

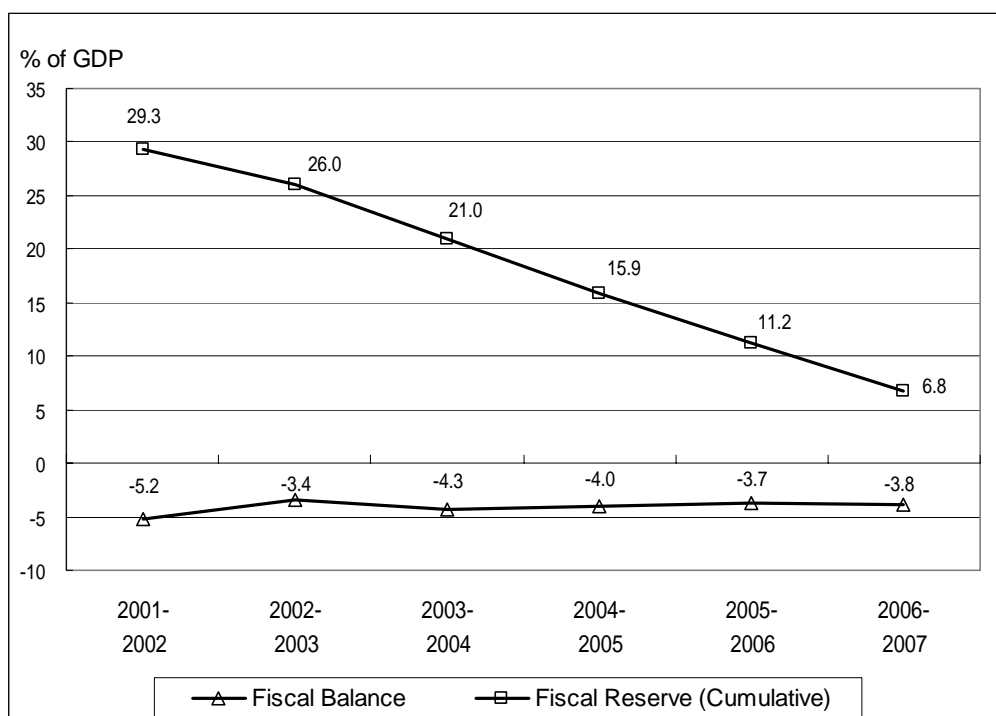
MODEL FINDINGS

Current Policies Scenarios

77. In the next five fiscal years, the budgetary position will worsen substantially in a **medium growth** scenario if the current revenue and expenditure policies are to continue. In 2006-07, the projected fiscal deficit is projected to be \$58 billion, being 3.8% of GDP. The fiscal reserves at \$369 billion in 2001-02 will be reduced to \$104 billion in 2006-07. The budgetary positions in respect of the next five years are set out in Table 13 and Chart 14 below.

Table 13 - Projected Budgetary Positions 2001-02 to 2006-07 - Current Policies Scenario (Medium Growth)							
		2001-02 ³	2002-03	2003-04	2004-05	2005-06	2006-07
Revenue	\$ bn	174	221	221	229	241	251
	% to GDP	13.8	17.5	17.1	16.7	16.5	16.3
Operating Revenue	\$ bn	151	168	182	189	199	208
	% to GDP	12.0	13.4	14.1	13.8	13.6	13.5
Capital Revenue	\$ bn	22	53	39	40	42	43
	% to GDP	1.8	4.2	3.0	2.9	2.9	2.8
Expenditure	\$ bn	240	263	277	284	295	309
	% to GDP	19.0	20.9	21.3	20.7	20.2	20.1
Operating Expenditure	\$ bn	202	214	225	236	249	263
	% to GDP	16.0	17.0	17.3	17.2	17.1	17.1
Capital Expenditure	\$ bn	38	48	52	48	46	46
	% to GDP	3.0	3.8	4.0	3.5	3.1	3.0
Budget Balance	\$ bn	-66	-42	-55	-55	-54	-58
	% to GDP	-5.2	-3.4	-4.3	-4.0	-3.7	-3.8
Operating Balance	\$ bn	-50	-46	-43	-47	-50	-55
	% to GDP	-4.0	-3.7	-3.3	-3.5	-3.4	-3.6
Capital Balance	\$ bn	-16	4	-13	-7	-4	-3
	% to GDP	-1.2	0.3	-1.0	-0.5	-0.3	-0.2
Fiscal Reserve (cumulative)	\$ bn	369	327	272	217	163	104
	% to GDP	29.3	26.0	21.0	15.9	11.2	6.8

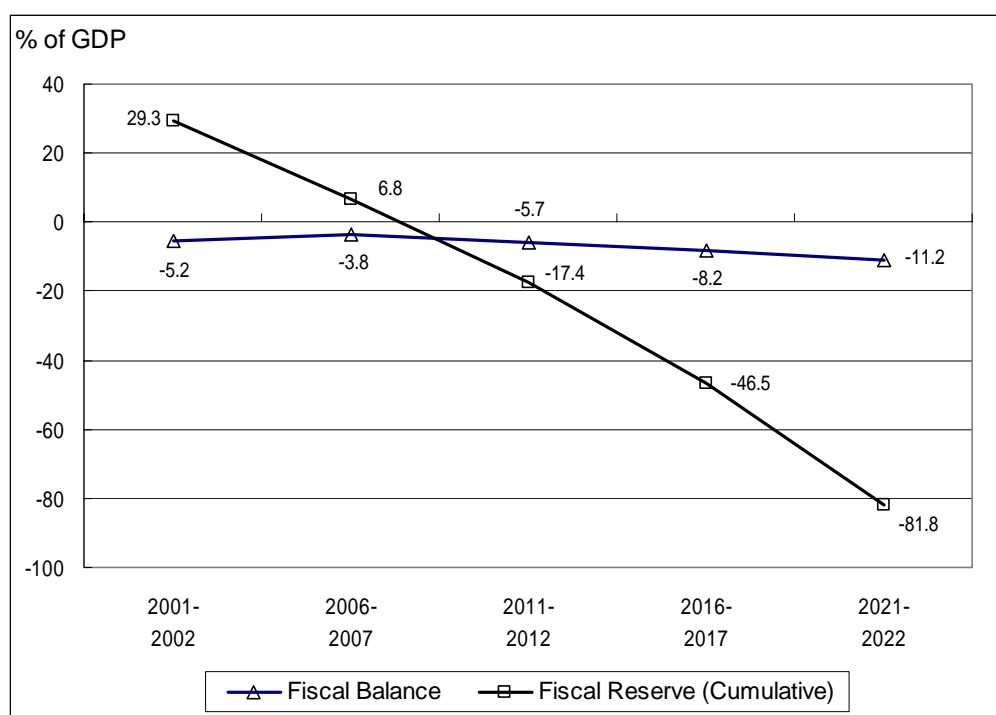
**Chart 14 – Projected Fiscal Balance and Fiscal Reserves 2001-02 to 2006-07
Current Policies Scenario (Medium Growth)**



78. The long-term projections under the current revenue and expenditure policies are set out in Table 14 and Chart 15 below. The projected consolidated deficit will total from \$58 billion in 2006-07 to \$114 billion in 2011-12, \$209 billion in 2016-17 and \$365 billion in 2021-22, representing 3.8%, 5.7%, 8.2% and 11.2% of GDP respectively. The fiscal reserves, at \$369 billion in 2001-02, will be depleted by 2008-09, resulting in a fiscal debt of \$343 billion in 2011-12 (equal to 17.4% of GDP) rising to \$2,661 billion in 2021-22 (equal to 81.8% of GDP). The full findings of the budget model with year-on-year breakdown of the operating and capital accounts and the surplus or deficit position over the 20-year period is at Annex VII.

Table 14 – Projected Budgetary Positions 2001-02 to 2021-22 Current Policies Scenario (Medium Growth)						
		2001-02 ³	2006-07	2011-12	2016-17	2021-22
Revenue	\$ bn	174	251	310	398	510
	% to GDP	13.8	16.3	15.7	15.7	15.7
Operating Revenue	\$ bn	151	208	255	327	419
	% to GDP	12.0	13.5	12.9	12.9	12.9
Capital Revenue	\$ bn	22	43	55	71	91
	% to GDP	1.8	2.8	2.8	2.8	2.8
Expenditure	\$ bn	240	309	424	607	875
	% to GDP	19.0	20.1	21.4	23.9	26.9
Operating Expenditure	\$ bn	202	263	361	519	751
	% to GDP	16.0	17.1	18.2	20.5	23.1
Capital Expenditure	\$ bn	38	46	6.3	89	124
	% to GDP	3.0	3.0	3.2	3.5	3.8
Budget Balance	\$ bn	-66	-58	-114	-209	-365
	% to GDP	-5.2	-3.8	-5.7	-8.2	-11.2
Operating Balance	\$ bn	-50	-55	-106	-192	-331
	% to GDP	-4.0	-3.6	-5.3	-7.6	-10.2
Capital Balance	\$ bn	-16	-3	-8	-18	-33
	% to GDP	-1.2	-0.2	-0.4	-0.7	-1.0
Fiscal Reserve (cumulative)	\$ bn	369	104	-343	-1,178	-2,661
	% to GDP	29.3	6.8	-17.4	-46.5	-81.8

**Chart 15 - Projected Fiscal Balance and Fiscal Reserves 2001-02 to 2021-22
Current Policies Scenario (Medium Growth)**



79. The worsening fiscal position mainly arises from a much faster growth of expenditure than revenue. In respect of revenue, this is projected to grow largely in line with GDP, being maintained at 15.7% of GDP in the long term, with operating revenue at 12.9% of GDP and capital revenue at 2.8% of GDP. In contrast, expenditure is projected to grow at a faster pace. Measured against GDP, it tracks an increasing trend from 19.0% in 2001-02, rising to 20.1% in 2006-07, 21.4% in 2011-12 and 26.9% in 2021-22. The bulk of the 7.9-percentage points increase in expenditure is attributable to operating expenditure, registering a 7.1-percentage points increase as a share of GDP in the longer term against a 0.8-percentage point increase for capital expenditure.

80. As the fiscal reserves are projected to run out in 2008-09, future expenditure will have to be financed partly by debt. As fiscal debt bears an interest cost, it exacerbates the annual fiscal deficit and the cumulative fiscal debt in later years. This is because of the effect from the double blow of having no revenue from investment income and incurring new expenditure on interest to service debt.

81. Under different economic assumptions, the level of deficits will change. In a **higher economic growth** scenario, the deficit is projected at \$60 billion in 2006-07 (equal to 3.5% of GDP), \$118 billion in 2011-12 (equal to 4.9% of GDP), \$236 billion in 2016-17 (equal to 7.0% of GDP) and \$442 billion in 2021-22 (equal to 9.3% of GDP). Fiscal reserves will be depleted in 2008-09. The projected budgetary positions are set out in Annex VIII.

Annex VIII

82. In a **lower economic growth** scenario, the budget deficit is projected to reach \$46 billion in 2006-07 (equal to 3.3% of GDP), \$106 billion in 2011-12 (equal to 6.7% of GDP), \$179 billion in 2016-17 (equal to 10.1% of GDP) and \$290 billion in 2021-22 (equal to 14.4% of GDP). Fiscal reserves will run out in 2008-09.

Annex IX

The projected budgetary positions are set out at Annex IX.

Alternative Projections

83. The projected fiscal positions described above are clearly unacceptable. To restore fiscal sustainability, it will be necessary to raise new revenue and/or reduce government expenditure. For illustration purposes, the Task Force has projected, under the **medium economic growth** scenario, a hypothetical situation which aims at restoring consolidated balance in five years' time, i.e. in 2006-07. It entails the raising of new revenue and/or expenditure cuts averaging \$35 billion per annum until 2006-07. The year-on-year projected budgetary positions are at Table 15 below.

Table 15 - Projected Budgetary Positions with Expenditure and/or Revenue Measures to Achieve Consolidated Balance 2001-02 to 2006-07 (Medium Growth)							
		2001-02 ³	2002-03	2003-04	2004-05	2005-06	2006-07
Revenue	\$ bn	174	227	224	234	248	261
	% to GDP	13.8	18.1	17.5	17.4	17.5	17.5
Operating Revenue	\$ bn	151	173	184	192	205	217
	% to GDP	12.0	13.8	14.4	14.3	14.5	14.5
Capital Revenue	\$ bn	22	54	40	41	43	44
	% to GDP	1.8	4.3	3.1	3.1	3.0	3.0
Expenditure	\$ bn	240	263	277	284	295	309
	% to GDP	19.0	20.9	21.6	21.1	20.8	20.8
Operating Expenditure	\$ bn	202	214	225	236	249	263
	% to GDP	16.0	17.1	17.6	17.6	17.6	17.7
Capital Expenditure	\$ bn	38	48	52	48	46	46
	% to GDP	3.0	3.9	4.1	3.5	3.2	3.1
Revenue Increase (Expenditure Cut) ¹²	\$ bn	N.A.	21	28	35	42	49
	% to GDP		1.7	2.2	2.6	2.9	3.3
Budget Balance	\$ bn	-66	-15	-25	-15	-5	0
	% to GDP	-5.2	-1.2	-1.9	-1.1	-0.4	0.0
Operating Balance	\$ bn	-50	-41	-41	-44	-44	-47
	% to GDP	-4.0	-3.3	-3.2	-3.3	-3.1	-3.1
Capital Balance	\$ bn	-16	5	-12	-6	-3	-2
	% to GDP	-1.2	0.4	-0.9	-0.5	-0.2	-0.1
Fiscal Reserve (cumulative)	\$ bn	369	355	330	315	309	309
	% to GDP	29.3	28.3	25.8	23.5	21.8	20.8

¹² As expenditure growth in line with trend real GDP growth is assumed in the model, "expenditure cut" may not be actual "cuts" in the initial years but rather constrained growth in expenditure.

84. Due to consecutive years of consolidated deficits before the restoration of fiscal balance, the fiscal reserves will gradually be run down. In the model, the fiscal reserves are projected to fall from \$369 billion in 2001-02 to \$309 billion in 2006-07, roughly equivalent to 12 months of government expenditure at the end of five years.

85. Beyond 2006-07, additional revenue and/or expenditure measures will still be required if the objective is to maintain consolidated balance until the end of the model period in 2021-22. This is because government expenditure will continue to outstrip government revenue, arising principally from the persistently higher prices pertaining to government spending than those pertaining to the economy. From 2007-08 to 2011-12, the revenue and/or expenditure measure averages \$76 billion per annum, it reaches \$118 billion per annum from 2012-13 to 2016-17, and \$183 billion per annum from 2017-18 to 2021-22. The fiscal reserves will progressively be drawn down. From roughly equivalent to 12 months of government expenditure in 2006-07, they will decrease in relative terms to 9.1 months of government expenditure in 2011-12, 6.8 months in 2016-17, and 5.1 months in 2021-22. The position is summarised in Table 16 below.

		2001-02 ³	2006-07	2011-12	2016-17	2021-22
Revenue	\$ bn	174	261	317	402	510
	% to GDP	13.8	17.5	16.6	16.4	16.2
Operating Revenue	\$ bn	151	217	262	331	421
	% to GDP	12.0	14.5	13.7	13.5	13.4
Capital Revenue	\$ bn	22	44	55	70	90
	% to GDP	1.8	3.0	2.9	2.9	2.9
Expenditure	\$ bn	240	309	406	542	725
	% to GDP	19.0	20.8	21.3	22.1	23.1
Operating Expenditure	\$ bn	202	263	345	460	616
	% to GDP	16.0	17.7	18.0	18.8	19.6
Capital Expenditure	\$ bn	38	46	62	82	109
	% to GDP	3.0	3.1	3.2	3.3	3.5
Revenue Increase (Expenditure Cut)	\$ bn	N.A.	49	89	141	215
	% to GDP		3.3	4.7	5.7	6.9
Budget Balance	\$ bn	-66	0	0	0	0
	% to GDP	-5.2	0.0	0.0	0.0	0.0
Operating Balance	\$ bn	-50	-47	-83	-129	-.196
	% to GDP	-4.0	-3.1	-4.4	-5.3	-6.2
Capital Balance	\$ bn	-16	-2	-6	-12	-19
	% to GDP	-1.2	-0.1	-0.3	-0.5	-0.6
Fiscal Reserve (cumulative)	\$ bn	369	309	309	309	309
	% to GDP	29.3	20.8	16.2	12.6	9.8

86. The positions when applying **higher and lower economic growth** assumptions are at Annex X and Annex XI respectively.

87. Having a substantial level of fiscal reserves has been one of the oft-cited strengths of Hong Kong's public finance system. The current guideline implies that the lower limit of the target fiscal reserves should be set at roughly 18 months of government expenditure¹³.

88. The Task Force has therefore projected, under the **medium economic growth** scenario, the size of the revenue or expenditure measure beyond 2006-07 if the objective is to restore the level of the fiscal reserves to 18 months of government expenditure in, say, ten years after 2006-07, i.e. in 2016-17¹⁴. From 2007-08 to 2011-12, the revenue and/or expenditure measures average \$110 billion per annum (equal to 6.4% of GDP), they reach \$161 billion per annum from 2012-13 to 2016-17 (equal to 7.2% of GDP) and \$203 billion per annum from 2017-18 to 2021-22 (equal to 7.1% of GDP). The position is summarised at Table 17 below.

¹³ The current fiscal reserves guideline sets the appropriate level of fiscal reserves at 9 to 15 months' government expenditure plus 75% to 125% Hong Kong Dollar money supply under the M1 definition. The lower range translates into the equivalent of about 18 months of government expenditure.

¹⁴ Theoretically we can set the objective to be achieved earlier than ten years, but given the magnitude of the revenue and/or expenditure measure, a ten-year timeframe appears a more realistic scenario.

Table 17 — Projected Budgetary Positions with Revenue and/or Expenditure Measures to Achieve Fiscal Reserves at 18 Months of Government Expenditure in 2016-17 and Thereafter (Medium Growth)

		2001-02 ³	2006-07	2011-12	2016-17	2021-22
Revenue	\$ bn	174	261	327	427	551
	% to GDP	13.8	17.5	17.1	17.4	17.6
Operating Revenue	\$ bn	151	217	270	354	457
	% to GDP	12.0	14.5	14.2	14.5	14.6
Capital Revenue	\$ bn	22	44	56	73	94
	% to GDP	1.8	3.0	2.9	3.0	3.0
Expenditure	\$ bn	240	309	406	542	725
	% to GDP	19.0	20.8	21.3	22.1	23.1
Operating Expenditure	\$ bn	202	263	345	460	616
	% to GDP	16.0	17.7	18.0	18.8	19.6
Capital Expenditure	\$ bn	38	46	62	82	109
	% to GDP	3.0	3.1	3.2	3.3	3.5
Revenue Increase (Expenditure Cut)¹²	\$ bn	N.A.	49	127	186	236
	% to GDP		3.3	6.6	7.6	7.5
Budget Balance	\$ bn	-66	0	47	72	62
	% to GDP	-5.2	0.0	2.5	2.9	2.0
Operating Balance	\$ bn	-50	-47	-74	-106	-159
	% to GDP	-4.0	-3.1	-3.9	-4.3	-5.1
Capital Balance	\$ bn	-16	-2	-5	-9	-15
	% to GDP	-1.2	-0.1	-0.3	-0.4	-0.5
Fiscal Reserve (cumulative)	\$ bn	369	309	508	813	1,088
	% to GDP	29.3	20.8	26.6	33.2	34.6

Annex XII 89. The positions when applying **higher and lower economic growth**
 Annex XIII assumptions are at Annex XII and Annex XIII respectively.

90. Besides compensating for the persistent higher price differential of government expenditure over the general price level as in the case of achieving consolidated balance over the longer term, the more severe revenue and/or expenditure measures are attributable to the need to top up the fiscal reserves to the target level. Essentially, if the fiscal reserves are to grow, tracking the growth of government expenditure, this requires continuous years of budget surpluses. In this connection, the Task Force notes that whenever the fiscal reserves are aligned to a certain number of months of government expenditure (or a certain percentage of GDP), this implies that so long as government expenditure (or GDP) experiences positive growth, then there would need to be sustained budget surpluses so that the fiscal reserves can grow concurrently.

91. The requirement to achieve a level of fiscal reserves equivalent to 18 months of government expenditure requires very substantial revenue and/or expenditure measures and may not be practically attainable without adversely affecting the economy. As an alternative illustration, the Task Force has projected the size of the revenue and/or expenditure measures required should it be considered that the level of the fiscal reserves can be pitched at a lower level, say, 12 months of government expenditure. To achieve this objective under the medium economic growth scenario, the size of revenue and/or expenditure measures average \$93 billion per annum (equal to 5.3% of GDP) from 2007-08 to 2011-12, and reach \$137 billion per annum from 2012-13 to 2016-17 (equal to 6.1% of GDP), and \$202 billion per annum from 2017-18 to 2021-22 (equal to 7.1% of GDP). This position is summarised at Table 18 below.

Table 18 – Projected Budgetary Positions with Revenue and/or Expenditure Measures to Achieve Fiscal Reserves at 12 Months of Government Expenditure in 2007-08 and Thereafter (Medium Growth)						
		2001-02 ³	2006-07	2011-12	2016-17	2021-22
Revenue	\$ bn	174	261	322	414	532
	% to GDP	13.8	17.5	16.8	16.9	16.9
Operating Revenue	\$ bn	151	217	266	342	440
	% to GDP	12.0	14.5	13.9	14.0	14.0
Capital Revenue	\$ bn	22	44	56	72	92
	% to GDP	1.8	3.0	2.9	2.9	2.9
Expenditure						
Expenditure	\$ bn	240	309	406	542	725
	% to GDP	19.0	20.8	21.3	22.1	23.1
Operating Expenditure	\$ bn	202	263	345	460	616
	% to GDP	16.0	17.7	18.0	18.8	19.6
Capital Expenditure	\$ bn	38	46	62	82	109
	% to GDP	3.0	3.1	3.2	3.3	3.5
Revenue Increase (Expenditure Cut)¹²						
Revenue Increase (Expenditure Cut)¹²	\$ bn	N.A.	49	107	159	235
	% to GDP		3.3	5.6	6.5	7.5
Budget Balance						
Budget Balance	\$ bn	-66	0	22	31	41
	% to GDP	-5.2	0.0	1.2	1.3	1.3
Operating Balance	\$ bn	-50	-47	-79	-118	-176
	% to GDP	-4.0	-3.1	-4.1	-4.8	-5.6
Capital Balance	\$ bn	-16	-2	-6	-10	-17
	% to GDP	-1.2	-0.1	-0.3	-0.4	-0.5
Fiscal Reserve (cumulative)						
Fiscal Reserve (cumulative)	\$ bn	369	309	406	542	725
	% to GDP	29.3	20.8	21.3	22.1	23.1

92. The positions when applying higher and lower economic growth assumptions are at Annex XIV and Annex XV respectively.

Annex XIV
Annex XV

93. The different size of revenue and/or expenditure measures required under the three different objectives of attaining consolidated balance in the longer term or maintaining an 18-month or 12-month government expenditure equivalent of fiscal reserves are summarised graphically in Chart 16. The level of fiscal reserves under the three scenarios are summarised graphically in Chart 17.

Chart 16 – Annual Revenue and/or Expenditure Measures Required under Different Scenarios (Medium Growth)

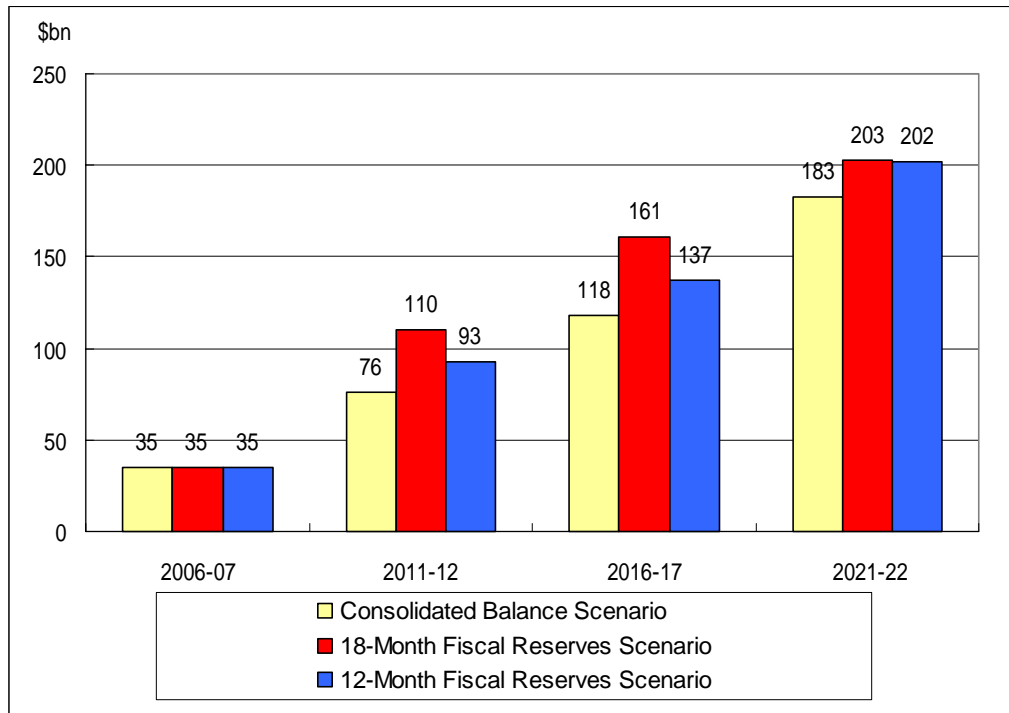


Chart 17 – Fiscal Reserves Levels under Different Scenarios (Medium Growth)

