cash flow requirements of the Government; the balance held in the Land Fund (about $220 billion) has **no authorised use**; and the balances held in various Funds (e.g. CWRF, Innovation and Technology Fund, Loan Fund, Lotteries Fund) set up by Resolutions of the Legislative Council (about $132 billion) **have their respective designated use**.

Challenges

1.33 The pressure to spend the fiscal reserves on services must be weighed carefully against the pressure to keep and save these for the longer term benefits to the community.

Conclusion

1.34 Hong Kong is able to withstand short to medium term fiscal challenges. But we are not immune to pressure and threats - pressure to increase spending, threat of slow-down in revenue growth, and pressure to run down the fiscal reserves, etc. The pressure to cope with an ageing population aggravates the concerns about fiscal sustainability in the long run. We will present the fiscal picture in the following chapters.