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The 2015-2016 Budget

March 2015

Two themes stated in the last year's budget have recurred in this year's budget. One is the possible appearance of a structural fiscal deficit within a decade, and the second is the need for continuing the one-off relief measures.

Faced with the possible structural fiscal deficit, the Financial Secretary has proposed to establish the Future Fund for seeking higher returns on the fiscal reserves through long-term investment. Indeed, the rate of investment returns was on the decline between 2009 and 2014, notwithstanding the increase in the amount of fiscal reserves the Government has placed with the Exchange Fund for investment income in recent years.

On the one-off relief measures, the Financial Secretary has set aside about 50% of the budget surplus on tax reductions, rates concession and other relief measures. Yet the impact of these measures is likely to be diluted in view of the high import leakage arising from Hong Kong's being an externally oriented economy.

Singapore announced its budget in the same week as Hong Kong. It features an alternative fiscal strategy of placing a greater weight on building its future through measures such as increase in continued education and training spending, more support for innovation and internationalization activities undertaken by Singaporean companies, and infrastructure investment.

The Council will resume the Second Reading debate on the Appropriation Bill 2015 at its meeting of 15 April 2015.

1. Background

1.1 The Financial Secretary delivered his eighth budget speech on 25 February 2015. Two themes stated in the last year's budget have recurred in this year's budget. One is the possible appearance of a structural fiscal deficit within a decade[1], and the other is the need for one-off relief measures to provide cushioning effects for the local economy and alleviate imminent economic hardships.

1.2 In his budget speech, the Financial Secretary has alerted the public to the possible structural fiscal deficit and the need for timely and early actions to avert the problem. The latter include measures to contain public expenditure, preserve the revenue base and save up in a timely manner to avoid the appearance of the structural fiscal deficit. On saving for the future, the Financial Secretary has accepted the recommendation of the Working Group on Long-Term Fiscal Planning to establish the Future Fund. The Fund is made up of HK$220 billion from the existing Land Fund and 25%-33% of the annual budget surplus as periodic top-ups.

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1 According to the report released by the Working Group on Long-Term Fiscal Planning in March 2014, the structural fiscal deficit could surface within a decade under most of the scenarios tested by the Working Group.

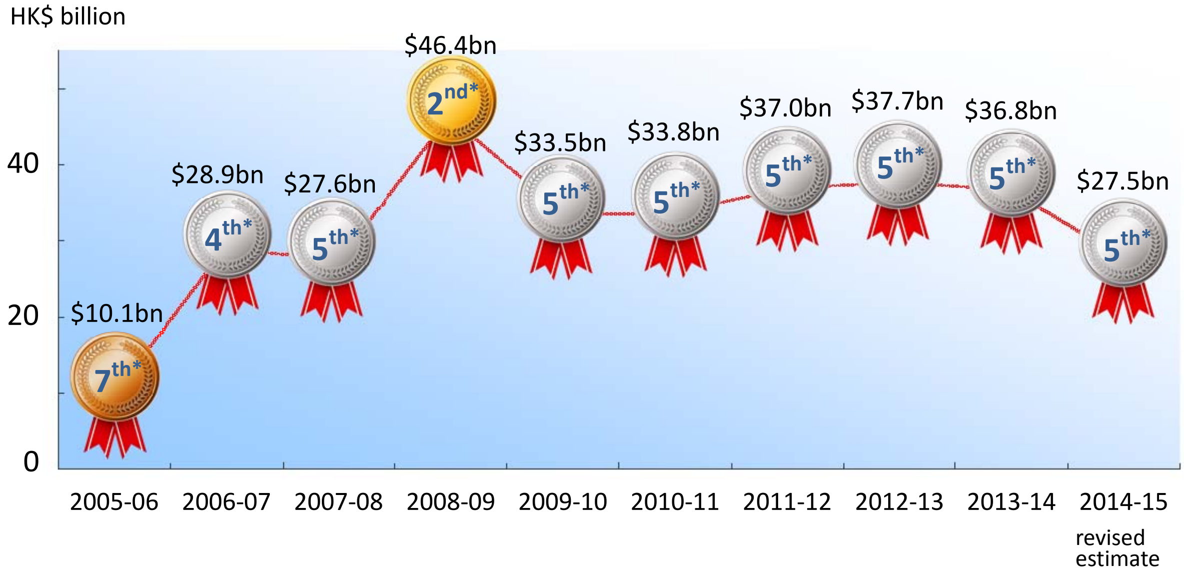
1.3 The Financial Secretary has continued the one-off relief measures in this year's budget. The Government recorded a better-than-expected budget surplus of HK$63.8 billion for the Financial Year ("FY") 2014-2015[2], which provided it with the fiscal capacity to introduce six one-off relief measures comprising tax rebates, rates concession, increased child allowance, extra social welfare payments and public rental waivers.

2. Measures to address structural fiscal deficit

2.1 Faced with a possible structural fiscal deficit, the Financial Secretary has announced in his budget speech preventive measures that address both expenditure and revenue sides of the public finances. On the expenditure side, the Government has launched the "0-1-1" envelope savings programme to contain public expenditure growth.[3] On the revenue side, the Financial Secretary proposes to explore again the feasibility of broadening the tax base, and establish the Future Fund to seek higher returns on the fiscal reserves through long-term investment.

2.2 While broadening the tax base may help stabilize the government revenue, any proposals for the introduction of a new tax may need to be premised on the collective consensus of the community and public support. Hence, another feasible alternative may be to invest the fiscal reserves for higher returns to address the possible structural fiscal deficit from the revenue side. Indeed, as shown in **Figure 1**, investment income from the fiscal reserves had been the fifth major contributor to the government revenue during most of the past decade.

Figure 1 – Investment income from the fiscal reserves, FY2005-2006 to FY2014-2015



Note: (*) Ranking among the major sources of the total government revenue.
Sources: Budget speech (various years) and Financial Services and the Treasury Bureau.

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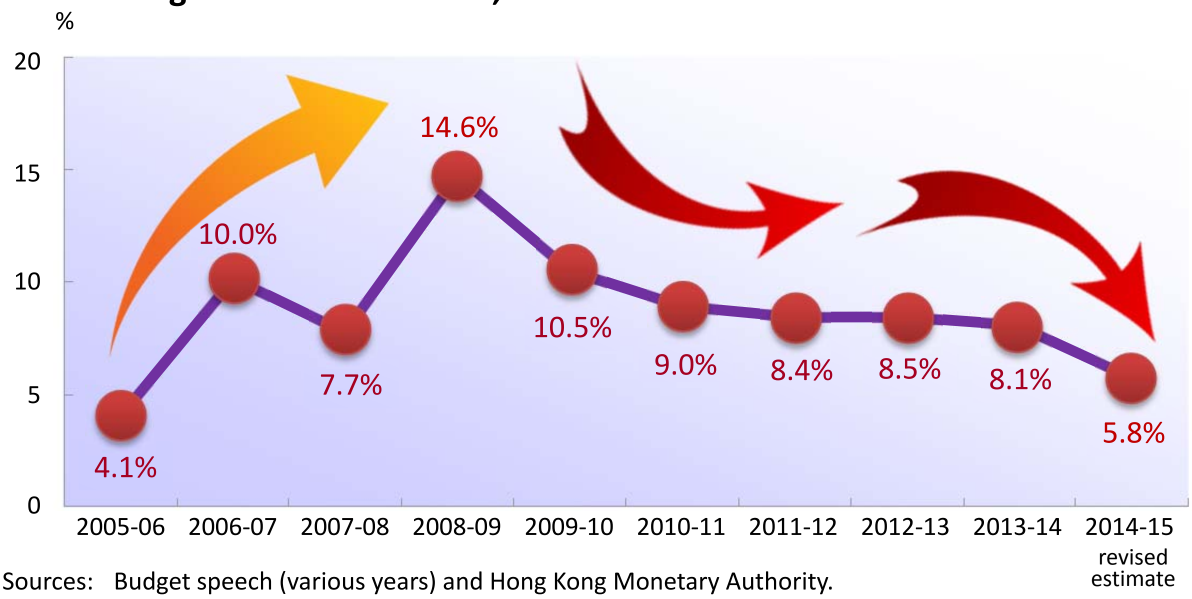
[2] The budget surplus was seven times the amount of HK$9.1 billion originally forecast by the Financial Secretary.
[3] The "0-1-1" programme is to reduce operating expenditure by a total of 2% over the next three financial years.

2.3 At present, the Government's fiscal reserves are placed with the Investment Portfolio of the Exchange Fund in return for investment income.[4] Under the current fee arrangement introduced on 1 April 2007, the investment income received by the Government from Hong Kong Monetary Authority ("HKMA") is calculated based on the average annual rate of return of the Investment Portfolio for the past six years[5]. There is also a guaranteed minimum return to ensure that the annual investment return in any year will not be lower than the average annual yield of three-year Exchange Fund Notes for the previous year.

2.4 The contribution of the investment income from the fiscal reserves to public coffers has been on the decline since FY2009-2010 (**Figure 2**). After reaching a high of HK$46.4 billion or 14.6% of the total government revenue in FY2008-2009, it has declined since then to reach a low of HK$27.5 billion or 5.8% in FY2014-2015. This was notwithstanding the surge in the amount of the fiscal reserves placed with the Exchange Fund during the period, which increased by 66% from HK$494.4 billion in FY2008-2009 to HK$819.6 billion in FY2014-2015. The reduced contribution of the investment income to public coffers mirrored the downtrend in their rates of return from 9.4% in 2008 to 3.6% in 2014, the second lowest in the last decade (**Figure 3**).

Figure 2 – Investment income from the fiscal reserves as a percentage of total government revenue, FY2005-2006 to FY2014-2015



Sources: Budget speech (various years) and Hong Kong Monetary Authority.

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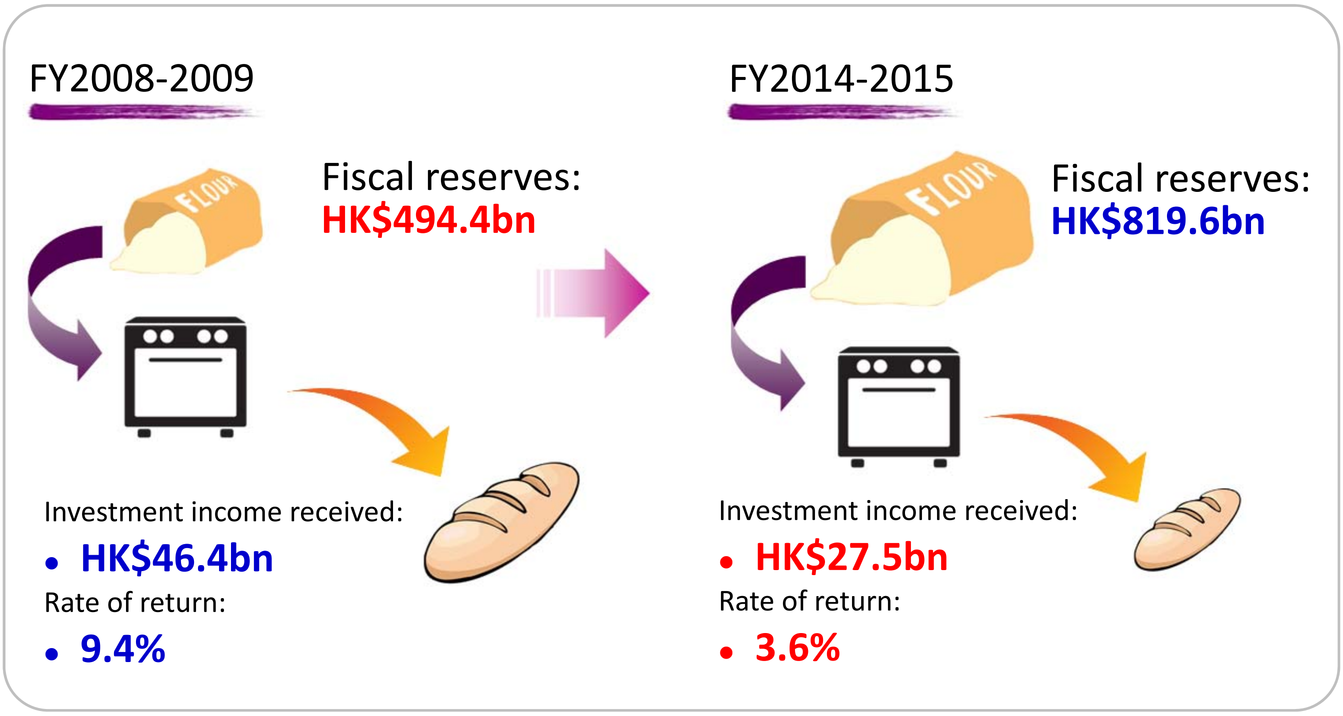
4 This arrangement was made in 1976 when the Government began to transfer its fiscal reserves to the Exchange Fund. According to the Hong Kong Monetary Authority, this new arrangement not only allows the fiscal reserves to be invested prudently, but also enhances the resources available to the Exchange Fund to perform more effectively its statutory functions as stipulated in the *Exchange Fund Ordinance*. See Hong Kong Monetary Authority (2014).

5 The Government has twice revised the fee arrangement for the fiscal reserves placed with the Exchange Fund before 1 April 2007. Prior to 1 April 1998, the fiscal reserves were placed as deposits with the Exchange Fund and received interest according to market rates. During the period from 1 April 1998 to 31 March 2007, the annual rate of return for the fiscal reserves placed with the Exchange Fund was linked to the rate achieved by the Fund.

Figure 3 – Amount of fiscal reserves placed with the Exchange Fund and the investment return achieved, FY2008-2009 and FY2014-2015

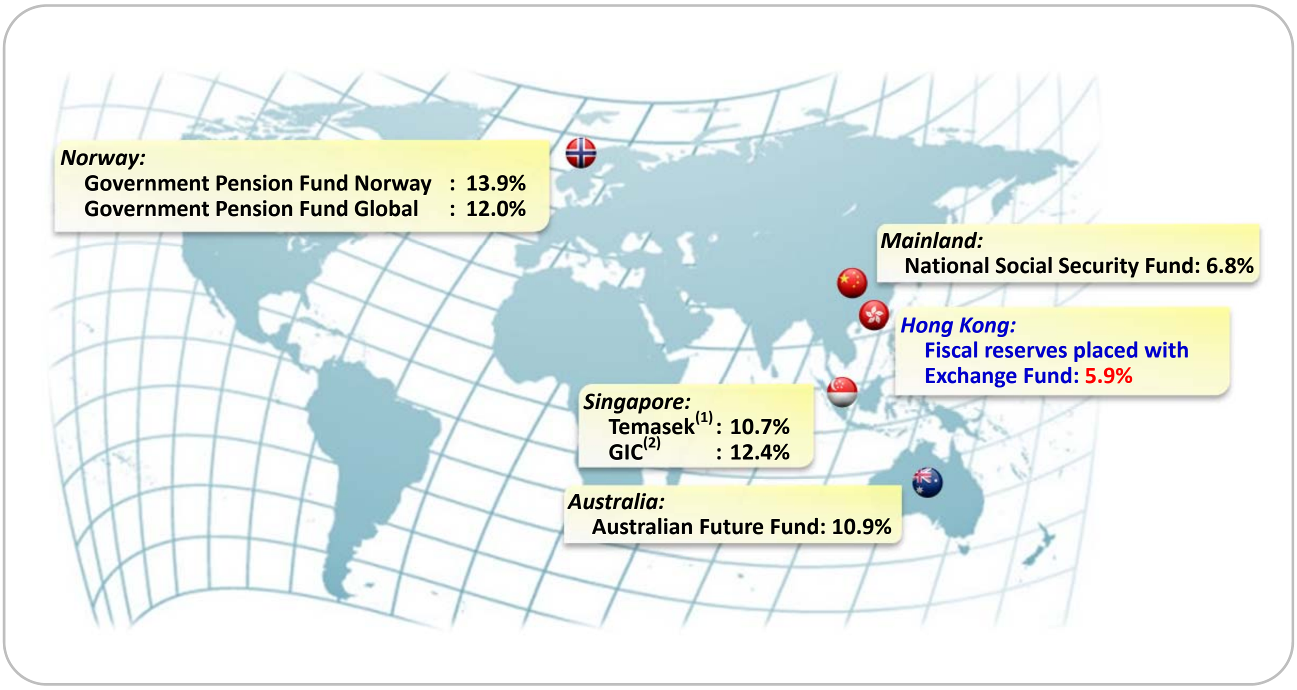


Sources: Budget speeches (FY2009-2010 & FY2015-2016) and Hong Kong Monetary Authority.

2.5 Reference can be made to the experience of other places that have accumulated large fiscal and foreign reserves. In many cases, these places have established sovereign wealth funds ("SWFs") to manage their reserves for a variety of purposes ranging from preparing for an ageing society to smoothing cyclical fluctuations in government expenditure.

2.6 Based on the latest statistics available, the average annual rates of return for some of the world's largest SWFs during 2009-2013 are shown in **Figure 4**. The return rates ranged from 6.8% to 13.9% which reflected the different investment strategies adopted by these SWFs.

Figure 4 – Average annual rates of return on Hong Kong's fiscal reserves and major sovereign wealth funds, 2009-2013



Notes: (1) Investment portfolio managed by the Temasek Holdings of Singapore.
(2) Investment portfolio managed by the Government of Singapore Investment Corporation (GIC).

Sources: Sovereign Wealth Fund Institute, Hong Kong Monetary Authority, National Council for Social Security Fund of China, Temasek Holdings, Government of Singapore Investment Corporation, Ministry of Finance of Norway, Folketrygdfondet and Future Fund Management Agency of Australia.

2.7 As shown in **Figure 4**, the Government Pension Fund Norway was among the best-performing sovereign wealth funds during 2009-2013. It achieved an average annual investment return of 13.9% over the period, due to its active investment strategy targeting to invest 60% in equities and 40% in bonds. For the more conservative National Social Security Fund ("NSSF") of the Mainland, it managed to achieve an average investment annual return of 6.8% during 2009-2013. According to NSSF[6], it adheres to an investment policy of "Safety Priority and Prudent investment" while pursuing an investment philosophy of "Valuable investment, Long-term investment and Responsible investment."

[6] See National Social Security Fund (2010).

2.8 Higher investment returns on the fiscal reserves will provide the Government with a greater fiscal capacity[7] for spending on public infrastructure, human resources and/or other areas to the benefit of the people. Yet, the current arrangement of placing the fiscal reserves with the Investment Portfolio of the Exchange Fund might affect the choice of investment strategies and hence explain the low investment income the Government received in recent years. According to HKMA, the Investment Portfolio mainly holds bonds, supplemented by some equities, in order to preserve capital as well as liquidity. Its investment return is less attractive vis-à-vis the Long-Term Growth Portfolio[8] established by HKMA in 2008, when the Exchange Fund started to diversify its investment into higher return new asset classes.

2.9 At present, the Long-Term Growth Portfolio mainly holds private equity investments and real estate assets. In 2014, it achieved an annualized since-inception internal rate of return of 13.5%. Compared with the annual rate of return of 2% achieved by the Investment Portfolio in 2014, the attractive return of the Long-Term Growth Portfolio has led the Working Group on Long-Term Fiscal Planning to propose setting aside about 50% of the Future Fund into the Long-Term Growth Portfolio.

3. Investing for long-term growth

3.1 In his FY2015-2016 budget speech, the Financial Secretary announced to continue the one-off measures implemented in recent years. These measures amounted to HK$34 billion or about 50% of the budget surplus, aiming to "alleviate the financial burden of the public, stimulate consumption, stabilise the economy and preserve employment."[9] Yet the impact of these relief measures is likely to be diluted as it filters through the local economy[10]. Hong Kong is a highly externally-oriented economy and any additional spending by the benefit recipients will soon get spent on imported goods and services. Reflecting the high import leakage, the United Nations estimated Hong Kong's private consumption expenditure multiplier at 0.86 in 2010.[11] That means, a HK$1 increase in consumer spending in a given year only contributes an additional HK$0.86 to Gross Domestic Product ("GDP") in that year.

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7 The Government would have received an extra HK$7.6 billion in investment income should the investment returns on the fiscal reserves placed with the Exchange Fund be raised by one percentage point in 2014.

8 The Exchange Fund also consists of another portfolio, the Backing Portfolio, which holds highly liquid US-dollar debt securities to provide full backing to the Monetary Base as required under the Currency Board arrangement.

9 See 2015-2016 Budget Speech.

10 See Yip (2014).

11 See United Nations (2010).

3.2 Singapore announced its FY2015 Budget in the same week as Hong Kong, which represents an alternative fiscal strategy. The budget was widely reported as a forward looking one with long-term investment in building skills and capacity that would prepare Singapore for future challenges.[12] Singapore's budget, with the theme "Building Our Future, Strengthening Social Security"[13], comprises the following four key areas of focus:

(a) investing in skills of the future – continued education and training spending to be increased to an average of over S$1 billion (HK$6.1 billion) per year from 2015 to 2020;

(b) promoting innovation and internationalization – more support for innovation and internationalization activities, e.g. government grants for small and medium enterprises to innovate and a new tax incentive for the Singapore companies to expand overseas;

(c) investing in infrastructure to meet future economic and social needs – including the development of Changi Airport Terminal 5, enhancement of the public transport system and healthcare infrastructure; and

(d) building a fair and just society with a focus on supplementing retirement incomes of the needy elderly.[14]

3.3 In the case of Hong Kong, a vast amount of public resources has been budgeted for infrastructure spending over the last decade. Analyzed by policy area group, public expenditure on infrastructure increased by an annual average of 7.4% between FY2005-2006 and FY2014-2015 (**Figure 5**). The growth rate was higher than that of other policy group areas related to long-term development of Hong Kong, such as health[15], education and economic.

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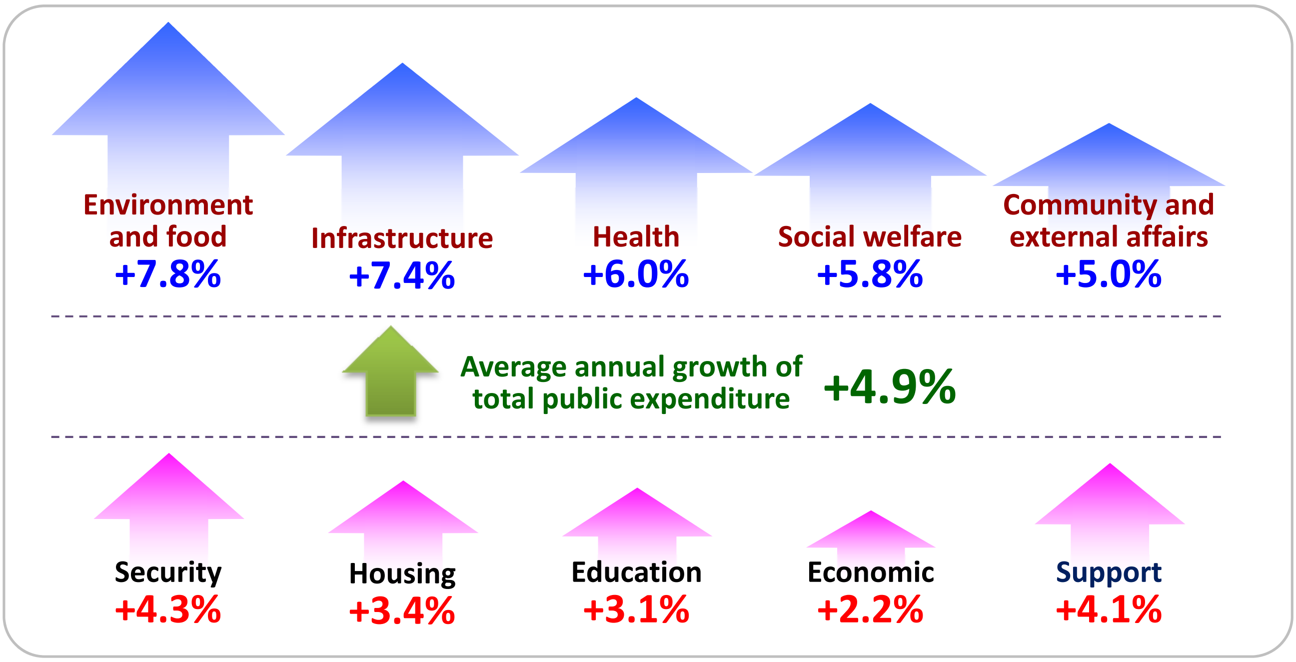
[12] See, for example, DBS Group Research (2015), KPMG (2015) and The Business Times (2015).

[13] Singapore also announced short-term relief measures in its FY2015 Budget. The relief measures include the Enhanced GST Voucher Scheme, Service and Conservancy Charges Rebates, personal tax income rebate and levy reduction for hiring foreign domestic workers, which cost Singapore a total of S$1.3 billion (HK$8.0 billion).

[14] For FY2015, Singapore is expected to run a budget deficit of S$6.7 billion (HK$41 billion), which is equivalent to 1.7% of GDP. The deficit is mainly due to S$6 billion (HK$37 billion) set aside for investments in Changi Airport, research and productivity.

[15] According to the European Commission (2013), cost-effective and efficient health spending is a productive or growth-friendly type of expenditure. Investing in health will improve the employability of people of working age and enable them to stay longer in the workforce. It also helps limit future costs related to the treatment of preventable diseases.

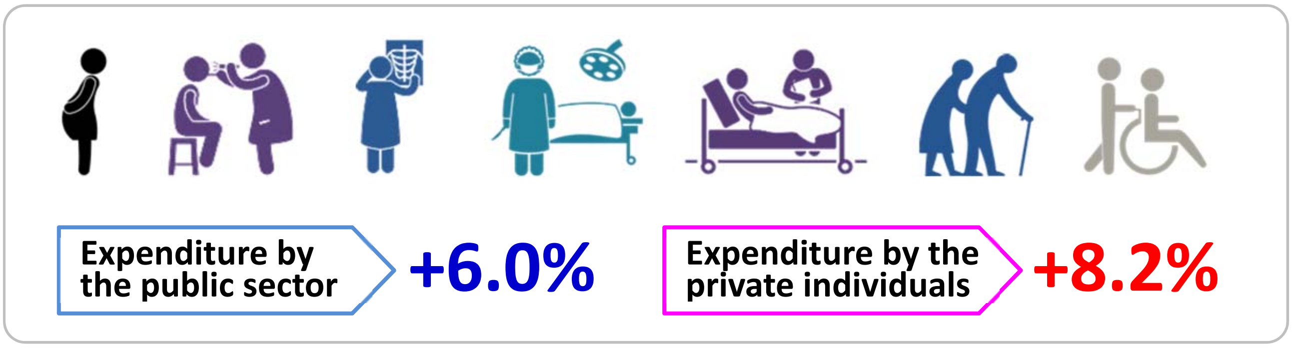
Figure 5 – Average annual growth of public expenditure by policy area group, FY2005-2006 to FY2014-2015



Sources: Budget speech (various years) and Census and Statistics Department.

3.4 During 2005-2014, public health expenditure increased by an annual average of 6.0% while private consumption expenditure on health services increased by 8.2%[16] (**Figure 6**). This could be translated into an increasingly higher share of private consumption expenditure on health services to total health expenditure. According to the latest data available from the Food and Health Bureau[17], the share of private health expenditure to the total health expenditure has been steadily on the rise from 45.6% in 2005 to 51.7% in 2012.

Figure 6 – Average annual growth of health expenditure, 2005-2014



Sources: Budget speech (various years) and Census and Statistics Department.

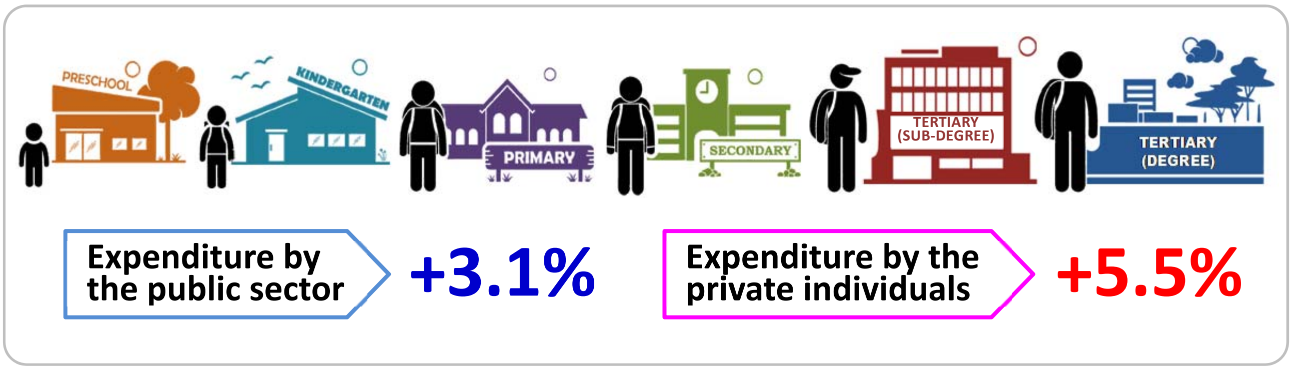
[16] Due to data limitation, financial year figures have been adopted in calculating the growth rate of public health expenditure, whereas calendar year figures have been adopted in calculating the growth rate of private consumption expenditure on health services.

[17] See Food and Health Bureau (2015).

3.5 For public education expenditure, it increased by an annual average of 3.1% between 2005 and 2014. The slow growth is of particular concern in view of the keen demand for workers with better knowledge with the transformation of Hong Kong into a more knowledge-based economy. Furthermore, investing in educational capital is widely considered as the most important means of raising productivity over the long term. Higher productivity helps maintain Hong Kong's trend GDP amid its dual challenges of an ageing population and a shrinking labour force.[18] As an indication of the extent to which education increases individuals' productivity, a study conducted by the Organisation for Economic Co-operation and Development ("OECD") in 2013 showed positive returns for continuing on to tertiary education after upper secondary education in all the OECD countries with data[19]. The rates of return averaged at 13.0% for men and 11.5% for women.

3.6 While public education expenditure increased by an annual average of 3.1% during 2005-2014, the corresponding growth rate for private consumption expenditure on education services was 5.5%[20] (**Figure 7**). Putting this into perspective, for every HK$100 spent by the Government on education, the additional amount spent by the private individuals increased from HK$34 in 2005 to HK$43 in 2014.

Figure 7 – Average annual growth of education expenditure, 2005-2014



Sources: Budget speech (various years) and Census and Statistics Department.

3.7 The above trend was attributable to, among others, increased private investment on education by parents and/or students themselves in recent years. On pre-primary education, the percentage of kindergarten students paying full

[18] See Wong (2013).
[19] The study was based on the 2009 figures or the latest figures available. See Organisation for Economic Co-operation and Development (2013).
[20] Due to data limitation, financial year figures have been adopted in calculating the growth rate of public education expenditure, whereas calendar year figures have been adopted in the calculation for private consumption expenditure on education services.

tuition fees increased from 12.8% in 2007-2008 to 24.7% in 2014-2015. This reflected the increase in the number of kindergartens not participating in the Pre-primary Education Voucher Scheme ("PEVS") [21] from 146 to 254 over the period.

3.8 As to higher level of education, the percentage of primary students enrolled in those schools collecting school fees (i.e. direct subsidy scheme schools, private schools and international schools) increased from 11.3% to 19.0% between 2004-2005 and 2013-2014. The corresponding share for secondary students exhibited a similar rising trend from 12.6% to 18.5% over the same period. On tertiary education, the increase in the supply of self-financed first-year tertiary education places (9 170) outpaced that of publicly-funded (3 908) between 2004-2005 and 2013-2014.

3.9 Another noteworthy trend in public expenditure is the much lower growth rate of the government's spending on the policy area group "economic", which comprises the expenditure spent on nine policy areas[22] closely related to the economic development of Hong Kong. The growth rate, at an annual average of 2.2% between FY2005-2006 and FY2014-2015, was the lowest among all policy area groups. It was also lower than the annual average inflation rate of 3.0% over the period (Figure 5).

4. Observations

4.1 Two themes stated in the last year's budget have recurred in this year's budget. One is the possible appearance of a structural fiscal deficit within a decade, and the other is the need for continuing the one-off relief measures implemented in recent years. On these two themes, there are several areas which warrant special attention:

(a) faced with the possible structural fiscal deficit, the Financial Secretary has proposed establishing the Future Fund to seek higher returns on the fiscal reserves through long-term investment. This echoes similar calls from the local community in view of the recent years of reduced investment returns on the fiscal reserves placed with the Investment

[21] The Government introduced the non-means-tested PEVS in 2007-2008. The scheme provides direct fee subsidy for parents of children attending local non-profit-making kindergartens under PEVS.

[22] These nine policy areas are: (a) air and sea communications and logistics development, (b) commerce and industry, (c) employment and labour, (d) financial services, (e) information technology and broadcasting, (f) manpower development, (g) ports, competition policy and consumer protection, (h) public safety, and (i) travel and tourism.

Portfolio of the Exchange Fund. In FY2014-2015, investment income from the fiscal reserves contributed only HK$27.5 billion or 5.8% of the total government revenue, compared with a high of HK$46.4 billion or 14.6% in FY2008-2009;

(b) Singapore announced its FY2015 budget in the same week as Hong Kong, which represents an alternative fiscal strategy. It puts a greater emphasis on building its future with the use of public resources more on investment expenditure items;

(c) in the case of Hong Kong, public expenditure on infrastructure increased more rapidly than that on the policy area groups of health, education and economic. The slow growth of public education expenditure is of particular concern in view of the need to raise productivity over the long term amid the population ageing and associated shrinking labour force in Hong Kong; and

(d) private spending on health and education services has grown at a faster pace than the corresponding expenditure by the public sector. During 2005-2012, the share of private health expenditure to the total health expenditure increased from 45.6% to 51.7%. As regards education services, for every HK$100 spent by the Government on education, the additional amount spent by private individuals increased from HK$34 in 2005 to HK$43 in 2014. In other words, a higher share of private consumption expenditure on health and education services is observed.

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