Managing Financial Resources in Achieving Policy Objectives of the Hong Kong Special Administrative Region Government

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(The following is a speech by the Acting Chief Executive & Financial Secretary, Mr. John C. Tsang, delivered at the AGM and Luncheon of the Hong Kong Public Administration Association, held in the Hong Kong Polytechnic University on 17 June, 2016.)

Peter (President of the Hong Kong Public Administration Association, Prof. Peter Fong), distinguished guests, ladies and gentlemen,

It is my great pleasure to be here with you all today. I was told a while ago that I could speak on any topic that I thought appropriate and Peter, let me remind you, that kind of invitation in the wrong hands could be a very big mistake. But relax, I shall not overstep my boundaries on this occasion. I do not intend to spring any surprises today. So I'd like the friends from the media to know that. No surprises today.

About this time last month, LegCo (the Legislative Council) passed the Appropriation Bill 2016, putting an end to the long drawn-out but rather eccentric discussion on the Bill. As with the case of my previous Budgets that were also punctuated heavily with filibusters, this year the interests of the public and the media focused mainly on the relief measures, and not the politically laden proclamations and proposed amendments. Thus spoke pragmatic Hong Kong.

Since matters on the current state of our public finance and how we are managing our financial resources in achieving our policy objectives have not been extensively articulated, I thought it would be a good opportunity for me to do so today.

I fully understand that this topic is not exactly the most interesting thing for listeners, especially after a gratifying meal. So I promise that I shall keep my talk as short as I can, to about 10, 15 minutes, and hopefully, you can stay awake during the talk. Meanwhile, maybe you can order some coffee.

Let me first set the scene with some upbeat news. You will be happy to know that the state of our public finance remains healthy. We have experienced 12 successive years of budget surpluses, and yours truly has been Financial Secretary for nine of those 12 years.

We are, by and large, government with a small "g". Public expenditure constitutes about 20 per cent of our GDP. Government revenue generally matches that, roughly equivalent to about 20 per cent of GDP as well. Our fiscal reserves exceed HK$800 billion - about 35 per cent of our GDP.

That should be good news, particularly for, say, ministers from Europe, they would love to hear something like that. But there is always the flip side of the coin. And that relates to matters that are of serious concern to us. The biggest concern of all is that our labour force is set to decline from around 2018, resulting in the reduction of our tax income as well as constraints on our economic growth.

In the event, how should we manage the contraction of our tax income? Would raising taxes help compensate for the reduction in our working population? Would the younger generation be able to afford higher taxes? Would government have the resources to expand services for the growing number of our older generation? These are all good public administration questions and I'm sure an esteemed body like yourselves would be in a very good position to deal with some of them.

In the next few minutes, I would like to share with you our thinking in striking the right balance in response to some of these pertinent questions.

Some have said that we could have spent a great deal more on services for the people in Hong Kong, if not for the underestimation of Government revenue. I can assure you that it is not intentional on our part to underestimate our income, but as an open and small economy, we are often subject to the whims of the volatile external sector.

I can also assure you that we have not constrained our expenditure because of the underestimation of our income. In fact, for the decade between 2006-07 and 2016-17, our GDP grew by 65 per cent, Government revenue grew by 73 per cent and Government expenditure by 115 per cent, all on a cumulative basis. In short, Government expenditure has grown a lot faster than revenue growth, while the economy lagged behind both.

We need to focus on the discrepancy of the speed of growth of our revenue and expenditure as well as the economy. Occasional revenue windfalls cannot justify more rapid expenditure growth, especially expenditure on a recurrent basis. We need to find a delicate, but most importantly, a sustainable, balance among these three factors.

So while we are here — and, I trust, most of you are still somewhat conscious — let me touch on our fiscal reserves. Given that they exceed HK$800 billion, are we being overly prudent with Government expenditure? Are we insensitive to the needs of the community? Should we not dip into our reserves, or as some have suggested, our Exchange Fund?

Perhaps I should, first of all, make clear that we cannot just take money from the fiscal reserves to cover spending in the implementation of policies without recourse to

LegCo. As a matter of fact, much of the fiscal reserves are actually locked up in funds with designated uses, such as funds for supporting public works projects, funds for paying pensions to public officers, as well as funds for financing innovation and technology projects, etc.

It is true that, in absolute dollar terms, our fiscal reserves have more than doubled from HK$369 billion to HK$854 billion over the past decade. But so did Government expenditure. In terms of months of Government expenditure that our reserves can cover, the number has remained quite constant, about 20 or so.

I should add that the fiscal reserves are all that we have to meet our day-to-day operational needs, to meet our outstanding commitments for capital works as well as our liabilities, such as pensions for public officers. Just to give you some perspective. Outstanding commitments for capital works projects underway amount to over HK$300 billion. These are bills we have to pay. The value of pensions as of March 2015 has reached a substantial level of $816 billion. This is the total amount, and we only need to pay out about HK$30 billion each year. But it is still a large commitment.

The fiscal reserves can be quickly depleted, as the deficit years between 1998-99 and 2003-04 demonstrated all too well. During that period, Hong Kong faced severe economic downturns and 40 per cent of our fiscal reserves were depleted in one go. The reserves provide us with a shock-absorbing cushion during these economic bad times.

The primary objective of the Exchange Fund, as laid down in the Exchange Fund Ordinance, is to affect the exchange value of the currency of Hong Kong for the purpose of maintaining the monetary and financial stability of Hong Kong. It is essential that we maintain a sizable Exchange Fund that is commensurate with the scale of Hong Kong's financial system in order to deal with potential risks and to stabilise the financial system, and preserve market and public confidence during unforeseen circumstances.

And coming back to our topic today, the management of public finance is really an art — the art of allowing expenditure to grow, while containing the growth to align with GDP and revenue growth; the art of acceding to some expenditure demands but declining others, when all seem well justified in isolation; the art of balancing short-term needs and long-term fiscal sustainability. The art, too, of relaying the inconvenient truth - that resources are limited - without being chased out of town, hopefully.

Allow me now to explain how we have allocated Hong Kong's money.

You should be interested to know that in the past 10 years, recurrent expenditure for social welfare has increased by 104 per cent; for health, it's up 92 per cent; and for education, it has climbed 70 per cent from a very high base. Despite these significant increases, we still have been able to add to our reserves, gathering resources that would protect us from the rainy days ahead.

Major recurrent funding initiatives in these past few years include the 3-3-4 new senior education structure reform, the Old Age Living Allowance, the HK$2,000 Elderly Healthcare Voucher Scheme, the Low Income Family Allowance and the HK$2 public transport subsidy scheme for those who are 65 and above and for the disabled.

These are all big-ticket items. In the past six years, for example, annual spending on the healthcare voucher scheme has risen from HK$100 million to HK$1.3 billion — up 13 times. As for the HK$2 public transport subsidy scheme, it has risen from HK$200 million per year to HK$1.1 billion — a five and a half-fold increase.

From 2017-18 on, Government will spend about HK$6.7 billion per year to implement our new free kindergarten education policy. This will more than double our existing recurrent funding on pre-primary education. This is money well spent, I agree, but it is still a large sum. Not exactly chicken feed.

We have also been investing heavily in capital works projects, from healthcare and education, to sports, recreation and district facilities. Capital works expenditure last year was HK$76 billion, and it will remain at this high level and more for the next few years.

These expenditures, I should add, have yet to reflect the fiscal pressure emanating from our aging population. If we were to continue at this level of spending, we run the risk of a structural deficit, as clearly articulated in the study by our Working Group on Long-Term Fiscal Planning.

Which is why we are making strenuous efforts to contain expenditure growth. Among other things, we have initiated a three-year programme to achieve efficiency savings of 2 per cent, just 2 per cent, from operating expenditure, beginning in 2015-16.

We are encouraging departments to re-engineer and re-prioritize — we call that R&R — in order to free up savings for new or enhanced services. This is also a good opportunity for our controlling officers to have a good look at their baselines and the services that they have been rendering.

To stabilise revenue, we are reviewing fees and charges in accordance with cost-recovery and user-pays principles. Income, as an example, from fees and charges, amounts to around HK$15 billion per year.

As to new taxes and ways to broaden our tax base, we keep an open mind, because I fully recognise the difficulty in forging any form of consensus on this most contentious political issue of all. In formulating options for expanding tax revenue, we should insist, and we would insist, that any such measures should be fair and ably reflect the capacity-to-pay principle. They should also be in line with Hong Kong's simple and low tax system.

We have also been formulating strategic investment and savings plans to better

cope with known fiscal challenges. In January this year, we established the Future Fund, created to secure higher overall returns for Hong Kong. Rather than investing all of our fiscal reserves in highly liquid, conservative investment options, we have allocated a portion for investment in longer term, higher-risk assets.

The Future Fund is the part we have set aside for longer-term investments. Other than the initial endowment of HK$220 billion, we shall be injecting about one-third of the HK$14.4 billion actual surplus for 2015-16 into the Future Fund as a top-up, come July 1. That amounts to about HK$4.8 billion.

We have also established a Housing Reserve, using the investment returns in 2014-15 and 2015-16, in order to assist the Housing Authority to fulfil its 10-year housing objective despite its depleting financial situation. Our Housing Reserve balance, by the way, now stands at HK$74 billion.

Securing Hong Kong's future, of course, demands more than containing expenditure, more than stabilising revenue, and more than clever saving and clever investing. We need, as well, to ensure that our economic growth engine continues in high gear.

But that's another bedtime story, one that I'll save for another day when I am invited back again.

So for you ladies and gentlemen who are still awake, that is my story for today. I originally allotted time for some questions but I do need to run off to attend to some urgent issues, so I do apologise, and I look forward to speaking with you again soon. So now back to you, Peter.