STRUCTURAL vs CYCLICAL

36. While cyclical features with impact on fiscal revenue and expenditure ostensibly existed in the period between 1998-99 to 2001-02, the persistence of deflation and asset price downdrift has given rise to the concern that there could be more deep-seated forces at play which might have affected, in a material way, the generation of government revenue and the management of government expenditure.

37. On the revenue side, the Task Force has identified a few features which have given or may give rise to structural consequences.

38. First, the Task Force considers that a fundamental change has occurred in the **property market**, making it a much smaller generator of government revenue, whether directly in the form of premiums (from land sales and land use modifications) and stamp duty (from property transactions) or indirectly through property-related profits tax revenue. From a high of $63.6 billion in 1997-98, being 4.8% of GDP, the yield of land premium has declined substantially to an estimated $8.6 billion in 2001-02, being only 0.7% of GDP. The yield in money terms is set out in Table 8 below.

Table 8 – Revenue from Land Premium

Fiscal Year	1991-1992	1992-1993	1993-1994	1994-1995	1995-1996	1996-1997	1997-1998	1998-1999	1999-2000	2000-2001	2001-2002[3]
	$bn	$bn	$bn	$bn	$bn	$bn	$bn	$bn	$bn	$bn	$bn
Land Premium	8.9	8.9	18.5	19.1	19.4	27.0	63.6	19.3	34.8	29.5	8.6

39. Besides reduced land premium revenue, the revenue yield of stamp duty on property transactions has suffered, largely tracking the consolidation of the property market. In the 1990s before the Asian financial crisis (1991-92 to 1997-98), the average annual revenue from stamp duty on property transaction was $11.2 billion. This fell to an average of only $5.2 billion per annum from 1998-99 to 2001-02. The yield in money terms is set out in Table 9 below.

Table 9 – Revenue from Stamp Duty on Property Transactions

Fiscal Year	1991-1992	1992-1993	1993-1994	1994-1995	1995-1996	1996-1997	1997-1998	1998-1999	1999-2000	2000-2001	2001-2002[3]
	$bn	$bn	$bn	$bn	$bn	$bn	$bn	$bn	$bn	$bn	$bn
Stamp Duty	6.9	9.5	12.8	9.5	7.6	15.1	17.3	6.3	4.9	4.9	4.5

40. In respect of profits tax, the consolidation in the property market exerted a downward pressure on the yield from the property and banking sectors as shown in Table 10 below. From the peak of $23.0 billion in both 1996-97 and 1997-98, the property and banking sectors together contributed only $13.2 billion profits tax in 1999-2000.

Table 10 – Profits tax contribution from the property and banking sectors

Fiscal Year	1991-1992	1992-1993	1993-1994	1994-1995	1995-1996	1996-1997	1997-1998	1998-1999	1999-2000
	$bn	$bn	$bn	$bn	$bn	$bn	$bn	$bn	$bn
Property Sector	6.7	9.7	13.0	13.7	14.5	14.3	14.0	12.1	7.9
Banking Sector	4.0	5.8	7.0	7.1	8.0	8.7	9.0	5.8	5.3
All Corporations	25.0	32.7	39.3	40.0	42.1	45.5	44.2	37.3	35.3

41. The Task Force considers this fundamental change may have been spurred by dissipation, in an era of low or negative inflation, of previously-held expectations for price gains. The Task Force also considers relevant a degree of downward pressure on property prices in Hong Kong caused by a price differential narrowing process at work on account of the ever closer economic linkages between Hong Kong and the Mainland.

42. The Task Force considers another fundamental change has taken place on the revenue side, namely the prominence of **investment income from the fiscal reserves.**

Table 11 - Investment Income in Money Terms and as a Percentage of Operating Revenue and Expenditure

Fiscal Year	1991-1992	1992-1993	1993-1994	1994-1995	1995-1996	1996-1997	1997-1998	1998-1999	1999-2000	2000-2001	2001-2002[3]
Investment income ($bn)	3.0	1.8	3.4	4.9	5.9	5.6	15.0	31.6	36.8	19.5	0.0
Investment income as a percentage of operating revenue	3.0%	1.5%	2.4%	3.4%	3.9%	3.3%	7.3%	17.9%	21.0%	11.4%	0.0%
Investment income as a percentage of operating expenditure	4.2%	2.1%	3.5%	4.6%	4.8%	4.1%	9.3%	17.8%	20.9%	10.5%	0.0%

43. As can be seen from Table 11 above, up to 1996-97, investment income from fiscal reserves constituted a small and relatively stable share of government operating revenue. It funded a small and relatively constant portion of government operating expenditure. However, the position changed dramatically in the years from 1997-98 onwards, partly arising from the swelling of the fiscal reserves upon receipt of the balance from the HKSAR Land Fund and partly from the volatility of the rate of investment return (ref. paragraph 26 above).

44. As the investment income from the fiscal reserves has become such a pivotal part of government operating revenue funding a significant portion of government operating expenditure, the revenue from this source has to increase every year in money terms and in proportion to the annual increase in government operating expenditure. This means the Government needs to achieve annual operating surplus, so that the fiscal reserves continue to increase, and so that the investment income (assuming a constant rate of return) also increases in proportion to the increase in annual operating government expenditure. An increase in fiscal reserves and therefore an increase in investment income may also be achieved if there is a sizeable annual capital surplus. In short, long-term fiscal sustainability requires an annual surplus out-turn so that a sizeable portion of government expenditure may continue to be funded from the investment income from the fiscal reserves.

45. The Task Force, however, notes that the fiscal trend in recent years was in an opposite direction from the prerequisite stated above, as illustrated by the emergence and increased operating deficit since 1998-99 (as described in paragraphs 27 and 28 above) and the capital deficit trend (referred to in paragraph 34 above). The Task Force foresees the possibility of a structural problem if a sizeable consolidated and operating deficit is allowed to persist year after year. Such deficits will eat into the fiscal reserves. Declining fiscal reserves will reduce the investment income. Reduced investment income will aggravate the fiscal deficit. A downward spiral will readily develop, leading to the depletion of fiscal reserves and the relegation into chronic fiscal debt.

46. The Task Force has also identified a third development which may have structural impact on the HKSAR's revenue. This is the increasing **outreach of the Hong Kong economy to the Mainland and elsewhere**, on the back of the progressive opening up of the Mainland markets and the globalisation of business activities. Conceivably, this development could induce certain structural effects on government's tax revenue, particularly on direct tax revenue, due to the territorial source principle for tax liability demarcation (i.e. only Hong Kong-sourced profits and salaries are liable to tax). The Task Force, however, has not been able to ascertain the magnitude of any such effect at this stage.

47. On the expenditure side, the Task Force has identified some features which have given, or may give, rise to structural consequences.

48. The first feature is the **differential price movements in government expenditure and that in the general economy**. Price changes in government expenditure are measured by the Government Consumption Expenditure (GCE) deflator, while those in the economy as a whole are measured by the GDP deflator. If the prices pertaining to government spending persistently rise faster than the general price level in the economy, as seems likely given the heavy wage content particularly in government operating expenditure, the budgetary guideline of aligning trend government expenditure growth in real terms with real trend GDP growth would not entail budget balance[9]. This is because the differential price trends will act to continuously open up the fiscal gap. In other words, a structural deficit will emerge and worsen where nominal government expenditure rises faster than nominal GDP, unless nominal government revenue is also able to rise at the same pace as that of nominal government expenditure.

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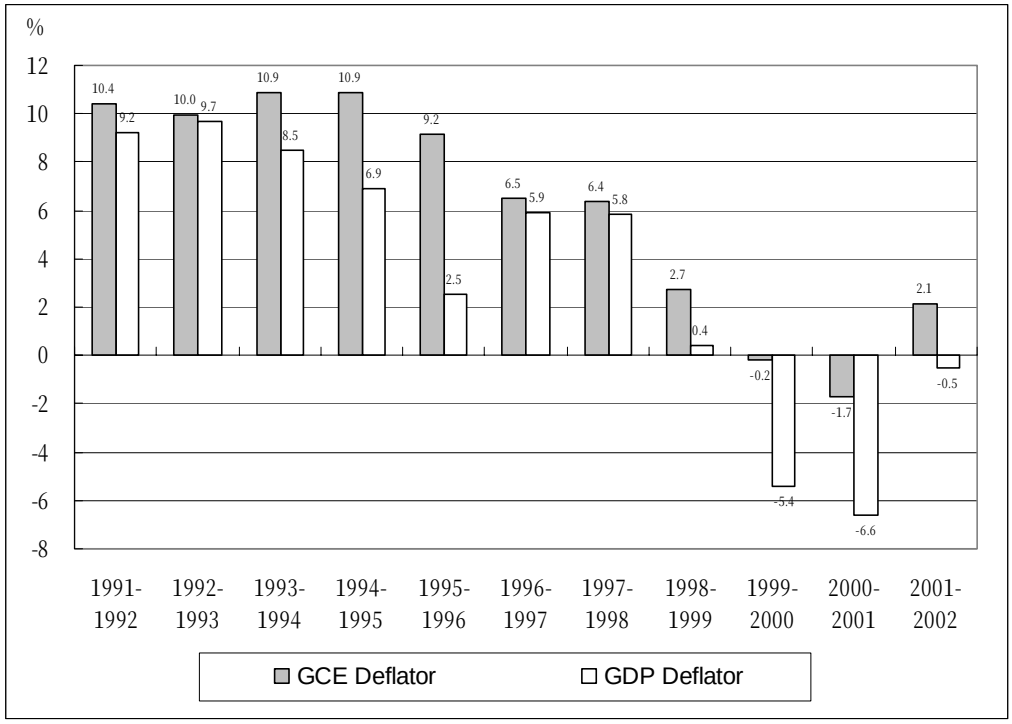
[9] The established guideline for controlling the growth of government expenditure is that government expenditure as a whole should be in line with the trend growth of GDP in real terms.

49. A comparison of the changes in GCE deflator and GDP deflator for the period 1991-92 to 2001-02 is set out in Chart 11 below.

Chart 11 – Changes in the GCE Deflator and GDP Deflator



50. As can be seen from the above figures, changes in the GCE deflator are persistently higher than those in the GDP deflator meaning the cost of government spending has consistently been increasing faster than general price levels in the economy. This has resulted in an increase in nominal government expenditure expressed as a share of GDP (ref. Chart 8 above). Several factors are at work in so far as the price rigidity of government expenditure is concerned. Most notably, certain key expenditure items such as salaries (of civil servants and employees of government funded organisations), pension and social security payments have intentionally not been adjusted downward even when the economy deflates.

51. Another feature identified by the Task Force is the **ageing of Hong Kong's population** which is expected to worsen substantially in the 2010s. The Task Force has noted that the primary effect of an ageing population will be on government expenditure relating to social security payments. When both the absolute number of persons aged 65 and above and the elderly dependency ratio increase, a strain results on the expenditure side.

52. The Task Force has also noted that following the economic slowdown since 1997-98, the Government has been maintaining its expenditure growth above the growth of the economy. This approach was consciously adopted as a **counter-cyclical fiscal measur**e and justified on economic grounds. To have reduced government expenditure at a time of contraction within the economy would have risked compounding the prevailing adverse economic sentiment. As a direct consequence, the differential between nominal growth in government expenditure and nominal growth in GDP has continued to widen and is now a primary cause of the current stress on the fiscal system. The Government needs to ensure a return to tighter expenditure control or increase revenue when the economy recovers. Otherwise, lack of redress measures would turn a cyclical phenomenon into a structural one.