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.