Contents

Introduction

1. The Working Group on Long-Term Fiscal Planning presented in March 2014 a quantitative appraisal on the medium to long term fiscal challenges that Hong Kong would face, on account of the demographic projections based on the 2011 population census and the trend projections on economic growth, government expenditure and revenue.

2. Budgetary deficits would start to haunt us, far sooner and harder than most would expect. The elderly population aged 65 and above would nearly double in 15 years' time and would increase from 15% of the population in 2014 to some 30% in 2041. The cost of health care and elderly-related welfare services would increase substantially as a share of government expenditure and the Gross Domestic Product (GDP). On the other hand, labour force is projected to shrink in about four years' time and unless managed, would be a drag on economic growth. Economic growth and government revenue would be adversely affected.

3. As a mature economy, Hong Kong has long past the fast-growing periods enjoyed in the 1970s and 1980s, when real GDP grew at some 8% to 9% per annum. From 1997 to 2014, real GDP grew at 3.3% per annum on a trend basis.

Working Group Projections

4. Having examined the change in population structure, the stage of Hong Kong's economic development, and the nature of Government's expenditure especially in the education, welfare and health portfolios, the Working Group has projected that from 2014-15 to 2041-42 –

   (a) **Real GDP** would grow at around **2.8%** per annum on a trend basis. The trend projection for **nominal GDP** is **4.4%** per annum.

   (b) **Government revenue** would grow at **4.5%** (nominal) per annum. This assumed, rather boldly, that labour productivity for the projection period would remain as strong as in the past, although labour supply would drop in numbers.

   (c) **Government expenditure** would grow at a trend rate of **5.3%** per annum under the **No Service Enhancement scenario**, which assumed that services would **not** be enhanced from 2014-15 to 2041-42. If services were enhanced and the corresponding expenditures were raised every year at 1%, 2% or 3% (trailing Historical Trends), government expenditure would grow at respectively 6.0%, 6.7% or 7.5% per annum on a trend basis.

5. With government expenditure projected to grow at trend rates that exceed the projected growths in GDP and in government revenue, it is not difficult to foresee a fiscal sustainability problem. The Working Group has projected that a **structural deficit would strike within a decade under most of the scenarios tested**.

6. The Working Group has made a conscious effort to avoid overstating expenditure requirements or understating Hong Kong's growth and revenue potential. The projections have not taken into account the financial implications of new or proposed initiatives like the provision of free kindergarten education.

7. The Working Group recommended that the Government should take resolute and early actions to cope with the fiscal challenges. These include stimulating economic development, containing the growth of government expenditure, stabilising or broadening the revenue base, making better use of the fiscal reserves, starting a savings scheme, etc.

Working Group Phase 2

8. As a positive response to the findings of the Working Group, the Financial Secretary has initiated government-wide measures to contain the growth of government expenditure and review scope for revenue reforms.

9. On 4 July 2014, the Financial Secretary extended the appointment of the Working Group. The Terms of Reference and Membership of Phase 2 of the Working Group are at **Annex A**. First, the Financial Secretary has tasked the Working Group to ***"explore and propose options for a savings scheme (the 'Future Fund') for Hong Kong"***. As the Working Group has explained in the previous report, the fiscal challenges ahead are serious and call for a multi-pronged approach to dampen its adverse effects. Whilst the concept of a Future Fund – being a new proposition for Hong Kong, has attracted most community interest and concern following the release of the report, saving alone is **not** the way to prosperity. A savings scheme is **not** enough to address a structural deficit problem. It is **not** a substitute for needed policy changes to find new growth opportunities for Hong Kong. Nor is it an excuse to merely lock up resources to serve no good purpose.

10. That said, the Working Group believes that a well-designed savings scheme may serve as an effective, though not primary, fiscal tool to **optimise returns** on our fiscal reserves, and to **mitigate the adverse impact** a structural deficit may bequeath on the economy in the not-too-distant future. It seeks to foster a stronger sense of fiscal discipline and allow long-term interests to be protected against short-term pressures which are often felt as more pressing. As its name suggests, the Future Fund serves the future. **Chapter 1** sets out the Working Group's thinking on how it may work for Hong Kong.

11. Secondly, the Financial Secretary has requested the Working Group to ***"advise on how the Government can step up the management of its assets"***. The Working Group has taken stock of the financial and fixed assets of the Government and identified scope for seeking higher financial returns on these for the Government. The Working Group findings are set out in **Chapter 2**.

12. Finally, the Financial Secretary has tasked the Working Group to ***"advise on how the key findings and recommendations of the Working Group may be relayed to the community in a sustained and effective manner***". Enabling the community to appreciate the seriousness of the fiscal challenges ahead is no easy task. **Chapter 3** recapitulates for easy reference the measures and follow-up actions which the Government has adopted since the release of the Working Group Report in March 2014. The Working Group has also authorised the production of four short videos and an interactive game to facilitate easier and better understanding of the fiscal sustainability problems. As referenced in **Chapter 3**, these can be accessed vide the website of the Treasury Branch, Financial Services and the Treasury Bureau (http://www.fstb.gov.hk/tb/en/).

Fiscal Sustainability

13. Between June 2013 and December 2014, the non-official experts as well as ex-officio members on the Working Group have all worked tirelessly to complete a long-term fiscal sustainability appraisal for Hong Kong, developed concrete proposals for initiating a Future Fund, and tendered advice on how the Government might manage its financial and fixed assets. Upon the delivery of this Phase 2 Report, the Working Group would have completed its public mission.

14. Despite changes in the economy and in the Government's estimated budgetary position between the release of the March 2014 report and this supplementary report, the Working Group still embraces the long-term trend analysis summarised in paragraphs 4 and 5 above. **Fiscal sustainability remains a serious issue**. The fiscal challenges ahead are real and would affect all sectors that rely on the Government for services and funding.

15. It is the collective and sincere wish of the Working Group to drive home a few key messages – our **economy** needs new growth areas; **government expenditure growth** needs to be contained and should be commensurate with GDP growth; **government revenue** needs consolidation and reform to broaden the tax base; and **savings** for better returns should start before too late. All said, early and preventive actions are called for to avoid the projected structural deficit problem presented in the March 2014 Report becoming self-fulfilling.

Chapter 1 – Saving for the Future

(A) Need for a Savings Scheme

1.1 Hong Kong has enjoyed over ten successive years of budget surpluses. Our fiscal reserves are running at a high of over $700 billion. Do we really need a Future Fund?

1.2 The Working Group Report released in March 2014 highlighted the massive pressure that an ageing population would put on public finance. The anticipated challenges to our public finance call for resolute and early actions to manage our finances in a sustainable manner.

1.3 The Working Group urges the Government to take timely and effective measures to address the problem, failing which the healthy state of our public finance would deteriorate gradually. A structural deficit could surface within a decade should government expenditure grow in line with historical trends and exceed the rate of GDP or revenue growth on a long-term basis. To fund the shortfalls, fiscal reserves could be depleted within another decade after the onset of structural deficit.

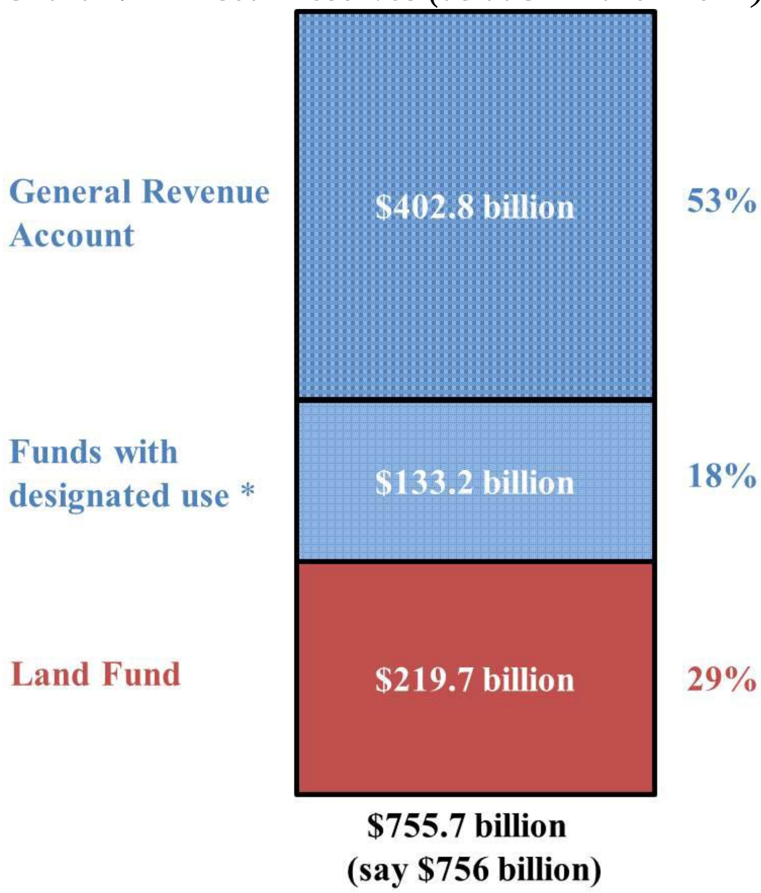
1.4 The idea of a savings scheme is to set aside some funding for long-term investment and hopefully yield higher returns in the medium to long term. As a good fiscal discipline, the savings scheme should be clearly segregated from the more liquid "cash in hand" for meeting daily and short-term government needs.

1.5 According to the long-term projections set out in the Working Group Report, there will still be budget surpluses for the coming few years, but probably not for too long. The Working Group **recommends** that the Government should start planning early, when we can still afford to set aside part of our fiscal reserves for long-term investments with possibly higher returns. Setting up a Future Fund is not a total solution but would alleviate the pressure of future generations.

Fiscal Reserves for Hong Kong

1.6 The fiscal health of Hong Kong is envy to many. As at end March 2014, the Government's fiscal reserves stood at $756 billion (after rounding). The figure reflects the sum total of the cash balances of the Government held in various government account/funds, as broken down below –

Chart 1.1 – Fiscal Reserves (as at 31 March 2014)



* Funds with designated use include Capital Investment Fund, Capital Works Reserve Fund, Civil Service Pension Reserve Fund, Disaster Relief Fund, Innovation and Technology Fund, Loan Fund and Lotteries Fund. It does not include the Bond Fund, the balance of which is not part of the fiscal reserves.

1.7 Except for the $400 billion plus in the General Revenue Account, the rest or **about half** of the fiscal reserves is held in various Funds the ambit and use of which are governed by the legal instrument supporting their establishment in the first place.

1.8 Worth noting is that the Land Fund was established on 1 July 1997 by Resolution of the Provisional Legislative Council to receive and hold all of the assets, net of expenses, transferred from the Hong Kong Special Administrative Region Government Land Fund. According to the Resolution, the Land Fund can be used only for investment and not for the provision of any government services. The Resolution does **not** allow the Government to freely transfer resources from the Land Fund to the General Revenue Account or other government funds. Should the Financial Secretary decide to draw down on the Land Fund, he would need to seek the approval of the Legislative Council, as were the cases in 2003-04 and 2004-05 when $120 billion and $40 billion respectively was transferred to the General Revenue Account to meet the anticipated cash flow shortfalls following repeated budget deficits since 2000-01. In gist, the balance in the Land Fund cannot be readily deployed[1].

1.9 The $756 billion fiscal reserves as at end March 2014 is equivalent to **around 21 months of gross government expenditure**. Noting that there will probably still be budget surpluses for the coming few years, the Working Group considers that there is room for the Government to consider setting up a Future Fund by making use of the Land Fund.

Existing Investment of Fiscal Reserves

1.10 The Government has placed its fiscal reserves with the Exchange Fund since 1976, in return for investment income. This arrangement has allowed the fiscal reserves to be invested in a prudent manner and has enabled the Exchange Fund to perform more effectively its statutory functions under the Exchange Fund Ordinance (Cap. 66).

[1] See **Annex B** for background on the Land Fund.

1.11 Since April 2007, the Government and Hong Kong Monetary Authority (HKMA) have agreed that the investment income on the fiscal reserves (including the Land Fund) shall be calculated on the basis of the higher of –

(a) the average annual investment return of the Exchange Fund's Investment Portfolio for the past six years, and

(b) the average annual yield of three-year Exchange Fund Notes for the previous year subject to a minimum of zero percent.

1.12 The 2007 agreement offers greater stability of investment income as a source of government revenue and greater predictability of the revenue stream for budgeting. It also preserves the long-term value of our assets by achieving a reasonable rate of investment return.

Overseas Reference[2]

1.13 In considering what we would like to get out of a savings scheme, the Working Group has made reference to the practice of overseas sovereign wealth funds (SWFs). The number and total assets under the management of SWFs have been growing rapidly over the past few years. SWFs are often defined as special purpose investment funds or arrangements created to achieve financial objectives, which are often established either out of official foreign currency operations, the proceeds of privatisations, fiscal surpluses, and/or receipts from commodity exports.

---

2 Reference on SWFs are drawn from the following publications of the International Monetary Fund (IMF) and the International Working Group of Sovereign Wealth Funds (IWG) –

(a) Abdullah Al-Hassan, Michael Papaioannou, Martin Skancke, and Cheng Chih Sung, 2013, "Sovereign Wealth Funds: Aspects of Governance Structures and Investment Management", IMF Working Paper No. 13/231.

(b) Udaibir S. Das, Yinqiu Lu, Christian Mulder, and Amadou Sy, 2009, "Setting up a Sovereign Wealth Fund: Some Policy and Operational Considerations", IMF Working Paper No. 09/179.

(c) The IWG Secretariat in collaboration with the Members of the IWG, 2008, "Sovereign Wealth Funds Current Institutional and Operational Practices".

1.14 The types and policy objectives of SWFs much depend on country-specific circumstances and may evolve over time. A typical type of SWFs is saving fund, created when governments have budgetary surpluses and have little or no international debt. Excess surpluses are set aside to save and invest with a view to spreading wealth across generations (e.g. Abu Dhabi Investment Authority, Libyan Investment Authority). This may be done by setting up an endowment type fund that makes use of the surpluses to generate future stream of financial cash flows to benefit the present and future generations. The investment mandate of saving funds often emphasises longer-term and high risk-return profile.

1.15 Another common category of SWFs is pension fund, established to cover the projected higher liability related to sustaining pension needs in the future. Examples include Australia, Ireland, New Zealand and Chile. Some countries set up stabilisation funds to insulate their budget and economy from commodity price volatility and external shocks (e.g. Chile (Economic and Social Stabilisation Fund) and Russia (Oil Stabilisation Fund)).

1.16 Some SWFs are held by the central bank and assumed a significant role in fiscal management. Other funds are set up in the form of reserve or national investment corporations with high degree of autonomy, e.g. Korea Investment Corporation of South Korea, Government of Singapore Investment Corporation and Temasek of Singapore.

Objectives of the Future Fund

1.17 Having considered the strength of our fiscal reserves and the objectives of some overseas savings schemes, the Working Group believes that the main objectives of the Future Fund should be a combination of "saving and investing", "for the benefit of future generations" and "enhancing fiscal sustainability".

1.18 In practical terms, the Working Group **recommends** that the Future Fund should seek **higher returns through long-term investments** (as elaborated in paragraph 1.41 below). The Working Group appreciates that higher returns normally entail higher investment risks; a fine balancing is needed. Over time, it is hoped that the Future Fund can be robust enough so that the Government has the option in acute or prolonged downswings to either draw on the Fund to stimulate the economy with countercyclical measures or to use it to help secure better terms for borrowing.

(B) Institutional Arrangements for the Future Fund

1.19 According to the long-term projections of the Working Group, structural deficits would strike within a decade or so under the Base Case, No Service Enhancement scenario. The time frame within which the Government can afford to set aside a portion of the fiscal reserves for longer-term investment is clearly limited. The coming ten years would be critical. If the Government is serious about a savings scheme, speed is of the essence.

1.20 The Working Group believes that the Fund should be established by adopting the fastest and simplest route. The cost of setting up and administering the Future Fund should be contained.

1.21 The Working Group explored the following options –

(a) **Administrative Route.** Under this option, the Government would designate a portion of the fiscal reserves, say the Land Fund as endowment plus budget surpluses as periodic top-ups, as the "Future Fund". The Future Fund would be a **notional account**, primarily held against the Land Fund (for the endowment and related investment returns) and the General Revenue Account (for the periodic top-ups). The investment of the Future Fund would still be governed by the Resolution on the Land Fund as well as the Public Finance Ordinance (Cap. 2) and determined by the Financial Secretary. In line with established practice, the Financial Secretary may direct the Chief Executive of the HKMA to manage the Future Fund.

(b) **Body Corporate.** This would involve establishing a statutory body corporate with independent board and governance structure, operating with full commercial discretion and flexibility. This investment corporation could be given a high degree of autonomy and its mode of operation could follow that of the Temasek of Singapore or the Korea Investment Corporation.

(c) **Trust Fund.** This would involve establishing a trust fund, either under an existing statute (e.g. Community Care Fund established under the Permanent Secretary for Home Affairs Incorporation Ordinance (Cap. 1044)) or through a non-statutory approach (e.g. Film Development Fund administered by the Commerce and Economic Development Bureau). As with the body corporate option, the trust fund will have its own board of governance as well as executive and investment committees.

1.22 The Working Group notes that both the body corporate and trust fund options require legislative backing, and may take well over a year for processing within the Government and the legislature, and extra time and costs for post-establishment formalities (like appointment of governing boards and investment managers).

1.23 With the administrative route, however, the need to set up a new statutory governance structure can be obviated. The management and utilisation of the Future Fund under this option may still rely on the legislative and governance framework provided under the Resolution on the Land Fund and the Public Finance Ordinance (Cap. 2).

1.24 To ensure that the Future Fund can be established as soon as practicable, the Working Group **recommends** adopting the **administrative route**, which is the most efficient and cost effective means of setting up the Fund.

Relationship with the Fiscal Reserves

1.25 The Working Group has carefully considered whether the Future Fund should remain part of the fiscal reserves. Segregating the Future Fund from the fiscal reserves may send a clearer signal to the community that the savings in the Future Fund are different and are **beyond** the usual reach of the Government.

1.26 However, the Working Group is mindful that netting off the Future Fund from the fiscal reserves may generate unwarranted concerns about a misconceived weakening of Hong Kong's fiscal strength and macroeconomic fundamentals, which may impact on our credit worthiness. In addition, the balance of fiscal reserves is also an important component of the Exchange Fund. Its placements with the Exchange Fund help reinforce public confidence in the Hong Kong dollar and our monetary stability. As at end March 2014, the balance of fiscal reserves was around 25% of the total assets of the Exchange Fund.

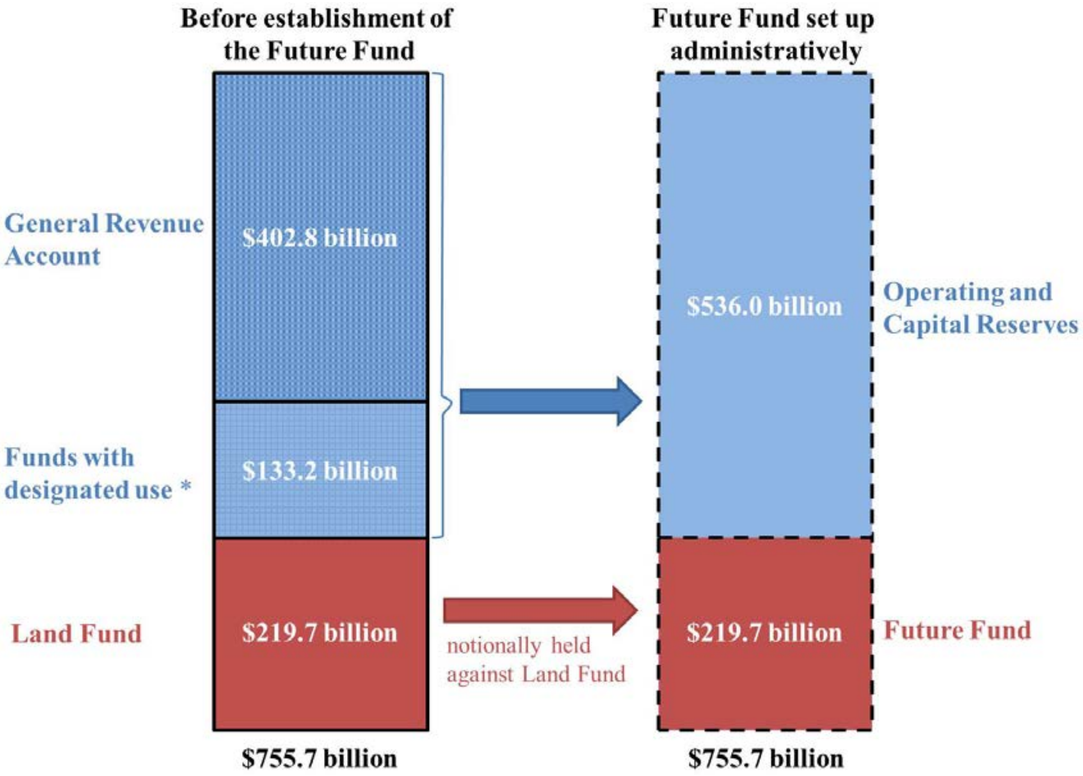
1.27 After due consideration, the Working Group **recommends** that the Future Fund should stay as part of the fiscal reserves. The fiscal reserves will be made up of two parts –

(a) the Future Fund; and

(b) the Operating and Capital Reserves (OCR). This is essentially the balance of the fiscal reserves that is not set aside for the Future Fund. It comprises the fund balances of the General Revenue Account and designated funds other than the Land Fund. It is the more liquid part of the fiscal reserves.

1.28 An illustration of the composition of the fiscal reserves upon the establishment of the Future Fund is set out in **Chart 1.2** –

Chart 1.2 – Distribution of the Fiscal Reserves
(Illustration based on 31 March 2014 position)



* Funds with designated use include Capital Investment Fund, Capital Works Reserve Fund, Civil Service Pension Reserve Fund, Disaster Relief Fund, Innovation and Technology Fund, Loan Fund and Lotteries Fund. It does not include the Bond Fund, the balance of which is not part of the fiscal reserves.

(C) Source of Funding for the Future Fund

1.29 Other than proposing a ready "endowment" of about $220 billion from the Land Fund, the Working Group deliberated on whether the Future Fund should have regular top-ups. As a fiscal discipline, the Working Group **recommends** that whenever affordable, the Government should consider transferring a designated percentage of the Government's annual budget surplus to the Future Fund as regular top-ups.

1.30 The Working Group appreciates that there is a natural trade-off between long-term and near-term needs. The higher the percentage of the annual budget surpluses set aside for saving in the Future Fund, the less would be the balance left for the OCR. The Working Group has analysed the effects of transferring 25%, 33% or 50% of the annual surpluses to the Future Fund. From a practical perspective, the Working Group considers that 25% to 33% would appear to be an appropriate tactical range.

1.31 The Working Group considered the idea of adopting a progressive two-tier structure for budget surpluses to be transferred as top-ups for the Future Fund. For "normal" years, the top-up can be fixed at a lower percentage; but for "exceptionally good" years with "exceptionally high" surpluses, a higher top-up percentage would apply. Upon deliberation, the Working Group does not consider a two-tier structure justifiable since the projected amount of additional transfer is not expected to be significant in the coming years (given that both the number of years with surplus as well as the amounts of surplus are not expected to be large). It is also hard to define "exceptionally good" years or "exceptionally high" surpluses.

1.32 The Working Group **recommends** that about a quarter to a third of the budget surpluses every year should be transferred to the Future Fund as regular top-ups. The Government would need flexibility to adjust the transfer amount having regard to the prevailing fiscal situation and needs of the community.

(D) Investment Strategy for the Future Fund

1.33 The Working Group has considered whether the Future Fund should be managed by the HKMA or invested by external fund investment managers. The Working Group **recommends** that the Future Fund should continue to be placed with the Exchange Fund as this –

(a) would allow the Future Fund to benefit from the Exchange Fund's established investment infrastructure and expertise. The Exchange Fund has accumulated experience and expertise in the investments in long-term assets which could complement the objective of the Future Fund;

(b) can lower costs because of the economies of scale of the Exchange Fund investments; and

(c) would be a quicker route. As explained in paragraph 1.19 above, the Future Fund is expected to have a limited life span. It is not worthwhile or economical to set up a separate institution and develop the investment framework afresh.

1.34 The Working Group also recognises that continued placement with the Exchange Fund can enhance the financial resources for the Exchange Fund to maintain the financial and monetary stability of Hong Kong and is desirable. The balance of the fiscal reserves stands at about 25% of the total assets of the Exchange Fund.

The Investment Portfolio of the Exchange Fund

1.35 At present, the Government's fiscal reserves are placed with the Investment Portfolio of the Exchange Fund, which strives to preserve capital as well as liquidity. The Investment Portfolio mainly holds bonds, supplemented by some equities. Its investment performance may be seen as less attractive vis-à-vis most equity funds during an economic upturn or stock market boom, but can avoid major losses in the face of a market slump and dramatic economic swings.

The Long-Term Growth Portfolio of the Exchange Fund

1.36 Since 2008, the Exchange Fund has started to diversify its investment into new asset classes, which gradually developed as the Long-Term Growth Portfolio. At present, this portfolio mainly holds private equity investments and real estate assets, which are similar to those asset classes commonly held by some SWFs.

1.37 As compared with the traditional assets held under the Investment Portfolio which are of lower risk and liquid, certain new asset classes may help deliver higher return in the medium and long term despite their lower liquidity and higher risk. In line with the principle of prudence and keeping risks within controllable limits, the Exchange Fund has capped the size of the Long-Term Growth Portfolio at one-third of the accumulated surplus of the Exchange Fund[3].

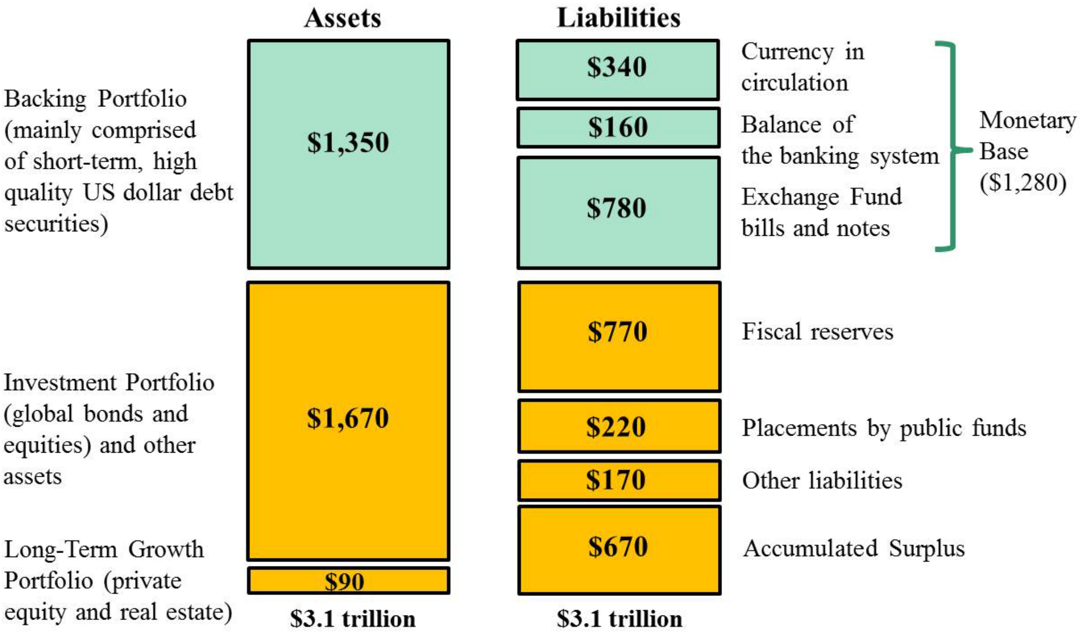
1.38 The performance of the Long-Term Growth Portfolio has been quite encouraging. The low asset valuation immediately after the global financial crisis in 2008-2009 presented a good timing for the Exchange Fund to enter the private equity and real estate markets. At the end of 2013, the annualised internal rate of return since the portfolio's inception was around 16%. An overview of the Exchange Fund's overall asset allocation as at end 2013 is set out in **Chart 1.3** below[4] –

---

3 Mr. Norman T.L. Chan, Chief Executive of HKMA, 14 May 2012, HKMA's Insight "Diversification of Investment of the Exchange Fund". http://www.hkma.gov.hk/eng/key-information/insight/20120514.shtml

4 Mr. Norman T.L. Chan, Chief Executive of HKMA, 28 July 2014, HKMA's Insight "The Exchange Fund – Last Line of Defence for Financial Stability". http://www.hkma.gov.hk/eng/key-information/insight/20140728.shtml

Chart 1.3 – Assets and Liabilities of the Exchange Fund ($ billion)



Source – HKMA

1.39 The Long-Term Growth Portfolio is managed by external private equities and real estate managers. Private equities investment is mainly made through funds and co-investment while real estate investment is mainly on high-quality commercial properties in major overseas cities. The asset classes and market value of the Long-Term Growth Portfolio as at end 2013 is as follows –

New Asset Classes	**Market Value $ billion**	**Annualised return from inception to end 2013**
Private Equity	64.2	15.9% (Internal Rate of Return)
Real Estate	24.4	
Total	**88.6**	

Note

1. Outstanding investment commitments at the end of 2013 amounted to $80.2 billion.
2. Investment cap is 1/3 of the Accumulated Surplus, or $220 billion at the end of 2013.

Investment objective of the Future Fund

1.40 The Working Group has deliberated thoroughly on the investment objectives and investment approach for the Future Fund.

1.41 As explained in paragraph 1.18 above, the main practical function of the Future Fund is to seek higher returns through long-term investments. The Working Group appreciates that most long-term risk-bearing investment tools do not or cannot offer annualised guaranteed returns. It does not feel able to prescribe a specific target rate of return for the Future Fund. As a practical way forward, the Working Group **recommends** that the investment objective of the Future Fund may be set as –

> "*achieving within acceptable risks a return that is higher over the medium to long term than the return for the rest of the fiscal reserves under the 2007 agreement between the HKMA and the Government*".

Investment approach for the Future Fund

1.42 The Working Group is mindful that investment is about a balance between risk and return. Common investment risks include credit risk, market risk and liquidity risk. As a general rule, higher potential return involves greater risk.

1.43 With the OCR standing at $536 billion (as at end March 2014), which is equivalent to about 15 months of government expenditure, there is capacity for the Future Fund to be invested in assets with higher risks. But exactly how far the Future Fund can afford to bear risks is ultimately a matter of professional judgement and fine balancing depending on the prevailing market situation.

1.44 In consultation with HKMA, the Working Group explored the trade-off between return and risk under various investment combinations – with the Future Fund assigning 50% or more of its resources for investment in the Long-Term Growth Portfolio, and assigning the rest for placements with public equities, bonds, and the Investment Portfolio. Relying on market data since 2004 (suitably adapted for the Long-Term Growth Portfolio which was developed only in 2008), the Working Group noted that the **annualised returns** in various combinations of long-term investments would typically **exceed** that achieved for the fiscal reserves under the 2007 agreement with the Exchange Fund. However, when **annualised volatility** is taken into account, the risk-adjusted performance of the various investment combinations[5], varies considerably.

1.45 The Working Group appreciates that in addition to the risk-adjusted investment returns, the liquidity needs and other considerations are also important determinants of the desired investment approach. As far as the Future Fund is concerned, the following factors should also be taken into account when deciding on the investment mix –

(a) **Liquidity needs** for the Government. Within the coming few years, the OCR balances would remain healthy. The need for the Government to have to draw on the Future Fund should be low. Hence the investment of the Future Fund can theoretically be more aggressive. Ten years down the line, however, the risk of population ageing eating into the OCR balances would be material. The need for the Government to draw on the Future Fund would be more imminent. The asset allocation would have to be fine-tuned.

(b) **Investment tenure**. A longer-term investment horizon can ride out year-on-year volatility, including the possibility of less favourable returns in individual years, and hopefully can achieve an ultimately better return compared with the Investment Portfolio in the medium to long term. To allow more time for long-term investments to reap and realise better returns, the Working Group considers that there

5 Risk-adjusted investment performance can be measured by tools such as the Sharpe Ratio, which is a ratio of excess return (portfolio return over risk-free rate) per unit of the variability of portfolio return. The higher the ratio, the better the risk-adjusted return of the portfolio.

should be a ten-year time bar before withdrawals can be made. The risk appetite at the start of the ten-year window should theoretically be higher than that towards the end.

(c) **Market dynamics**. Managing an investment portfolio requires very close monitoring of market changes including interest rate movements, geopolitical tensions, flow of funds, trends in the property market, threats of economic crisis, etc. While seeking a better investment return for the Future Fund, the Working Group appreciates that a prescriptive approach in setting the exact investment mix would **not** be practical. Much depends on prevailing economic and market conditions.

(d) **Product availability and risk diversification**. Investment in long-term assets cannot be blindly hushed through. The right kind of products with the right investment prospects have to be available for investment at the right time when funding can be released. To avoid vintage or product concentration, as well as to facilitate risk diversification and re-balancing, investments may need to be spread over different years or over different types of products through periodic adjustments to the allocation of assets within the Future Fund.

1.46 The annualised returns on the Long-Term Growth Portfolio are attractive. The Working Group has considered how far the Future Fund should invest in this Portfolio having regard to the size of its investment. The Exchange Fund's current investment in the Long-Term Growth Portfolio is about $100 billion. Its cap is one third of the Accumulated Surplus of the Exchange Fund, i.e. about $220 billion. If 100% of the Future Fund were to be invested into the Long-Term Growth Portfolio in the coming few years, this would raise the Exchange Fund's investment in that Portfolio from about $100 billion to $320 billion or $440 billion depending on whether the Exchange Fund were to increase its own investment in that Portfolio up to the investment cap during the same period. Even if the entire amount of investment would be spread over different years, the relatively large annual investment size would pose substantial challenge in the sourcing of investment opportunities in the long-term assets market while maintaining the quality of investment.

1.47 On balance, given the need for product and vintage diversification, given the substantial sums involved, and given the need to kick-start the long-term investments of the Future Fund soonest possible within its anticipated short life span, the Working Group believes that it would be reasonable for only about **50% of the Future Fund** (i.e. about $100 billion) to be set aside for investment into the Long-Term Growth Portfolio. This would **already double** the Exchange Fund's current investment in that Portfolio.

1.48 The Working Group would not want to rule out any long-term investment option at this stage. Nor does it feel right or able to prescribe a fixed or rigid asset allocation as the investment guide for the Future Fund. The Working Group **recommends** that –

(a) **Maximum flexibility** should be allowed for the investment strategy to be adjusted periodically, having regard to the trade-off between risk and return, the investment tenure, liquidity needs of the Government, etc.

(b) It would be reasonable for **about 50%** of the Future Fund to be set aside for placement with the Exchange Fund's **Long-Term Growth Portfolio**. The rest may be placed with the Investment Portfolio, bonds, public equities or other long-term investment products.

(c) The Future Fund's placements under the Long-Term Growth Portfolio would be **phased in** over a couple of years, to allow for product and vintage diversification and to build in flexibility to allow the Exchange Fund to invest and dispose of the right investments at the opportune time (instead of imposing a rigid deadline).

(d) The portion of the Future Fund which would continue to be invested in the **Investment Portfolio** (as with the fiscal reserves before the establishment of the Future Fund) should **continue to earn an investment return calculated in accordance with the formula agreed in 2007** (as explained in paragraph 1.11 above).

(e) The Future Fund would be managed as part and parcel of the Exchange Fund and is therefore subject to the same **investment management regime** and oversight by the Exchange Fund Advisory Committee on such matters as investment guidelines, due process in investment decision-making, and control of risk and compliance. Separately, however, the HKMA should consult the Financial Secretary, the Secretary for Financial Services and the Treasury and such other persons as the Financial Secretary deems fit at least once a year on the **investment strategy** and **asset allocation** for the Future Fund, having regard to the investment objective of the Future Fund, liquidity needs of the Government, the target asset allocation, investment performance and investment environment, etc.

(E) Withdrawals from and Designated Use of the Future Fund

Withdrawals from the Future Fund

1.49 The Future Fund is meant to be set aside for long-term investments for at least a ten-year period. However, in the event of a sudden economic downturn with the OCR fast depleting, the Government would need to consider whether to –

(a) break the ten-year placement with the Exchange Fund and suffer a loss;

(b) arrange for debt financing or asset securitisation; or

(c) consider a combination of these.

1.50 The Working Group considers it prudent to develop an alert system to determine what the critical threshold for the OCR balance should be, below which the Government should be seriously concerned and should consider developing contingency plans. The Working Group believes that the threshold should be expressed as X-months equivalent of gross government expenditure or net government expenditure (i.e. anticipated expenditure minus anticipated revenue).

1.51 As shown in **Chart 1.4**, the Government usually has cash flow shortfall in the early months of a financial year as the majority of the revenue (e.g. profits and salaries tax) is received in the second half of the year. The analysis in **Chart 1.5** shows that the cash flow shortfall faced by the Government during a year could be as much as three to four months of gross government expenditure, or six months of net cash outflow (for nine years out of the 16 years since 1998-99).

Chart 1.4 – Government's Cash Flow Pattern (Illustration)

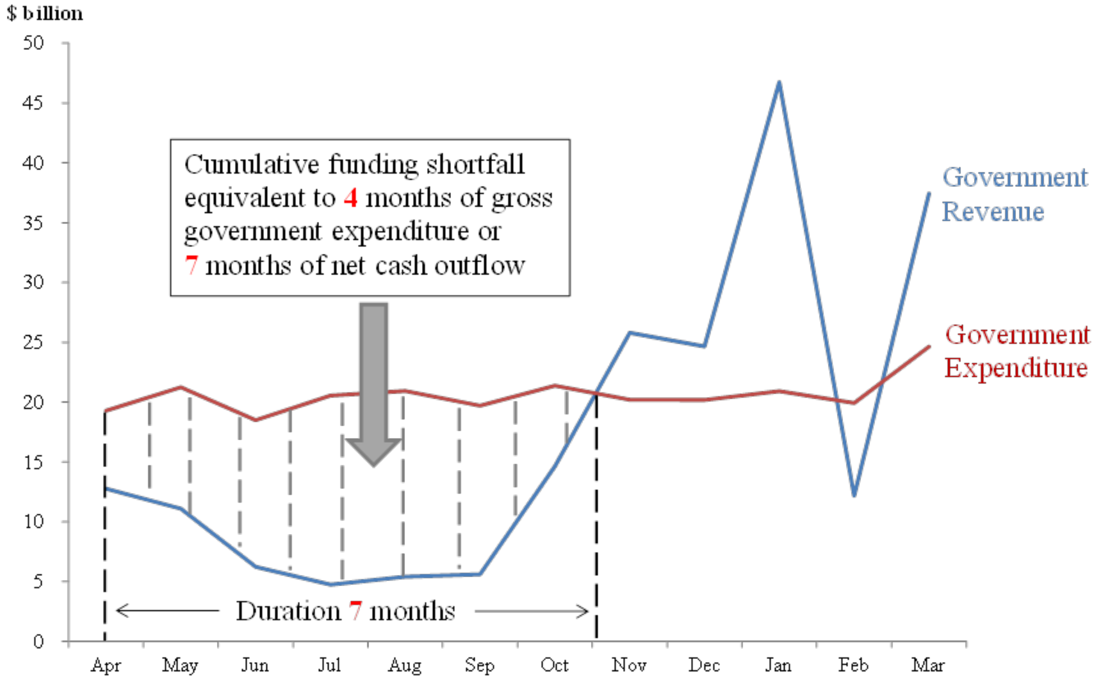
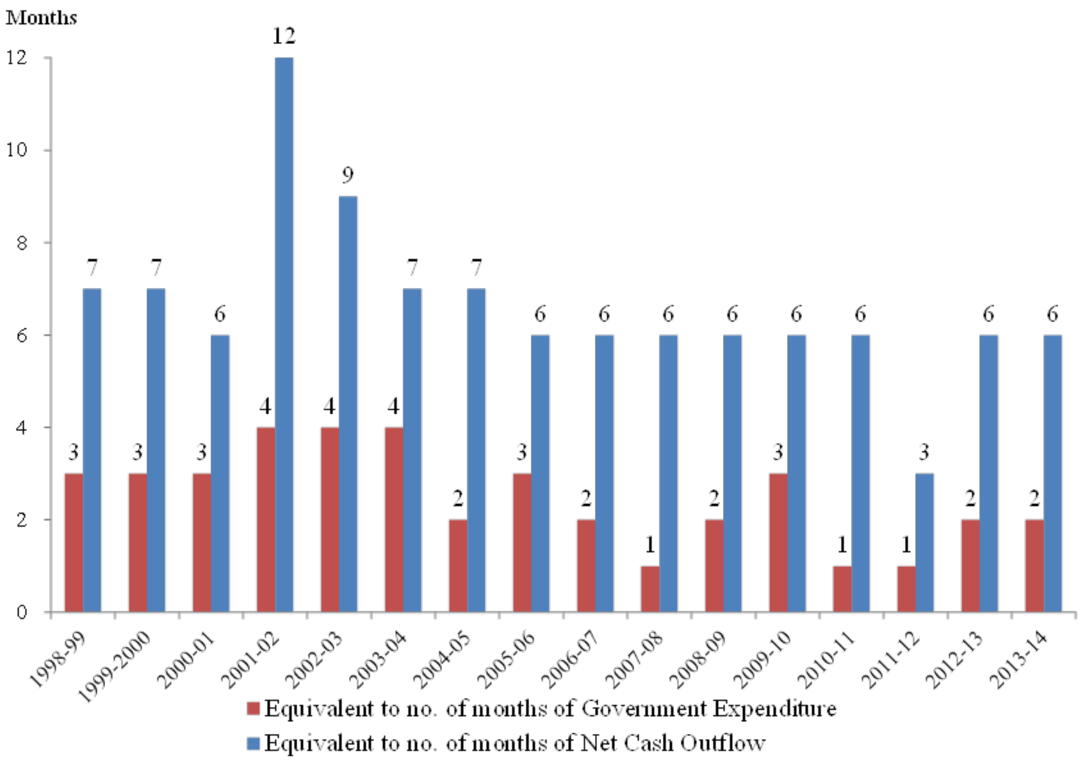


Chart 1.5 – Maximum Amount of Cash Flow Shortfall (Past Trend)



1.52 The Working Group notes that the accuracy of projecting the amount of gross government expenditure is likely to be higher than that of projecting the amount of net cash outflow; the latter involves also the projection of future revenue, which is volatile in nature. The Working Group agrees to express the threshold in terms of months of **gross** (vs net) government expenditure.

1.53 Other than the three to four months of gross government expenditure required to cover in-year cash flow shortfalls, the OCR needs a reasonable buffer to support contingent requirements, e.g. additional welfare expenditure during an economic downturn. This may be set at two months' equivalent of government spending. This buffer would also allow time for the Government to alert HKMA to prepare for possible withdrawals from the Future Fund (since the investments will be placed in longer-term investments and are less liquid). Thus, the Working Group **recommends** that the critical threshold should be set at six months' equivalent of gross government expenditure, i.e. four months plus two months buffer.

1.54 The trigger is meant to facilitate tracking. If the OCR balance can only cover six months of government expenditure, there is a real cause for concern. But it does **not** necessarily or automatically justify a drawdown from the Future Fund. The Working Group **recommends** that other viable options including debt financing or securitisation of government assets have to be exhausted before deployment of the Future Fund, or breaking up the ten-year placement of the Future Fund, is to be considered.

Designated use of the Future Fund

1.55 For illustration, if the investment return on the Future Fund averaged at 5% per annum and there could be regular top-ups at 33% of the annual budget surpluses, the balance of the Future Fund would amount to **about six to nine months' equivalent of gross government expenditure** (depending on the expenditure scenario) when the OCR balance hits the threshold of six months' equivalent of gross government expenditure. This is not a lot.

1.56 If the investment return of the Future Fund were one to three percentage points higher than 5% per annum, the corresponding balance of the Future Fund could be as follows –

Table 1.1 – Projected Future Fund balance when the OCR balance = 6 months of government expenditure

Assumed average return per annum	**Projected Future Fund Balance** (Months of government expenditure)	
	No Service Enhancement#	**Historical Trend***
5%	9	6
6%	10	7
7%	12	7
8%	13	8

Base Case, No Service Enhancement Scenario assumes that expenditure would be adjusted to reflect demographic and price changes only, and that services in education, social welfare and health would freeze at prevailing levels from now to 2041-42.

* *Base Case, Service Enhancement at Historical Trend Scenario further assumes that expenditure on education, social welfare and health services would grow @ 3% per annum.*

1.57 It is hard to anticipate the Government's and the community's needs ten years down the road. The Working Group does not feel right to commit the Future Fund to very specific uses. In fact, when the Land Fund was drawn down in 2003 and 2004, the objective was supposedly meeting the Government's operating shortfall, i.e. covering all purposes.

1.58 If the OCR balance is as low as six months of gross government expenditure and if, having exhausted all other viable contingency options including debt financing or securitisation of government assets, there remains a need to draw down from the Future Fund, the Working Group believes that the Future Fund should logically be confined to **absolutely essential** expenditure items. Whether these items are technically classified as capital, recurrent or one off might not be material – provided they are all badly needed.

1.59 There is a well understood tension between immediate needs and longer-term more sustainable needs for the community. The Working Group believes that even in such dire circumstances when the Future Fund has to be drawn down, due consideration should also be given to **investments in countercyclical measures to revive and stimulate economic growth**, not just payouts to fill immediate cash flow gaps and to offer immediate relief for the community. These pro-growth measures include investments in strategic infrastructure projects and other countercyclical measures. Naturally, as the Future Fund is not a recurrent stream of funding, it should not be relied upon to fund recurrent expenditure unless all other viable fund-raising options have been exhausted.

(F) Views on the Future Fund

1.60 Since the release of the Working Group Report in March 2014, the proposition of setting up a Future Fund for Hong Kong has aroused considerable public interest and discussion. Some doubt the need to set up a Future Fund because they do not believe Hong Kong would really have a structural deficit problem. They fail to see why resources should be locked up to tackle future problems when problems of the day are deemed to be more pressing.

1.61 Some sectors are keen to have funds to serve their preferred objectives. Some consider it meaningful to create the Future Fund only if it could generate higher returns, but are concerned that this would be constrained by the investment vehicles available to the Government and its risk appetite, which tends to be prudent.

1.62 The Working Group appreciates the feedback and suggestions and hopes that this Report can assure the public that the Future Fund is a mere long-term investment option that can be made to work. It seeks to foster a stronger sense of fiscal discipline and allow long-term interests to be protected against short-term pressures which are often felt as more pressing. As its name suggests, the Future Fund serves the future. The Future Fund, though not the total solution for the anticipated fiscal problems, would help alleviate the pressure of future generations and mitigate the adverse impact a structural deficit may bequeath on the economy in the not-too-distant future.

(G) Recommendations

1.63 The Working Group reiterates that in the face of our coming fiscal challenges, the Government must continue to identify growth opportunities, exercise strict control over expenditure growth and stabilise as well as broaden the revenue base. Establishing the Future Fund as soon as practicable and placing it with longer-term and higher-yield investments is a constructive measure. But it is not the total solution for our fiscal challenges.

1.64 The Working Group **recommends** the following –

(a) The Future Fund should seek to achieve within acceptable risks a return that is higher over the medium to long term than the return for the rest of the fiscal reserves under the 2007 agreement between the HKMA and the Government.

(b) The Future Fund should remain an integral part of the fiscal reserves, held only in the form of a notional account through administrative means. The part of the fiscal reserves outside the Future Fund will be referred to as "Operating and Capital Reserves" (OCR).

(c) The Future Fund should be placed with the Exchange Fund for a ten-year investment period (at least for the initial endowment). Maximum flexibility should be allowed for the investment strategy to be adjusted periodically, having regard to the trade-off between risk and return, investment tenure, liquidity needs of the Government, market dynamics, product availability, etc.

(d) The Future Fund would have an “initial endowment” notionally held against the Land Fund, and regular “top-ups” pitched at about 25% to 33% of the annual budget surpluses, notionally funded by the General Revenue Account.

(e) About 50% of the Future Fund may be set aside for incremental placement with the Exchange Fund's Long-Term Growth Portfolio. The rest may be placed with bonds, public equities, other long-term investment products or the Investment Portfolio.

(f) The Future Fund placed with the Exchange Fund would be subject to the same investment management regime and oversight by the Exchange Fund Advisory Committee. Separately, the HKMA should consult the Financial Secretary, the Secretary for Financial Services and the Treasury and such other persons as the Financial Secretary deems fit at least once a year on the investment strategy and asset allocation for the Future Fund, having regard to the investment objective of the Future Fund, liquidity needs of the Government, the target asset allocation, investment performance and investment environment, etc.

(g) The Future Fund should not be deployed unless the OCR falls below a certain threshold and unless the Government has exhausted all other viable contingency options like debt financing or securitisation. Conceptually, the threshold can be the point when the OCR is left with about six months' equivalent of gross government expenditure.

(h) There is a well understood tension between immediate needs and longer-term more sustainable needs for the community. The Working Group recommends that even in such dire circumstances when the Future Fund has to be drawn down, investments in countercyclical measures to revive and stimulate economic growth should not be overlooked or substantially held back at the expense of payouts to fill immediate cash flow gaps and to offer immediate relief for the community.

Chapter 2 – Management of Government Assets

(A) Overview

2.1 In anticipation of the hefty requirements in public spending, the Working Group recommended in the March 2014 Report that the Government should consider managing its asset portfolio in a more proactive manner, and use the financial return to help reduce the fiscal pressures in the coming decades. The Working Group stressed that one-off revenue from asset disposal could not resolve a structural deficit problem. It could only serve as one of the alternatives to tide over short-term financial difficulties.

2.2 At the request of the Financial Secretary in July 2014, the Working Group has reviewed the nature and governance structure of the Government's investments in its fixed and financial assets. Investments held by the Hong Kong Housing Authority, the Hong Kong Link 2004 Limited and the Exchange Fund, though reflected in the accrual-based consolidated financial statements, are beyond the Terms of Reference of the Working Group.

2.3 The fixed assets of the Government were estimated to cost $240.1 billion as at end March 2014. The analysis to follow covers –

(a) the management of government buildings (estimated to cost $89.7 billion), including non-departmental quarters which would become surplus, and

(b) the management of four government utilities (the assets of which are estimated to cost $105 billion).

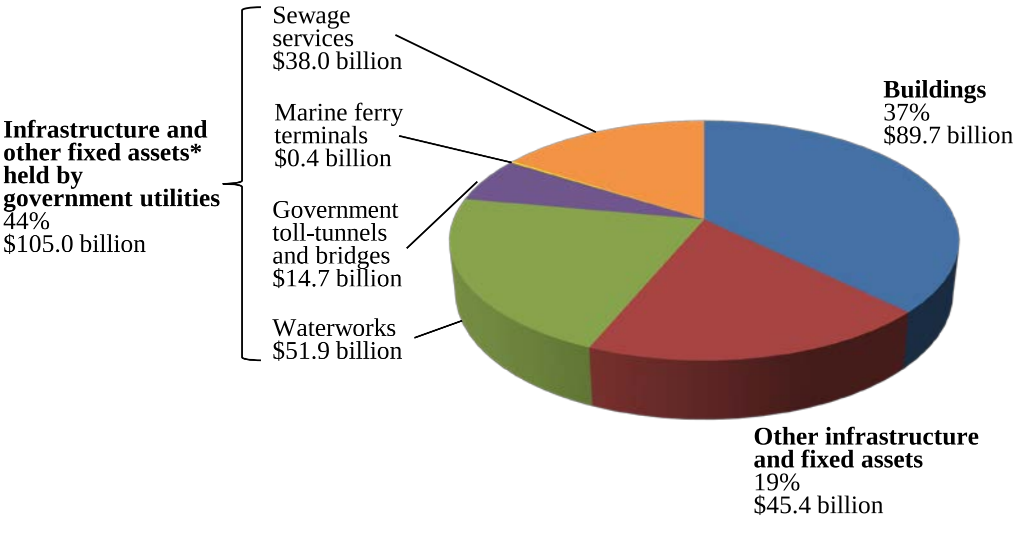
2.4 The financial assets of the Government were estimated to cost $1,332.6 billion as at end March 2014. The analysis covers the management of government business enterprises (GBEs) (estimated to cost $300.2 billion), nine outside the Government and five within (as Trading Funds). The rest of the financial assets are the fiscal reserves held with the Exchange Fund and cash, loans and advances, etc.

(B) Management of the Government's Fixed Assets

Fixed Assets

2.5 The fixed assets of the Government include the buildings held by the Government; the infrastructure and fixed assets held by four "government utilities" for the purpose of delivering water, sewage, ferry embarkation, and other services relating to the use of toll tunnel and toll bridges; and other infrastructure and fixed assets including capital works / projects in progress, computer assets and other plant and equipment. A breakdown of the Government's fixed assets is set out below –

Chart 2.1 – Government's fixed assets#
($240.1 billion as at 31 March 2014)



\# The above does not include the buildings under the ownership and management of the Hong Kong Housing Authority. These buildings comprised mainly the housing estates for 748 605 public rental housing units and other facilities such as retail facilities and welfare facilities. These are outside the Terms of Reference of the Working Group.

* "Other fixed assets" include computer assets, other plant and equipment and capital works / projects in progress.

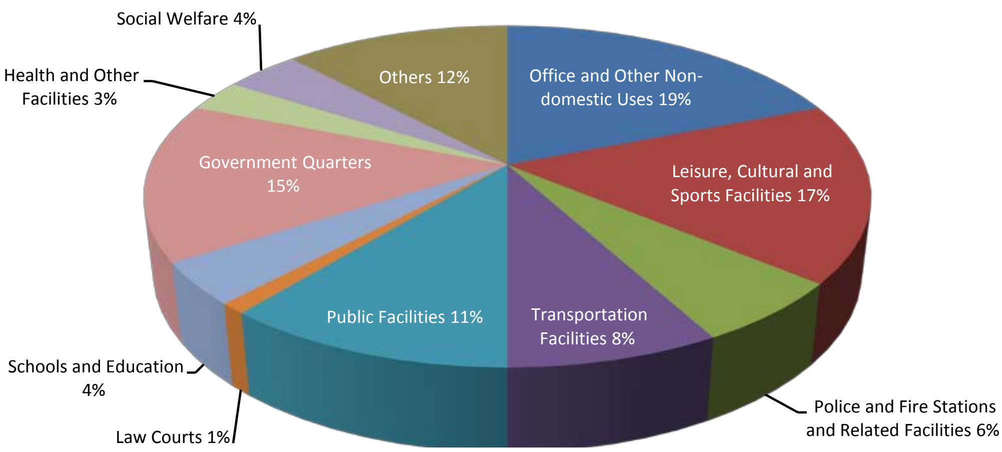
Government Buildings ($89.7 billion)

2.6 The Working Group has considered whether and how the current policy and strategy of managing government buildings can be suitably adjusted to maximise financial returns for the Government.

2.7 Government buildings are primarily used to support government operation and the delivery of public services. Under the current policy, government operations are accommodated in government-owned buildings as far as possible to provide security of tenure and minimise the Government's rental expenditure.

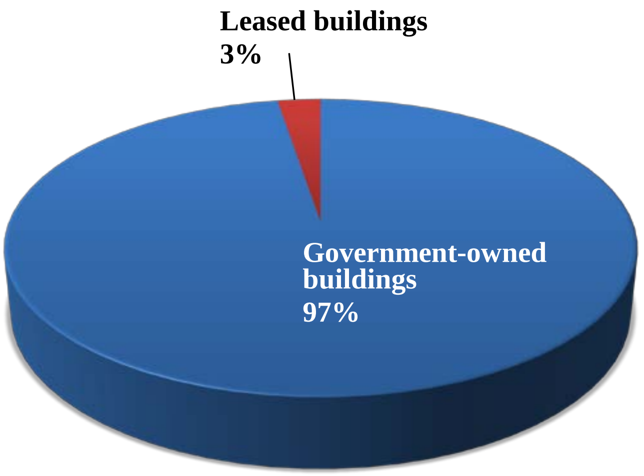
2.8 At present, there are a total of about 7 200 government-owned buildings, with an aggregate floor area of over 10 860 000 m^2. They include office buildings, leisure and cultural facilities, transportation facilities, health and welfare facilities, police and fire stations, law courts, schools as well as government quarters. Government quarters comprise mainly disciplined services quarters for eligible married junior disciplined services staff, and non-departmental quarters (NDQs) for senior civil servants who joined the service before 1 October 1990.

Chart 2.2 – Use of Government-owned Buildings by floor area



2.9 When the accommodation / operational needs of individual bureaux or departments cannot be met by government-owned buildings, the Government will lease buildings in the private market for the purpose. The Government will nevertheless delease rented accommodation and relocate the concerned government operation to government-owned buildings as circumstances permit. As at end 2013, the Government leased a total floor area of around 290 000 m^2.

Chart 2.3 – Percentage of Government-owned and Leased buildings by floor area



2.10 To help optimise site utilisation and generate revenue, the Government will consider ways of maximising the utilisation and revenue-generating potential of government-owned accommodation and government sites if suitable opportunities arise. They include commercialisation, redevelopment and disposal.

2.11 **Commercialisation.** Where appropriate, the Government will explore the feasibility and viability of commercialising any available space in government-owned buildings which is surplus to the Government's operational requirements. This will help exploit the potential of the buildings in full and generate revenue. Examples of commercial tenancies in government-owned buildings include shopping spaces, advertising spaces, car parks, automatic tellers and vending machines.

2.12 **Redevelopment.** The Government regularly reviews the site utilisation of government-owned buildings. Where cases of under-utilisation are identified, the Government will explore the possibility of reprovisioning the concerned government operation and work with the relevant bureaux / departments to release the site for redevelopment. This will help optimise the use of land resources and may generate revenue. Two recent examples of under-utilised sites released for redevelopment are the site at 650 Cheung Sha Wan Road where previously a building with government quarters, a post office and storage space stood; and the multi-storey carpark building site at 15 Middle Road in Tsim Sha Tsui. The Cheung Sha Wan Road site was sold for commercial / office development at a price of $1,002 million in April 2014 whereas the Middle Road site was sold for "Commercial / Office / Hotel" uses at a price of $4,688 million in September 2014.

2.13 **Disposal.** When government-owned buildings have become surplus to operational requirements and alternative gainful uses cannot be identified, the Government may dispose of them to generate revenue. In 2014, the following surplus government-owned buildings have been disposed of, generating revenue at a total of $400 million –

Table 2.1 – Disposal of surplus government-owned buildings

2014	Buildings	Revenue generated
June	Sale of three NDQs by open tender	$88 million
August	Sale of nine NDQs by public auction	$281 million
November	En bloc sale of 11 units at Man Yee Fisherman Village by public auction	$31 million

Alternatively, the Government may demolish the surplus buildings and return the site to Lands Department for development purposes.

2.14 The Working Group noted the broad portfolio of government buildings and discussed possible ways of managing some high-value government buildings as assets to provide a source of upfront cash if so required. Options discussed include –

(a) raising funds through using government buildings as underlying assets to support the **issue of bonds**. Proceeds from the bond issuance can be used for investment to generate income, and the investment income can be used partly for payment of interest to the bond holders. The legal ownership of the buildings will remain with the Government in the process and the security of tenure for government operations will not be affected; and / or

(b) securing an upfront cash flow through using government buildings under a **sale-and-lease-back** arrangement. The Government will have to give up ownership of the buildings as well as the security of tenure and pay rentals on a recurrent basis subject to market rental fluctuations; and / or

(c) forming a **real estate investment trust** by using income-generating government buildings which will operate as a portfolio of income-producing real estate, and to deploy the stream of income so generated for purchase and sale as liquid securities in the market. Instead of the existing arrangement of disposal by sale, these buildings can be retained as investment in the medium term and for possible capital appreciation over time. Only the income stream will be securitised and ownership of the buildings may remain with the Government in the process. But the buildings will be held for investment purpose, rather than serving government operational needs.

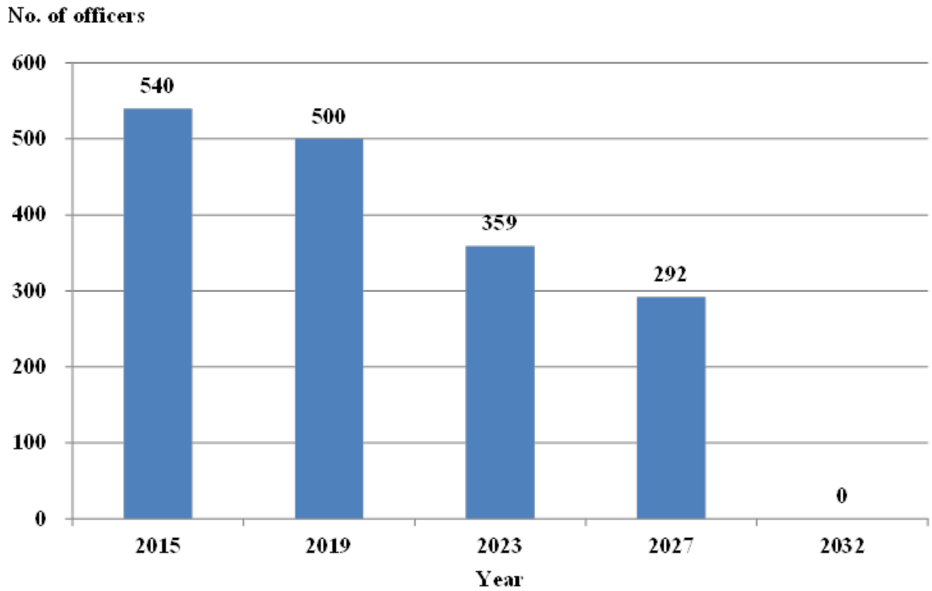
Recommendation – Government Buildings

2.15 The Working Group does not see any immediate fiscal need to pursue the above options and is concerned that option (c) above may not be consistent with the role of Government. The Working Group **recommends** that options (a) and (b) above be explored if the Government is under imminent cash flow pressure.

Surplus Non-departmental Quarters

2.16 The Working Group noted that a large number of surplus government-owned residential buildings would become available as the demand for NDQs provided for senior civil servants who joined the service before 1 October 1990 gradually phases out in the next two decades upon the retirement of eligible officers.

Chart 2.4 – Projected demand for NDQs



2.17 To address the issue of surplus NDQs, the Government introduced a rolling five-year NDQ disposal programme in 1996. The programme sets out sites anticipated for disposal in the coming five financial years so as to give ample advance notice to the affected NDQ occupants. The programme is reviewed annually by a working group convened by the Civil Service Bureau with representatives from the relevant bureaux and departments.

2.18 Noting that most of these surplus NDQs are situated in prime locations (e.g. Tai Hang Road, the Peak and Mid-levels) and have no direct impact on the delivery of public services, the Working Group agreed that surplus NDQs could be a significant source of revenue for the Government and considered how their returns could be maximised.

2.19 As at November 2014, there were 14 government-built NDQ sites (with 631 units) and 220 NDQ units in private developments, making up a total of 851 NDQ units.

2.20 **Government-built NDQ sites.** Under the existing government policy, government-built NDQ sites earmarked for disposal under the NDQ disposal programme are normally disposed of by land sale when all the units at the site are vacated. Some of the NDQ sites mentioned in paragraph 2.19 above have already been included in the NDQ disposal programme with planned dates for disposal. Since 2009, a total of five government-built NDQ sites have been disposed of by land sale, generating substantial revenue for the Government at a total of $31 billion.

Table 2.2 – Disposal of NDQ Sites since 2009

	NDQ Sites	**Sale Date**	**Revenue Generated**
1.	103 Mt. Nicholson Gap	July/2010	$10 billion
2.	1 Ede Road	August/2010	$1 billion
3.	3 & 5 Ede Road	October/2010	$2 billion
4.	21, 23, 25 Borrett Road	June/2011	$12 billion
5.	Glendale, 8, 10 & 12 Deep Water Bay Drive	May/2012	$6 billion
		Total	**$31 billion**

2.21 **NDQ units in private developments.** Individual surplus NDQ units in private developments are disposed of in the open market by public tender or auction. Since 2009, a total of 165 NDQ units in private developments have been disposed of, generating revenue at a total of $4,205 million.

Table 2.3 – Disposal of NDQ units since 2009

Year	No. of NDQ Units Sold	Revenue Generated
2009	102	$2,495 million
2010	16	$381 million
2011	15	$397 million
2012	20	$563 million
2013	-	-
2014	12	$369 million
Total	**165**	**$4,205 million**

2.22 As an interim arrangement pending permanent disposal, surplus NDQ units are normally leased out to make gainful use of the surplus buildings and help generate revenue. As at November 2014, there were 189 surplus NDQ units on leasing, generating annual rental revenue of about $108 million.

2.23 In considering whether the NDQ sites and units should be disposed of or retained with the surplus units leased out on a long-term basis to maximise possible returns, the Working Group has considered the following relevant factors –

(a) **Age of NDQs.** Some of the NDQ units are over 30 years. If the Government were to pursue the leasing option, there would be recurrent maintenance costs which could increase over time as the buildings further age. To maximise their rental value, substantial refurbishment works may be required which would incur significant capital outlays.

(b) **Role of Government.** NDQs were built or purchased to meet operational needs. A conscious policy decision would have to be made if the Government were to take up the role of a landlord and leasing agent.

(c) **Land and housing priorities.** Given the Government's policy priority of increasing land supply for housing and other developments, it may be difficult to justify retaining some surplus under-utilised NDQ sites to generate revenue.

2.24 Generally speaking, there may be greater room and flexibility for maneuvering in exploring the leasing-out option for NDQ units in private developments (compared with government-built NDQ units), as they are not site-tied and can be sold or leased out individually as and when appropriate. These NDQ units may also be potentially more attractive to prospective tenants. The choice between disposal or leasing-out of these surplus units would hinge on the cost-benefit appraisal for each case concerned.

2.25 The Working Group has considered the estimated disposal value vis-à-vis the estimated rental value of the NDQ sites and NDQ units within private developments that may be vacated and disposed of in the coming years. The analysis is set out in the following table –

Table 2.4 – Comparison of estimated disposal value and estimated annual rental value of NDQ sites and units

	Estimated disposal value (as at 1 Sept 2014)	**Estimated rental value** (per annum)	**Breakeven**
Nine NDQ sites*	$51 billion	$523 million	97.5 years
220 NDQ units in private developments	$8 billion	$144 million	55.5 years

* Excluding five NDQ sites which have already been included in the Government's NDQ disposal programme with planned disposal dates or have alternative government uses.

Recommendations – Surplus NDQs

2.26 Given the relatively low annual rental yield and the general shortage of land resources, the Working Group did not consider it worthwhile to retain the surplus NDQs and pursue the leasing-out option. The Working Group also considered it not advisable for the Government to keep surplus NDQs for the purpose of possible capital appreciation as it might create the misperception that the Government was participating in property market speculation.

2.27 In view of the above considerations, the Working Group **recommends** that the Government should continue with the established policy of disposing of NDQ sites and units by sale as and when they become available to generate one-off revenue. This will also free land and help increase land supply for housing or other development purposes. The potential revenue, depending on the timing of disposal, could be in the order of $59 billion.

2.28 For the disposal of these surplus buildings, the Working Group **recommends** that a pragmatic approach should be adopted to allow flexibility in the disposal mechanism. This is to ensure that valuable government buildings are not disposed of when market conditions are unfavourable. The disposal priority should be guided by the status of the NDQ decanting programme, the potential revenue to be captured, the site utilisation to be enhanced through redevelopment, and the sentiment of the market. As an interim arrangement pending permanent disposal, the existing practice of leasing out surplus NDQ units should continue.

Government Utilities ($105 billion)

2.29 The provision of water, sewage, ferry embarkation, and other services relating to the use of toll tunnel and bridges – generally referred to as "government utilities", involves very substantial upfront capital investment of public funds. In order to recoup the costs of investment as well as the costs of resources in managing the utilities, the Executive Council decided in 1995 that target rates of return should be set for government utilities with reference to those in the relevant industry sectors, in terms of the return on average net fixed assets valued at historical cost of the respective utilities. The Executive Council also decided that the target rates should be reviewed at five-year intervals taking into account the actual performance of the utilities and the changes in policy, economic and investment market conditions.

2.30 There are four government utilities, namely –

(a) Waterworks (managed by Water Supplies Department)

This utility covers the operation of the fresh and salt water supplies to the territory.

(b) Government Toll-tunnels and Bridges (managed by Transport Department)

This utility covers the operation of five Government-built toll-tunnels (namely Aberdeen Tunnel, Lion Rock Tunnel, Shing Mun Tunnels, Tseung Kwan O Tunnel and Route 8K between Sha Tin and Cheung Sha Wan) and the Lantau Link.

(c) Marine Ferry Terminals (managed by Marine Department)

This utility covers the operation of two marine ferry terminals (namely the Hong Kong-Macau Ferry Terminal at Sheung Wan and the China Ferry Terminal at Tsim Sha Tsui).

(d) Sewage Services (managed by Drainage Services Department)

This utility covers the treatment and disposal of sewage through the public sewerage system.

2.31 Following the last review in 2012, the prevailing target rates of return for the relevant utilities are set out below –

Waterworks	3.4%
Government Toll-tunnels and Bridges	6.6%
Marine Ferry Terminals	7.5%
Sewage Services	Cost recovery

The target rates of returns are derived with the use of the Capital Asset Pricing Model to evaluate the cost of capital for individual government utilities, and are measured in terms of return on average net fixed assets valued at historical cost. They are reviewed at five-year intervals taking into account the latest economic and investment market conditions as well as the risk return characteristics of companies in the relevant industry sectors.

2.32 As revealed in the Operating Accounts in respect of the four government utilities over the past five years from 2009-10 to 2013-14, the Marine Ferry Terminals operation has achieved a higher-than-target return, while the other three utilities have not been able to meet their respective financial targets.

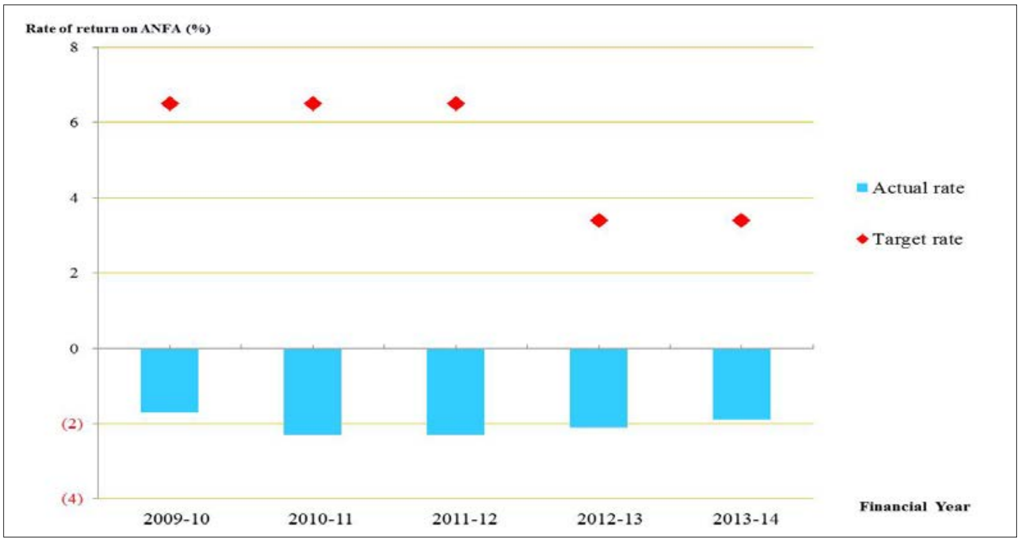
Waterworks

2.33 The Executive Council decided in 1995 that the target rate of return for Waterworks should be set at a risk-free rate (conceptually, this is the rate of return that can be earned with certainty such as rate of government bonds), on the ground that water was regarded as basic necessity and that the Government should absorb through general revenue any business risk associated with the Waterworks.

2.34 The Waterworks has been operating well below the target rate of return throughout the past five years from 2009-10 to 2013-14. In fact, it has been operating at deficits since 1998-99.

2.35 The Water Supplies Department has been implementing various measures to reduce expenditure through outsourcing, computerisation, streamlining work process, automation and remote control of plant operation, optimisation of plant maintenance, re-organisation and re-engineering the work flow, and implementation of electricity saving measures. Notwithstanding the various measures to reduce expenditure, the revenue of the Waterworks operation has still fallen short of meeting its expenditure. Water tariff, which constitutes 33% of the revenue of the Waterworks operation in 2013-14, has not been revised since 1995, contributing to the under recovery of the operating cost of the Waterworks operation.

Chart 2.5 – Target and actual rates of return for Waterworks

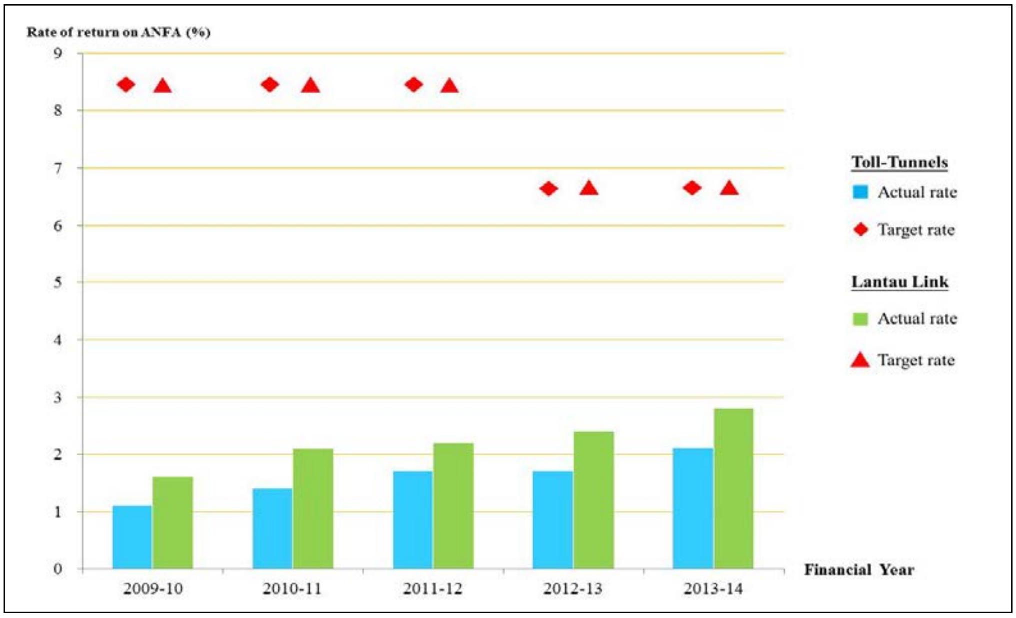


Government Toll-tunnels and Bridges

2.36 The Government Toll-tunnels and Bridges operation could not meet the target rate of return throughout the past five years from 2009-10 to 2013-14.

2.37 The daily operation of the five government toll-tunnels and Lantau Link has been outsourced to contractors who have to bear all recurrent expenses for maintaining and operating the facilities. While the Government has been striving to control the management costs by awarding the management contracts through open tender, the tolls, which account for about 99% of the revenue of the Government Toll-tunnels and Bridges operation, have not been revised for years. The toll levels for Aberdeen Tunnel, Shing Mun Tunnels and Tseung Kwan O Tunnel were last revised on 26 February 1993, Lion Rock Tunnel on 1 April 1999, and those for Route 8K and Lantau Link have not been revised since their respective commissioning on 21 March 2008 and 22 May 1997. In response to concerns expressed by the Legislative Council, the toll for Route 8K was set at a level lower than those originally put forward by the Government to meet the target rate of return.

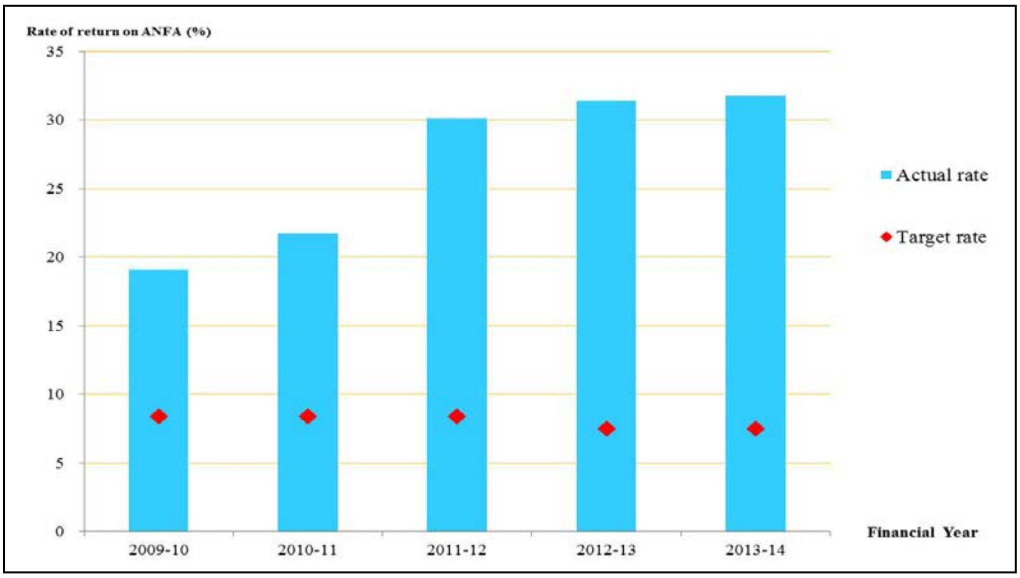
Chart 2.6 – Target and actual rates of return for Government Toll-tunnels and Bridges



Marine Ferry Terminals

2.38 The Marine Ferry Terminals have been operating above the target rate of return over the past five years from 2009-10 to 2013-14. In anticipation of continuous patronage growth, the operation of the two Marine Ferry Terminals is forecast to continue to meet the target rate of return in the coming years. The commissioning of the Hong Kong-Zhuhai-Macau Bridge may have a dampening effect on patronage.

Chart 2.7 – Target and actual rates of return for Marine Ferry Terminals

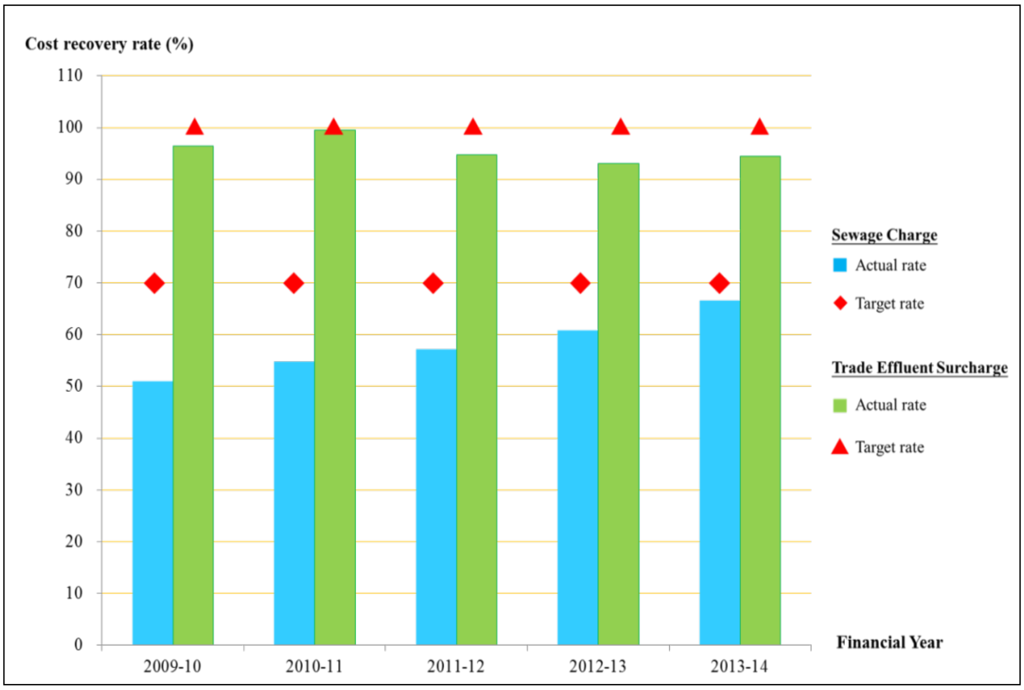


Sewage Services

2.39 In order to gain public acceptance of the sewage services charging scheme upon its introduction back in 1995, the Sewage Charge and the Trade Effluent Surcharge have each been set to recover the operating cost of Sewage Services only, but not the capital cost.

2.40 The Sewage Services operation has yet to achieve the target cost recovery rates, i.e. 70% recovery of the cost of treatment of waste water from Sewage Charge by 2017-18 and full (100%) recovery of the additional cost of treating effluents from Trade Effluent Surcharge. Nonetheless, revenue from Sewage Charge is still forecast to rise steadily up to 2017-18 because the Legislative Council agreed in May 2007 that the Sewage Charge be increased by ten annual increments of 9.3% from 2008-09 to 2017-18. To ensure that the Sewage Services operation will be able to achieve the target cost recovery rates beyond 2017-18, the Government will conduct a review of the Sewage Charge and the Trade Effluent Surcharge in due course.

Chart 2.8 – Target and actual cost recovery rates for Sewage Services



Monitoring mechanism for Government Utilities

2.41 An Operating Accounts Committee is set up for each of the government utilities to monitor their financial performance. Chaired by the Permanent Secretary for Financial Services and the Treasury (Treasury) and comprising representatives from the relevant policy bureaux and departments, each of these Committees is tasked to –

(a) vet the annual Operating Accounts, five-year projections, and any necessary cost-saving and revenue-generating measures;

(b) vet and approve fee revision proposals; and

(c) review periodically the target rates of return.

Recommendations – Government Utilities

2.42 The Working Group agrees that the structured mechanism for monitoring the financial performance of the government utilities on a periodic basis should continue.

2.43 The Working Group **recommends** that government utilities should continue to seek to improve their financial performance, by exploring cost-saving opportunities and implementing fee revision proposals.

2.44 The Working Group **recommends** that a review of the water tariff last adjusted in 1995 would be timely. This is necessary to uphold the "user pay" principle and help the Waterworks operation attain its target rate of return. With water tariff averaging at only about $50 a month for a domestic household, the Working Group considers that affordability should not be a real hurdle to a reasonable upward adjustment. The extra cost burden to the community can be allayed by greater efforts to economise on the consumption of water as a scarce resource.

2.45 The Working Group **recommends** that the Government should step up its efforts to encourage water savings while continuing to identify further ways to operate and maintain the Waterworks in an economical, efficient and effective manner.

2.46 As regards the Government Toll-tunnels and Bridges operation, the Working Group **recommends** that the Government should continue to keep in view the traffic situation of the government toll-tunnels and Lantau Link and opportunities for toll adjustment where it is justified on traffic grounds. The Working Group sees a need to improve the financial performance of the Government Toll-tunnels and the Lantau Link operations for attaining the target rate of return in the long run, while appreciating the political reality and the impact any toll adjustment may have on the overall scheme of development in Hong Kong.

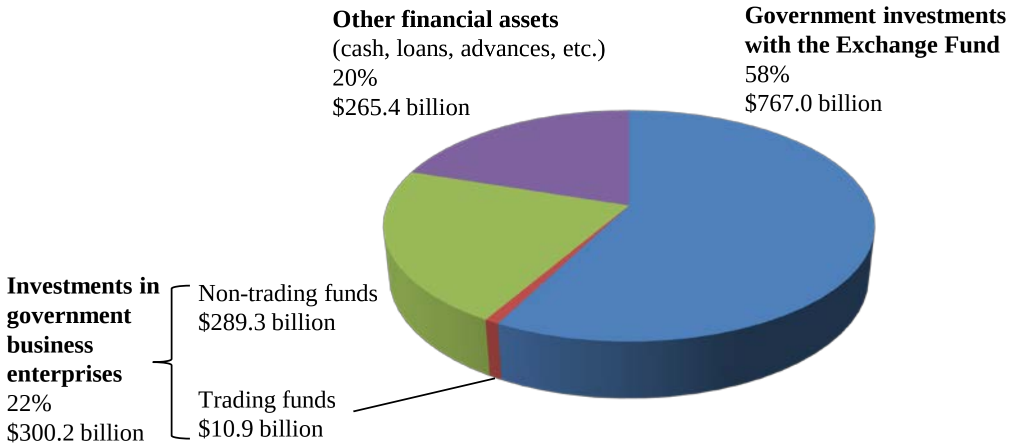
2.47 The Working Group **recommends** that the Government should continue to explore and discuss with the management contractors of the government toll-tunnels and Lantau Link ways to increase non-toll revenues and keep in view cost-saving opportunities.

(C) Investment in Financial Assets

Financial Assets

2.48 The financial assets of the Government include the fiscal reserves placed with the Exchange Fund; other cash, loans and advances, etc.; and most importantly for the current purpose of the Working Group, the Government's investment in a group of "government business enterprises" ("GBEs"). An overview is set out below –

*Chart 2.9 – Government's financial assets**
($1,332.6 billion as at 31 March 2014)



* The above does not include the financial assets held by the Exchange Fund, the Hong Kong Link 2004 Limited and the Hong Kong Housing Authority. These are outside the Terms of Reference of the Working Group.

2.49 $300.2 billion or 22% of Government's financial assets (totaling $1,332.6 billion) at end March 2014 relates to investments in GBEs. A list of GBEs in which the Government has an investment holding of not less than 20% as at 31 March 2014 and of which the Government shares the net earnings is at below –

Table 2.5 – GBEs

Government Business Enterprises		Government investment holding
1.	Airport Authority	100%
2.	Companies Registry Trading Fund	100%
3.	Electrical and Mechanical Services Trading Fund	100%
4.	Hong Kong Cyberport Development Holdings Limited	100%
5.	Hongkong International Theme Parks Limited	52.4%
6.	Hong Kong Science and Technology Parks Corporation	100%
7.	Hong Kong IEC Limited	74.9%
8.	Kowloon-Canton Railway Corporation	100%
9.	Land Registry Trading Fund	100%
10.	MTR Corporation Limited	76.5%
11.	Office of the Communications Authority Trading Fund	100%
12.	Post Office Trading Fund	100%
13.	Urban Renewal Authority	100%
14.	West Rail Property Development Limited	100%

2.50 The Government has shareholding in 14 GBEs, including five trading funds and nine "non-governmental" entities.

Management of GBEs other than Trading Funds ($289.3 billion)

2.51 Past investments in non-governmental GBEs were mainly designed to provide a worthwhile public service or to meet an important policy objective while generating a reasonable rate of return to the Government. Investments in these GBEs have been made through the Capital Investment Fund to meet public purposes in different forms, as follows –

(a) Public statutory corporations with shareholding structure –

(i) **MTR Corporation Limited** – to build and operate mass transit railway in Hong Kong;

(ii) **Airport Authority of Hong Kong** – to provide, operate, develop and maintain an airport for civil aviation in the vicinity of Chek Lap Kok;

(iii) **Kowloon-Canton Railway Corporation** – to hold railway system and to grant and oversee the service concession to the MTR Corporation Limited for operation of its railway system;

(iv) **Hong Kong Science and Technology Parks Corporation** – to oversee and manage the Hong Kong Science Park, InnoCentre, and the three industrial estates at Tai Po, Tseung Kwan O and Yuen Long;

(b) Private companies with shareholding structure formed under Companies Ordinance (Cap. 622) –

(i) **Hongkong International Theme Parks Limited –** to operate the Hong Kong Disneyland Resort;

(ii) **Hong Kong Cyberport Management Company Limited** – to operate the Cyberport which includes four office buildings, a hotel and an arcade;

(iii) **Hong Kong IEC Limited –** to develop and operate the AsiaWorld-Expo in Hong Kong;

(iv) **West Rail Property Development Limited** ("WRPDL") – to undertake residential development projects along the West Rail line; and

(c) Public statutory bodies without a shareholding structure –

(i) **Urban Renewal Authority –** to undertake, encourage, promote and facilitate the regeneration of the older urban areas of Hong Kong.

2.52 Except for the five Trading Funds, other GBEs are independent legal entities and have their own boards of directors for overseeing the business operation of GBEs. They have their own corporate governance and are accountable to their boards of directors. As such, the objectives of the Government, being a shareholder, are to ensure that the relevant corporations and companies –

(a) operate their business on commercial principles, creating and maximising shareholder value within their policy and regulatory environment; and

(b) provide a reasonable financial return to Government's investment, both in terms of achieving a specified level of dividend payments and optimising their financial structure.

2.53 Since the Government-invested corporations, companies and public bodies are serving a public purpose and operating under heavy policy requirements, the Government's investment would seek primarily to meet the relevant public policy objectives rather than to achieve a financial return. Unless there is a change in the objective of Government's investments, commercial return to Government may not always be overriding.

2.54 The financial performance of GBEs (except for Trading Funds to be analysed separately) varies. Some operate at an accounting profit with dividends paid to Government as shareholder; others may not be able to pay dividends but still suffice to generate operating cash to support their missions and functions. The financial performance of GBEs may be affected by quite a number of factors. For example, some companies, though profitable, have been undergoing expansion plans while some others are carrying heavy non-cash expenses like depreciation. Some GBEs are also tasked with public mission projects for nurturing specific industries, and this may affect their profitability.

2.55 The Government monitors the financial performance of the non-governmental GBEs through directorship appointments on the relevant governing boards. The official directors tender their views on the formulation of the business plans and financial forecasts of GBEs by taking into account the individual mission and objectives as well as financial performance of the GBEs.

Recommendations – GBEs other than Trading Funds

2.56 The Working Group notes that past investments of the Government in GBEs other than the Trading Funds are mainly to provide a worthwhile public service or to meet an important policy objective. As such, the Government's investment would seek primarily to meet the relevant public policy objectives. The Working Group also acknowledges that these GBEs have their own corporate governance and are accountable to their boards of directors. Direct instruction from the Government on the operation of business of these GBEs is not appropriate. The Working Group therefore focuses on exploring the fiscal options for the Government as the shareholder of GBEs, i.e. whether the Government should maintain its shareholding level in GBEs or dispose of its shareholding, either partially or fully, if the Government faces structural deficit, having regard to the financial performance of GBEs and their investment return to the Government as the shareholder.

2.57 The Working Group **recommends** that the Government should consider reducing or disposing of the Government's shareholding in non-governmental GBEs in times of serious financial distress. However, the one-off revenue from asset disposal **cannot** resolve the structural deficit problem. In considering adjusting the Government's shareholdings in GBEs, the overriding public policy objectives and the interests of minority shareholders should also be carefully considered. The Working Group believes that the Government should continue to be the majority shareholder in those GBEs which hold strategic assets like railways and the airport. For other GBEs, the Government should periodically review whether the extent of its shareholding in each remains commensurate with the public policy objectives.

2.58 The Working Group **recommends** that the Government should institute a more structured review for monitoring all GBEs as a group. Rather than monitoring the performance of individual GBEs, this proposed review is meant to –

(a) evaluate the relative financial performance of GBEs;

(b) compare their performance over time and/or against industry benchmarks; and

(c) assess whether the government investments have paid off, achieved their policy objectives and remain fit-for-purpose.

It would suffice for the structured review to be conducted once every three years.

Management of Trading Funds ($10.9 billion)

2.59 Trading funds are distinct accounting entities established under the Trading Funds Ordinance (TFO) (Cap. 430) for the provision of specific government services. While remaining as part of the Government, they are allowed greater financial and operational flexibilities to run their operations as businesses with a view to improving the quality of services and responding to customer demands.

2.60 Under the TFO, trading funds are required to achieve the following financial objectives –

(a) within a reasonable time, meeting expenses incurred in the provision of the trading fund services and financing liabilities of the trading fund out of the income of the trading fund, taking one year with another; and

(b) achieving a reasonable return, as determined by the Financial Secretary, on the fixed assets employed (target rate of return).

2.61 There are currently five trading funds, and their major nature of business and respective target rates of return are as follows –

Table 2.6 – Trading Funds' target rates of return

Trading Fund	Target Return
(a) Companies Registry Trading Fund (Incorporation of companies and ancillary services, company search)	6.7%
(b) Land Registry Trading Fund (Land search, registration of deeds)	6.9%
(c) Office of the Communications Authority Trading Fund (Regulation of telecommunication and broadcasting services)	6.7%
(d) Post Office Trading Fund (Postal and ancillary services)	5.9%
(e) Electrical and Mechanical Services Trading Fund (Electrical and mechanical engineering services)	7.8%

2.62 The target rates of returns are derived with the use of the Capital Asset Pricing Model to evaluate the cost of capital for individual trading funds, and are measured in terms of return on average net fixed assets valued at historical cost. They are reviewed at five-year intervals taking into account the latest economic and investment market conditions as well as the risk return characteristics of companies in the relevant industry sectors.

2.63 Except for the Post Office Trading Fund (POTF) which has not been able to meet the target rate of return since 2009-10, the other trading funds have more than achieved the respective target rates of return over the past five years from 2009-10 to 2013-14.

Table 2.7 – Actual (vs target) rates of return

Trading Fund	**2009-10**	**2010-11**	**2011-12**	**2012-13**	**2013-14**
Companies Registry Trading Fund	35.3% *(8.3%)*	59.4% *(8.3%)*	54.9% *(8.3%)*	63.6% *(6.7%)*	72.5% *(6.7%)*
Land Registry Trading Fund	38.5% *(8.3%)*	52.6% *(8.3%)*	19.7% *(8.3%)*	34.0% *(6.9%)*	15.8% *(6.9%)*
Office of the Communications Authority Trading Fund	32.2% *(8.5%)*	44.7% *(8.5%)*	48.8% *(8.5%)*	31.4% *(6.7%)*	26.0% *(6.7%)*
Post Office Trading Fund	6.6% *(8.4%)*	3.8% *(8.4%)*	-1.9% *(8.4%)*	-3.9% *(5.9%)*	-0.5% *(5.9%)*
Electrical and Mechanical Services Trading Fund	49.1% *(8.5%)*	58.1% *(8.5%)*	45.5% *(8.5%)*	38.1% *(7.8%)*	31.7% *(7.8%)*

2.64 A standing mechanism exists for the respective policy bureau and the Financial Services and the Treasury Bureau to regularly monitor the financial performance of the trading funds through –

(a) vetting and approving their annual business and corporate plans;

(b) vetting and approving their fee revision proposals and investment strategies; and

(c) reviewing and monitoring their interim and annual financial results twice a year.

2.65 In order to improve its financial performance, the POTF will continue to implement measures to generate revenue and manage costs. These include periodic review and adjustment of the principal postage rates and miscellaneous postal fees; introduction of new services to meet the delivery needs of online merchants and online shoppers; provision of one-stop customised philatelic souvenir service to generate additional revenue; and cost-savings measures through automation, mechanisation and business process re-engineering of postal operations.

Recommendations – Trading Funds

2.66 The Working Group agrees that the structured mechanism for monitoring the financial performance of the trading funds on a periodic basis should continue.

2.67 The Working Group **recommends** that trading funds should continue to enhance operational efficiency and achieve a reasonable rate of return while maintaining appropriate standards of public services.

2.68 The Working Group **recommends** that the POTF should continue to strive to improve its financial performance. This includes exploring outsourcing opportunities and implementing fee revision proposals.

(D) Asset Valuation

2.69 The Government's fixed assets are stated at cost less accumulated depreciation in the accrual-based consolidated financial statements whereas the investments in GBEs are stated at the Government's share of their net assets, less any impairment losses recognised.

2.70 Land is generally not capitalised as fixed assets because it would be difficult, if not impossible, to obtain objective valuation of all the land owned by the Government most of which do not have parallel instances in the private sector (e.g. land under roads and streets, police/fire stations, or prisons). The cost of land is not measurable in a reliable manner since it may involve different extent of land formation costs as well as the cost of ancillary facilities such as roads, drains and other social infrastructure. To demonstrate the Government's accountability, a Stewardship Statement is attached to the accrual-based consolidated financial statements to disclose the areas of land employed by the Government for delivery of public services and land allocated to the Housing Authority for public rental housing estates.

2.71 The Working Group noted that the existing approach of valuation of assets is basically in line with the generally accepted accounting practices and is appropriate. To enhance transparency, the Working Group suggests that the Government may consider, to the extent possible, disclosing additional information on the market value of the GBEs other than trading funds by way of notes to the accrual-based consolidated financial statements.

(E) Recommendations

Fixed Assets

2.72 **Government Buildings** ($89.7 billion as at 31 March 2014). The Working Group does not see any immediate fiscal need for the Government to consider disposing of the many high-value government buildings it possesses. However, if a need for cash arises, the Working Group **recommends** that the Government may consider raising funds through using some high-value government buildings as underlying assets to support the issue of bonds, or using them under a sale-and-lease-back arrangement.

2.73 **Non-departmental Quarters** (NDQs) (subset of Government Buildings). Nine NDQ sites and 220 NDQ units in private developments are expected to become surplus in the coming two decades upon the retirement of eligible civil servants who joined the Government before 1 October 1990. The Working Group **recommends** that the Government should continue with the established policy of disposing of NDQ sites and units by sale as and when they become available to generate one-off revenue. A pragmatic approach should be adopted to allow flexibility in the disposal mechanism and to avoid "fire sale". The disposal priority should be guided by the status of the NDQ decanting programme, the potential revenue to be captured, the site utilisation to be enhanced through redevelopment, and the sentiment of the market. As an interim arrangement pending permanent disposal, the existing practice of leasing out surplus NDQ units should continue.

2.74 **Government Utilities** ($105 billion as at 31 March 2014). Only one of the four government utilities (namely the Marine Ferry Terminals) managed to operate above the target rate of return from 2009-10 to 2013-14. The Working Group **recommends** that all government utilities, especially the other three (namely, waterworks, government toll-tunnels and bridges, and sewage services), should continue to seek to improve their financial performance, by exploring cost-saving opportunities and implementing fee revisions in a timely manner.

Financial Assets

2.75 **Government Business Enterprises (GBEs) other than Trading Funds** ($289.3 billion as at 31 March 2014). The Working Group appreciates that the Government's investments in many GBEs are guided by public policy objectives not limited to financial considerations. In times of serious financial distress, the Working Group **recommends** that the Government should consider reducing or disposing of the Government's shareholding in some GBEs. The Working Group believes that the Government should continue to be the majority shareholder in those GBEs which hold strategic assets like railways and the airport. For other GBEs, the Government should periodically review whether the extent of its shareholding in each remains commensurate with the public policy objectives. The Working Group would caution that one-off revenue from asset disposal **cannot** resolve a structural deficit problem; the overriding public policy objectives and the interests of minority shareholders should also be carefully considered.

2.76 The Working Group **recommends** that the Government should institute a more structured review for monitoring all GBEs as a group. Rather than monitoring the performance of individual GBEs, this proposed review is meant to –

(a) evaluate the relative financial performance of GBEs;

(b) compare their performance over time and/or against industry benchmarks; and

(c) assess whether the government investments have paid off, achieved their policy objectives and remain fit-for-purpose.

It would suffice for the structured review to be conducted once every three years.

2.77 **Trading Funds** ($10.9 billion as at 31 March 2014). The Working Group notes that four of the five trading funds – namely, the Companies Registry, Land Registry, Office of the Communications Authority, and Electrical and Mechanical Services Trading Funds, have been able to meet the target rates of return. The Working Group **recommends** that they should continue to enhance operational efficiency and achieve a reasonable rate of return. As for the Post Office Trading Fund, the Working Group appreciates the historical and legal constraints within which it operates and **recommends** that it should continue to strive to improve its financial performance. This includes exploring outsourcing opportunities and implementing fee revision proposals.

Chapter 3 – Soldiering On

Long-term Fiscal Sustainability Appraisal 2014

3.1 Nine months have lapsed since the publication of the Working Group Report in March 2014. With the release of this supplementary report, the Working Group would like to take the opportunity to –

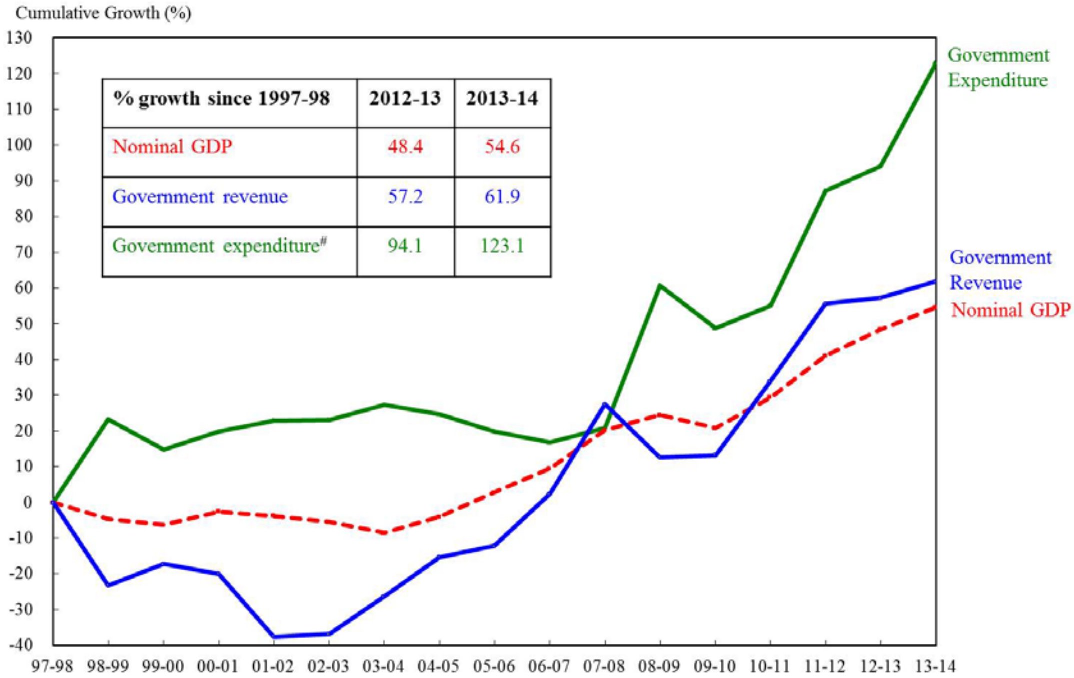
(a) rehearse the key findings of the long-term fiscal sustainability appraisal for Hong Kong, taking into account the actual (vs estimated) budgetary position for 2013-14; and

(b) take stock of what the Government has done to avert the structural deficit problem.

3.2 **The fiscal position of Hong Kong remains healthy**. 2013-14 yielded a budget surplus of $21.8 billion.

3.3 **Article 107 of the Basic Law** stipulates that Hong Kong *"shall follow the principle of keeping the expenditure within the limits of revenues in drawing up its budget, and strive to achieve a fiscal balance, avoid deficits and keep the budget commensurate with the growth rate of its gross domestic product"*. Between 1997-98 and 2013-14, government expenditure grew by 123% on a cumulative basis, **far outpacing** the corresponding GDP growth of 55% and revenue growth of 62%.

Chart 3.1 – Growth since 1997-98



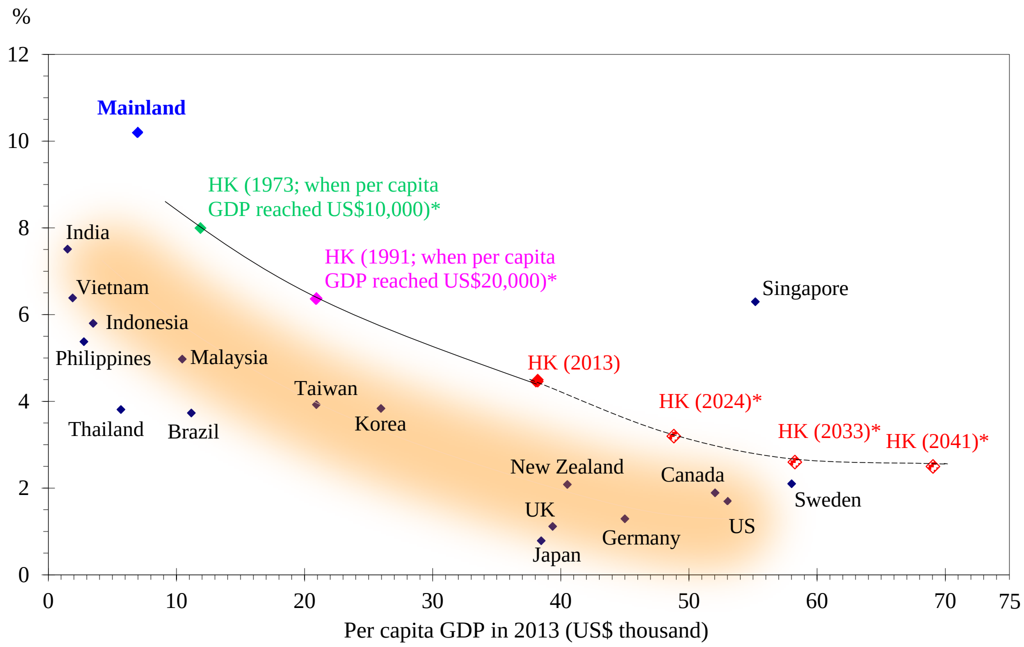
Government expenditure includes repayment of bonds and notes.

3.4 **The community in Hong Kong is ageing, at a pace relatively faster than many other economies**. The age group at or above 65 years old was 15% of the population in 2014, but would be 30% in 2041. The cost of health care and elderly-related welfare services would increase as a share of government expenditure and GDP.

3.5 Assuming that services would only be adjusted to reflect demographic and price changes but would not be enhanced from 2013-14 to 2041-42 (as in the **No Service Enhancement scenario**), the Working Group projected that government **expenditure** would grow at a trend rate of **5.3%** per annum. If services were enhanced and expenditures allowed to grow at 1%, 2% or 3% per annum, the trend rates of government expenditure growth would respectively be 6.0%, 6.7% or 7.5% per annum.

3.6 However, the growth potential of Hong Kong as a mature economy would be constrained by a declining labour force, even assuming that labour productivity would continue to stay at very competitive historical rates. The Working Group projected the long-term trend **GDP** growth at 2.8% per annum in real terms or 4.4% in nominal terms. By way of comparison, the 2004 – 2013 ten-year trend growth of mature economies like the UK, USA and Singapore were 1.1%, 1.7%, and 6.3% respectively. The long term trend growth in government revenue is projected at 4.5% (nominal) per annum.

Chart 3.2 – 10-year trend real GDP growth (2004-2013, unless otherwise stated)



* Per capita GDP figures for these data points are in 2013 constant dollar terms, i.e. they have been adjusted for change in prices over time for more meaningful comparisons. The figures beyond 2014 are projected figures derived from the macroeconomic assumptions under the Base Case and Census and Statistics Department's population projection.

3.7 Read together, the long term expenditure and revenue projections reveal that **structural deficits would surface within a decade under most of the scenarios tested**. Resolute and early action is needed to prepare Hong Kong for coping with the fiscal challenges.

3.8 The Working Group has recommended a full package of measures to step up fiscal discipline and mitigate the damages that fiscal pressures may bring to the community. These are flagged up below –

(a) containing expenditure growth,

(b) preserving, stabilising and broadening the revenue base,

(c) saving for the future,

(d) segregating and balancing the Operating and Capital Accounts,

(e) making clear what the fiscal reserves cover,

(f) stepping up the management of the Government’s assets, and

(g) sustaining the financial health of the Housing Authority.

Government Response

3.9 The Working Group appreciates that the Financial Secretary has taken on board many of the recommendations. Other than considering new policies to enhance labour participation and stimulate economic growth, the Financial Secretary has **launched a series of measures to contain the growth of government expenditure**. The latter includes –

(a) containing overall government expenditure growth within the forecast nominal GDP growth rates over the medium term;

(b) launching a 0-1-1 envelope savings programme (0% in 2015-16, 1% in 2016-17 and 2% in 2017-18 on a cumulative basis) for government operating expenditure for three years;

(c) launching a re-engineering and reprioritisation programme to prompt departments to drop outdated service priorities and re-engineer work procedures to save recurrent expenditure in the coming two to three financial years. The savings will be used to provide new and more targeted services;

(d) requiring the conduct of financial impact assessment for major new policies estimated to cost over $500 million a year;

(e) identifying individual policy areas for fundamental expenditure review to achieve the aim of doing more with less by streamlining procedures or consolidating potentially redundant services;

(f) considering options for multi-year funding for suitable subvented organisations should this save administrative work;

(g) streamlining and simplifying tender requirements and reducing unnecessary assessment criteria for marking schemes to enhance procurement efficiency; and

(h) seeking ten-year projections for capital works projects in critical areas such as developing land, enhancing healthcare and elderly facilities, and improving the environment.

3.10 The Financial Secretary has also **committed to exploring ways to broaden the revenue base**. To avoid excessive reliance on direct taxation, the Government has accorded more priority to indirect taxation and other forms of non-tax revenue collection and will continue to do so. The Government will include indirect tax items, in particular those which have not been adjusted for years, as subjects for regular review.

3.11 In considering the various options on broadening tax revenue in future, the Financial Secretary will have regard to whether the option is effective in broadening the revenue base, fair and in line with the "capacity to pay" principle, and in line with Hong Kong's simple and low tax system.

3.12 To preserve revenue, the Financial Secretary has undertaken to step up tax enforcement and would continue to review fees and charges according to the user-pay principle. As at end 2014, over 1 300 fee items have been reviewed and a further 1 000 fee items are undergoing the process; the net additional revenue arising from this latest round of comprehensive review is about $100 million per annum.

3.13 The Financial Secretary has also **tasked the Working Group to explore and propose options for a savings scheme** (**the "Future Fund"**) for Hong Kong. The Working Group's findings and recommendations are elaborated in **Chapter 1**.

3.14 In accordance with the Long Term Housing Strategy promulgated on 16 December 2014, the public housing supply target is to deliver 290 000 units in the next ten years. To ensure that the Housing Authority has adequate funding to meet that target, the Financial Secretary **announced on 18 December 2014 the establishment of a Housing Reserve** by earmarking the investment return on the fiscal reserves for 2014 (about $27 billion) for such purpose. The Housing Reserve and its investment return will be used to support the public housing development programme and related infrastructure.

3.15 To recapitulate, the Working Group has forewarned in the March 2014 Report that even under the 2013 government commitment to produce an average of 20 000 public rental housing (PRH) and 5 000 Home Ownership Scheme units a year, the Housing Authority would be projected to have a funding shortfall as from 2019-20 and the cumulative shortfall to 2041-42 could be $490 billion (assuming PRH rent could be raised 5% every two years) or $130 billion (assuming PRH rent could be raised 10% every two years). The latest ten-year target of 290 000 units would add to the pressure.

3.16 Given the huge financial commitment needed to support the public housing programme, advance planning is needed. The Financial Secretary intends to make provision for the Housing Reserve when the fiscal position is still steady; the Housing Reserve would be built up by instalments to reduce fiscal volatility. When the Housing Authority is ready and can reach agreement with the Government on the exact quantum and timing of financial support from the Government, formal approval will be sought from the Finance Committee of the Legislative Council for the sum to be appropriated.

Facing the Challenges Together

3.17 The long-term fiscal challenges brought by an ageing population and anticipated slower economic growth are very serious and require the concerted effort of the Government and the community to help drive changes.

3.18 In order to relay the key findings and recommendations of the Working Group's March 2014 Report to the community in a more "user-friendly" manner, four videos and an interactive game have been prepared. Readers are welcome to view the videos and try out the interactive game at the website of the Treasury Branch, Financial Services and the Treasury Bureau (http://www.fstb.gov.hk/tb/en/).

3.19 It is of the utmost importance that the Government and the community work together to maintain strict fiscal discipline as stipulated in Article 107 of the Basic Law by keeping expenditure within the limits of revenues in drawing up the budget, striving to achieve a fiscal balance, avoiding deficit and keeping the budget commensurate with the growth rate of GDP. The Working Group is confident that with resolute and timely action to address the fiscal sustainability issue, the structural deficit problem can be delayed or even averted.

Annex A

Working Group on Long-Term Fiscal Planning

Phase Two

Terms of Reference

1. In furtherance to the recommendations of the Working Group on Long-Term Fiscal Planning as set out in the Report released in March 2014, the Financial Secretary has invited the Working Group to –

(a) explore and propose options for a savings scheme (the "Future Fund") for Hong Kong, covering –

   (i) intended objectives of the Fund;

   (ii) governance and mode of operation;

   (iii) target saving level and mode of building up the savings;

   (iv) investment target and strategy;

   (v) circumstances triggering withdrawal;

(b) advise on how the Government can step up the management of its assets, including investments in government business enterprises and fixed assets, with a view to increasing the financial return to help reduce the fiscal pressures in the coming decades; and

(c) advise on how the key findings and recommendations of the Working Group, where agreed to be adopted by the Financial Secretary, may be relayed to the community in a sustained and effective manner. This includes developing analytical tools or communications strategies to facilitate better understanding of the fiscal challenges that Hong Kong faces in the medium to long term.

2. The Working Group will tender its advice to the Financial Secretary by end 2014 at the earliest.

Working Group on Long-Term Fiscal Planning

Phase Two

Membership

Chairperson

Ms Elizabeth Tse	Permanent Secretary for Financial Services and the Treasury (Treasury)

Non-official Members

Professor Liu Pak-wai	Research Professor Institute of Global Economics and Finance The Chinese University of Hong Kong
Professor Francis Lui	Director of Center for Economic Development Professor of Economics The Hong Kong University of Science and Technology
Mr Mark Saunders	Group Chief Strategy and Marketing Officer AIA Group Limited
Mrs Jennifer Wong	Former Partner KPMG
Mr Marcellus Wong	Senior Adviser PricewaterhouseCoopers

Ex-officio Members

Mr Martin Siu	Director of Accounting Services
Mrs Helen Chan	Government Economist
Ms Esther Leung	Deputy Secretary for Financial Services and the Treasury (Treasury)1

Secretary

Ms Susanna Cheung	Principal Assistant Secretary for Financial Services and the Treasury (Treasury)(H)

Annex B

Background on the Land Fund

The Sino-British Joint Declaration stipulated that premium income received by the Hong Kong Government from land transactions during the period from 27 May 1985 and up to 30 June 1997 shall, after deduction of the average cost of land production, be shared equally with the future Hong Kong Special Administrative Region Government (HKSARG). A HKSARG Land Fund was thus established in 1986 by the Chinese side in the Joint Liaison Group by way of a Deed of Declaration of Trust for the purpose of holding in trust for the future HKSARG its share of the land premium income.

2. With the establishment of the HKSARG on 1 July 1997, the assets of the HKSARG Land Fund with a net value of $197 billion were handed over to the HKSARG and the Deed of Declaration of Trust ceased to have effect. It was thereafter for the HKSARG to decide how the Fund should be expended. The Chief Executive appointed the Financial Secretary as the public officer to receive these assets as part of the HKSARG fiscal reserves. These assets became part of the general revenue[1] in accordance with section 3 of the Public Finance Ordinance (PFO) (Cap. 2). Following the establishment of the HKSARG, all income from land premium is credited directly to the Capital Works Reserve Fund for the purposes of financing the capital works programme and the acquisition of land.

3. As the HKSARG had not yet decided on the long-term use of the assets held in the trust fund, a separate fund, namely the Land Fund, was established by Resolution made and passed by the Provisional Legislative Council under section 29 of the PFO to receive, hold and invest the assets of the HKSARG Land Fund on 1 July 1997.

---

1 Section 3 of the PFO stipulates that except where otherwise provided by or under the PFO or any other enactment, any moneys raised or received for the purposes of the Government shall form part of the general revenue.

An electronic copy of the report is available at the website of the Treasury Branch, Financial Services and the Treasury Bureau (http://www.fstb.gov.hk/tb/en/)