CHAPTER 8

THE GOVERNMENT OF THE
HONG KONG SPECIAL ADMINISTRATIVE REGION

GENERAL REVENUE ACCOUNT

GOVERNMENT SECRETARIAT

Civil Service Bureau

Review of pension adjustment

Audit Commission
Hong Kong
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REVIEW OF PENSION ADJUSTMENT

Contents

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Summary and key findings

A. **Introduction.** Civil servants and judicial officers appointed on pensionable terms are entitled to civil service pensions in the form of a one-off commuted lump-sum gratuity plus a recurrent monthly pension. For officers who have joined the contributory pension benefits schemes, their dependants are eligible for a monthly dependant pension upon the death of the officers. Monthly pensions and dependant pensions are adjusted annually in accordance with the movement in the Consumer Price Index (A) — CPI(A). In 1998-99, the Government incurred $6,700 million in the payment of civil service pensions and dependant pensions (paras. 1, 3, 5 and 6).

B. **Development of the policy on pension adjustment.** It has been the Government's long-established policy to adjust monthly pensions and dependant pensions annually. In 1974, the policy on pension adjustment was reviewed. In 1975 and 1976, the Pensions (Increase) Ordinance (PIO — Cap. 305) and the Widows and Orphans Pension (Increase) Ordinance (WOPIO — Cap. 205) were enacted respectively. The policy objective of pension adjustment is to maintain the original purchasing power of the monthly pensions having regard to adjustments in the cost of living. Prior to April 1993, the award of pension increases was on a discretionary basis by administrative arrangements subject to the approval of the Legislative Council (LegCo) (paras. 9, 11 and 12).

C. **Pension increase as a statutory entitlement.** The amendments to the PIO and the WOPIO, enacted in January 1993 to enshrine the pension increase mechanism in legislation, took effect on 1 April 1993. From then on, pension increase has become a statutory entitlement. Audit notes that the PIO and the WOPIO only provide for pension increase in the event of inflation. However, there is no provision for pension adjustment in the event of deflation (paras. 16 and 24).

D. **Pension adjustment in the event of deflation.** Legal advice has confirmed that the PIO and the WOPIO in their current form provide only for pension increase on account of inflation. Audit notes that if pensions are frozen in the event of deflation, the purchasing power of pensions will be enhanced rather than maintained. The present base year for the CPI(A) is October 1994 to September 1995. The available data indicate that the CPI(A) will drop by 3.8% in 1999-2000 (i.e. from 116.6 in 1998-99 to 112.2 in 1999-2000) and will rebound in 2000-01. Based on these data, Audit has computed the total financial implications to the Government for providing pensions at an enhanced level of purchasing power in the event of deflation. Audit estimates that, under the present pension adjustment mechanism, the total financial implications to the Government are $4,903 million. If the average monthly CPI(A) for 2000-01 dips further below the 1999-2000 level of 112.2, the financial implications to the Government of providing pensions at an enhanced level of purchasing power will be further increased. If deflation recurs in subsequent years (i.e. 2000-01 and after), there will be further financial implications to the Government (paras. 17, 24, 25, 27 and 30 to 34).

E. **Civil Service Bureau's review of the pension adjustment mechanism.** At the Executive Council (ExCo) meeting held in May 1999, the Secretary for the Civil Service said that in the light of the change in economic circumstances, the Government was reviewing the policy on pension adjustment in the event of deflation. In January 2000, Audit informed the Civil Service Bureau that this was a fundamental issue with substantial financial implications which required clarification by ExCo (paras. 38 and 46).

F. **Audit recommendations.** In January 2000, Audit recommended that the Secretary for the Civil Service should, in consultation with the Secretary for the Treasury and the Director of Accounting Services:

— as soon as possible, review the arrangement for pension adjustment in the event of deflation and put up the issue to ExCo for consideration (first inset of para. 47); and

— inform the Finance Committee of LegCo of the outcome and seek its funding approval if there were additional financial implications for dealing with pension adjustment in the event of deflation (second inset of para. 47).

G. **Response from the Administration.** In late February 2000, the Secretary for the Civil Service informed Audit that, in consultation with the Secretary for the Treasury and the Director of Accounting Services, he had reviewed the effect of deflation under the current pension increase policy and mechanism as enshrined in the pension increase legislation. On 22 February 2000, a submission was made to ExCo. After considering the outcome of the review and having noted the movement of CPI(A) in 1999, ExCo advised and the Chief Executive ordered that the current pension increase policy and mechanism as prescribed in the pension increase legislation should be maintained and re-affirmed. The Secretary for the Civil Service has also said that no separate submission to the Finance Committee is required for compliance with the existing pension increase legislation. The Secretary for the Treasury has said that, in line with the good practice of keeping LegCo informed of significant matters concerning government expenditure, she would advise that the Administration should brief the relevant LegCo Panel on the review. She understands that the Civil Service Bureau is planning to do this in due course (paras. 48 and 49).

INTRODUCTION

Pension benefits for civil servants

1. Civil servants and judicial officers appointed on pensionable terms are entitled to civil service pensions in the form of a one-off commuted lump-sum gratuity plus a recurrent monthly pension, either immediately on retirement or as deferred pensions upon reaching normal retirement age. An officer's pension entitlement is directly proportional to his highest pensionable emoluments (which are normally his final salary) and length of pensionable service.

2. The provision of civil service pensions is governed by the following legislation:

— Pensions Ordinance and Regulations (Cap. 89) for civil servants and judicial officers under the Old Pension Scheme;

— Pension Benefits Ordinance and Regulations (Cap. 99) for civil servants under the New Pension Scheme; and

— Pension Benefits (Judicial Officers) Ordinance and Regulations (Cap. 401) for judicial officers under the New Pension Scheme for Judicial Officers.

The New Pension Schemes for civil servants and judicial officers were implemented on 1 July 1987. Officers who were in the service as at 30 June 1987 were given an option to remain in the Old Pension Scheme or to join the New Pension Schemes. Officers appointed on or after 1 July 1987 on pensionable terms are only eligible for the New Pension Schemes.

3. For civil servants and judicial officers who have contributed to either one of the two contributory pension benefits schemes (namely the Widows and Orphans Pension Scheme and the Surviving Spouses' and Children's Pensions Scheme), their dependants are eligible for a recurrent monthly dependant pension upon the death of the officers.

4. The provision for pension adjustment is governed by the following legislation:

— Pensions (Increase) Ordinance (PIO — Cap. 305) for civil service pensions and dependant pensions granted under the Surviving Spouses' and Children's Pensions Scheme; and

— Widows and Orphans Pension (Increase) Ordinance (WOPIO — Cap. 205) for dependant pensions granted under the Widows and Orphans Pension Scheme.

5. Under the present system, monthly pensions and dependant pensions are adjusted annually in accordance with the movement in the Consumer Price Index (A) — CPI(A). The commuted lump-sum gratuity does not attract pension increases. However, for officers who have been granted deferred pensions payable on their reaching the normal retirement age, their commuted lump-sum gratuities attract pension increases. For officers on early retirement, their monthly pensions are not eligible for immediate pension increases. Their pension increases are accumulated and their monthly pensions will be adjusted by the accumulated pension increases on their reaching the normal retirement age.

6. In 1998-99, the Government incurred $6,700 million in the payment of civil service pensions and dependant pensions. Figure 1 on the centre pages shows the amount of pension payments for the years 1993-94 to 1998-99.

Administrative framework

7. The Civil Service Bureau (CSB) is responsible for the overall management of the civil service, including the formulation of policy on pension matters. The Treasury is responsible for the day-to-day management of the pension schemes and the payment of pensions through the Government's payment system. The Standing Commission on Civil Service Salaries and Conditions of Service (Standing Commission) advises the Chief Executive on matters related to the pay and conditions of service for the civil service, including pension benefits. The Census and Statistics Department is responsible for the compilation and publication of the consumer price indices to reflect the impact of consumer price changes on households in different expenditure ranges. The present base year for the consumer price indices is October 1994 to September 1995.

Audit review

8. In view of the prospect of deflation in 1999-2000, Audit has recently conducted a review of the pension adjustment mechanism. The audit, which commenced in October 1999, focused on the pension adjustment mechanism in the event of deflation. This review follows the guidelines for conducting value for money audits agreed between the Public Accounts Committee and the Director of Audit, and accepted by the Administration. The audit does not question the merits of the policy objective of pension adjustment. The audit review indicates that the pension adjustment mechanism provides only for increase of pensions in accordance with inflation and does not provide for adjustment of pensions on deflation. In January 2000, in view of the very substantial financial implications involved, Audit recommended to the CSB that the issue should be submitted to the Executive Council (ExCo) for consideration. Following Audit's recommendations, on 22 February 2000, a submission was made to ExCo. ExCo advised and the Chief Executive ordered that the current pension increase policy and mechanism as prescribed in the pension increase legislation should be maintained and re-affirmed.

PENSION ADJUSTMENT MECHANISM

Development of the policy on pension adjustment

9. It has been the Government's long-established policy to adjust monthly pensions and dependant pensions annually. The policy is stated in the following ExCo Memoranda:

— ***ExCo Memorandum dated 22 November 1975.*** Civil service pensions are increased to ensure that the original purchasing power of the monthly pensions is maintained. This is based on the principle that pensions should be increased to ensure that the purchasing power of original pensions is not affected by rising prices;

— ***ExCo Memorandum dated 7 May 1990.*** It is the Government's declared policy to review pensions regularly and to adjust them in line with changes in the cost of living. Pension increases which maintain the original purchasing power of pensions should be paid as of right (see paragraph 14 below); and

— ***ExCo Memorandum dated 20 May 1999.*** The objective of pension adjustment is to maintain the original purchasing power of the monthly pensions having regard to adjustments in the cost of living.

10. From 1946 to 1974, 14 ex-gratia increases in pensions were granted. These increases were granted at irregular intervals, on an ad hoc basis, through administrative arrangements. From 1968 to 1974, pensions were adjusted immediately following a civil service salary adjustment, after taking into account the increase in the cost of living and salary increase during the review period. The pension increases were usually in line with the salary increases.

11. The policy on pension adjustment was reviewed in 1974. One of the proposals was that pension increases should be assessed independently of salary increases. The reason was that salary increases were subject to several factors (such as comparisons with pay levels in the private sector, re-gradings and the general level of economic activity) which were not relevant to pensions.

12. Following the 1974 review, the PIO and the WOPIO were enacted in 1975 and 1976 respectively to provide that previous pension increases granted would remain valid for their respective periods and to clarify the bases for pension increase. The ordinances did not specify how the increase should be computed but the Government's policy was to increase annually the monthly pensions in accordance with the increase in the CPI(A). The award of pension increases was on a discretionary basis by administrative arrangements subject to the approval of the Legislative Council (LegCo).

Pension increase as a statutory entitlement

Proposal in 1985

13. In 1985, the Administration proposed to ExCo that pension increase should be made a statutory entitlement. However, ExCo advised and the then Governor ordered that pension increases should continue to be discretionary for the following reasons:

— to provide by law for index-linked pensions virtually ruled out any flexibility in reacting to economic or budgetary circumstances; and

— the 1984 Sino-British Joint Declaration provided for the Government to pay pensions on terms no less favourable than before. To change the discretionary arrangements for pension increases into legally binding provisions could be seen as a lack of confidence in the Government.

ExCo's decision in 1990

14. In May 1990, the Administration recommended again to ExCo that pension increases against price inflation should be granted as of right and that the existing method of adjustment be statutorily provided for in the pensions increase ordinances. ExCo approved in principle the Administration's recommendation. ExCo was informed that:

— with the enactment of the Pension Benefits Ordinance in 1987 which made pension benefits a right, it was only logical that pension increases which maintained the original purchasing power of pensions should also be paid as of right;

— pension increases had been granted annually since 1976 without fail. It would be a very drastic course of action if in future, pensioners were to be denied increases against price inflation, even for budgetary reasons. In the United Kingdom, civil service pension increases were statutorily provided for;

— the recommended change would also partly help address staff concern about the security of pensions; and

— there were no financial and staffing implications in embodying the current administrative arrangements for pension increases in legislation, other than that it would no longer be possible to refuse to grant a pension increase.

Divided views of the Standing Commission

15. In 1991, the Administration consulted the Standing Commission about the proposal of making pension adjustment a statutory entitlement. In its letter of May 1991 addressed to the then Governor, the Standing Commission stated that:

— there were divided views among its members on this proposal. Those members who supported the proposal were of the view that annual adjustment to maintain the original purchasing power of the pension benefits was appropriate. Embodying the existing practice into law would have the dual effect of enhancing civil servants' confidence in the value of their pensions and of reassuring pensioners that the impact of price inflation would be compensated by the annual adjustment to their pension benefits;

— on the other hand, some members felt that pension adjustments, like salary adjustments, should have regard to the economic and financial situation in Hong Kong. To make pension adjustment a statutory entitlement would tie the hands of the Government should it wish to change the policy; and

— in conclusion, the Standing Commission did not tender definitive advice on the Administration's proposal and suggested that the Administration should take the divided views of its members into account in deciding on whether the proposal should be taken forward.

In November 1991, the Administration submitted to ExCo an information note which reported the advice of the advisory bodies and the reaction of the main staff councils to the modifications to civil service pension arrangements. The Administration reported the divided views of the Standing Commission on the proposal to make index-linked pension increase a statutory right but concluded that the Administration should implement all the proposed modifications as soon as possible. ExCo noted these points.

16. The amendments to the PIO and the WOPIO, enacted in January 1993 to enshrine the pension increase mechanism in legislation, took effect on 1 April 1993. From then on, pension increase has become a statutory entitlement. The amended PIO and WOPIO specify that the percentage increase in pensions should be pegged to the annual percentage increase in the average monthly CPI(A) for a year over that of the last year.

17. Table 1 below shows the pension adjustments and civil service salary adjustments from 1993-94 to 1999-2000. The background information about civil service salary adjustments is at Appendix A.

Table 1

Pension adjustments and civil service salary adjustments 1993-94 to 1999-2000

Effective date	Average monthly CPI(A) for the preceding year (Note)	Movement in the average monthly CPI(A)	Pension adjustment	Cumulative pension increase from 1 April 1993	Salary adjustment
		(%)	(%)	(%)	(%)
1 April 1993	81.6	9.05	9.05	9.05	9.76 — 10.66
1 April 1994	88.2	8.1	8.1	17.88	9.47 — 9.89
1 April 1995	95.8	8.7	8.7	28.14	9.98 — 10.14
1 April 1996	103.4	7.9	7.9	38.26	7.67 — 7.68
1 April 1997	109.5	6.0	6.0	46.56	6.81 — 6.90
1 April 1998	115.4	5.4	5.4	54.47	5.79 — 6.03
1 April 1999	116.6	1.0	1.0	56.01	0

Source: *Records of the Treasury and the Census and Statistics Department*

Note: *The base year for the CPI(A) compiled by the Census and Statistics Department is October 1994 to September 1995. Indices for earlier years are converted to this basis by applying a conversion factor.*

Pension adjustment in the event of deflation

Present pension adjustment mechanism

18. The present pension adjustment mechanism is governed by the PIO and the WOPIO which provide that the annual percentage increase in pensions should be pegged to the annual percentage change in the average monthly CPI(A) of a financial year over that of the preceding year. If the average monthly CPI(A) of a financial year exceeds that of the preceding year, which when expressed as a percentage exceeds 0.1%, a percentage of increase equal to the excess will be declared. It has been the usual practice, adopted administratively since 1982, for pension increases to take effect from 1 April of the next financial year. However, there is no provision for pension adjustment in the event of deflation.

Trend of consumer prices

19. The CPI is a means to reflect changes in the price level of consumer goods and services purchased by households. An increase in the CPI indicates rising prices (inflation) and a decrease in the CPI indicates falling prices (deflation). Different CPIs are compiled to reflect the impact of consumer price changes on households in different expenditure ranges. The CPI(A), CPI(B) and CPI(C) are compiled based on the expenditure patterns of households in the relatively low, medium and relatively high expenditure ranges. A Composite CPI is compiled based on the expenditure patterns of all households taken together to reflect the impact of consumer price changes on the household sector as a whole.

20. The CPI(A) is chosen for pension adjustment because it is more representative of the monthly household expenditure of pensioners. The CPI(A) had been on a rising trend for many years. However, in October 1998, the CPI(A) recorded a decline of 0.1% over a year earlier. This was the first decline recorded since 1975. The CPI(A) continued to show a decline on a year-on-year basis after October 1998. Figure 2 on the centre pages shows the CPI(A) and its rates of change on a year-on-year basis for the period January 1998 to December 1999.

21. The decline in the CPI(A) reflected the falling prices of commodities and services. Figure 3 on the centre pages shows the changes in the CPI(A) at commodity and service level between December 1998 and December 1999.

22. In July 1999, the Government Economist estimated that consumer prices in terms of the Composite CPI would decline by 2.5% in 1999. In August 1999, the Government Economist revised the forecast rate of change in the Composite CPI for 1999 further downwards to –3.5%, from the earlier forecast of –2.5%. In November 1999, the Government Economist further revised the forecast rate of change in the Composite CPI to –4%. According to past statistics, the CPI(A) had been moving closely with the Composite CPI, with generally less than a percentage point deviation in their rates of change each year over the past decade.

Audit observations on pension adjustment in the event of deflation

Movement in the CPI(A) in the near future

23. The projections made by the Government Economist on the movement in the Composite CPI indicate that the Hong Kong economy is undergoing a period of deflation. Based on the Census and Statistics Department's figures, Audit notes that the average monthly CPI(A) for 1999-2000 will be about 112.2, representing a decrease of 3.8% (i.e. $(116.6 - 112.2) \div 116.6 \times 100\%$) from the CPI(A) of 116.6 for 1998-99 as indicated in Table 2 below.

Table 2

Average monthly CPI(A)
for the year 1999-2000

Year	Month	Index
1999	April	114.0
	May	114.0
	June	113.8
	July	112.2
	August	111.5
	September	112.2
	October	112.2
	November	111.5
	December	111.3
2000	January	110.8
	February	111.5) (Note)
	March	111.2)
Average		**112.2**

Source: *Census and Statistics Department's records*

Note: *Indices for February and March 2000 were forecasted by the Census and Statistics Department.*

Legal advice and pension adjustment in the event of deflation

24. Deflation is the result of falling prices of commodities and services. Audit notes that the provisions of the PIO and the WOPIO only provide for one aspect of pension adjustment, i.e. pension increase granted on the upward movement in the CPI(A) in the event of inflation. There is no explicit statement or relevant information in the three ExCo Memoranda (i.e. of 1975, 1990 and 1999) mentioned in paragraph 9 above regarding the course of action to be taken and the financial

implications of pension adjustment in the event of deflation. Legal advice, sought by the CSB in November 1998, has confirmed that the PIO and the WOPIO in their current form provide only for increase on account of inflation. There is no provision for pension adjustment in the event of deflation.

25. **Audit notes that when monthly pensions are frozen during deflation, the purchasing power of monthly pensions is higher than the prevailing price level. The purchasing power of the monthly pensions has in fact been enhanced rather than maintained. Audit has also found that the existing pension adjustment mechanism as prescribed by the present legislation provides only for increases. In January 2000, in view of the prospect of deflation in 1999-2000, Audit informed the CSB that there was a need for the Administration to seek ExCo's clarification on the matter.**

Adjustment of pension in years subsequent to deflation

26. Under the PIO and the WOPIO, pensions cannot be adjusted downwards in accordance with the decrease in CPI(A) in the event of deflation. After a deflationary period, an inflation period could follow, as it is likely in the present case. **Under the present system, the upward pension adjustments in subsequent years of inflation, due to increase in the CPI(A), will be made without taking into account the effect of the decrease in the CPI(A) in the years of deflation. As a result, the purchasing power of pensions is enhanced rather than just being kept in line with the cost of living.** The effect of adjustment of pensions in the event of deflation is shown at Figure 4 on the centre pages.

27. As indicated at Figure 4 on the centre pages, monthly pensions were increased by 1% on 1 April 1999 in accordance with the upward movement in the average monthly CPI(A) from 115.4 in 1997-98 to 116.6 in 1998-99. Based on the Census and Statistics Department's figures (see paragraph 23 above), Audit estimates that the average monthly CPI(A) for 1999-2000 will be 112.2 and that there will be a 3.8% decrease (i.e. $(112.2 - 116.6) \div 116.6 \times 100\%$) from 116.6 in 1998-99. Under the present system, monthly pensions will not be adjusted downwards but will be maintained at the CPI(A) level of 116.6. Assuming that the monthly average CPI(A) will rebound from 112.2 to 116.6 in 2000-01, a 3.9% (i.e. $(116.6 - 112.2) \div 112.2 \times 100\%$) upward movement will be recorded. In accordance with the present pension adjustment mechanism, the purchasing power of monthly pensions frozen at the CPI(A) level of 116.6 will be increased by 3.9% to 121.1 in 2001-02. **As a result, the purchasing power of pensions for existing pensioners will be enhanced by 3.9% despite a 3.8% deflation in 1999-2000. This enhancement of pensions will have a continued impact on the pension payments in subsequent years.**

28. **If pensions are frozen in a year of deflation and are then adjusted in accordance with the increase in CPI(A) after the year of deflation, the purchasing power of pensions will be enhanced. In January 2000, Audit advised the CSB that the Administration should bring this matter to the attention of ExCo and seek ExCo's advice accordingly.**

Financial implications to the Government

29. In January 2000, Audit advised the CSB that there were significant financial implications to the Government for providing pensions at an enhanced level of purchasing power in the event of deflation. The following two categories of pensioners would be affected:

— existing pensioners who are eligible for immediate pension increases; and

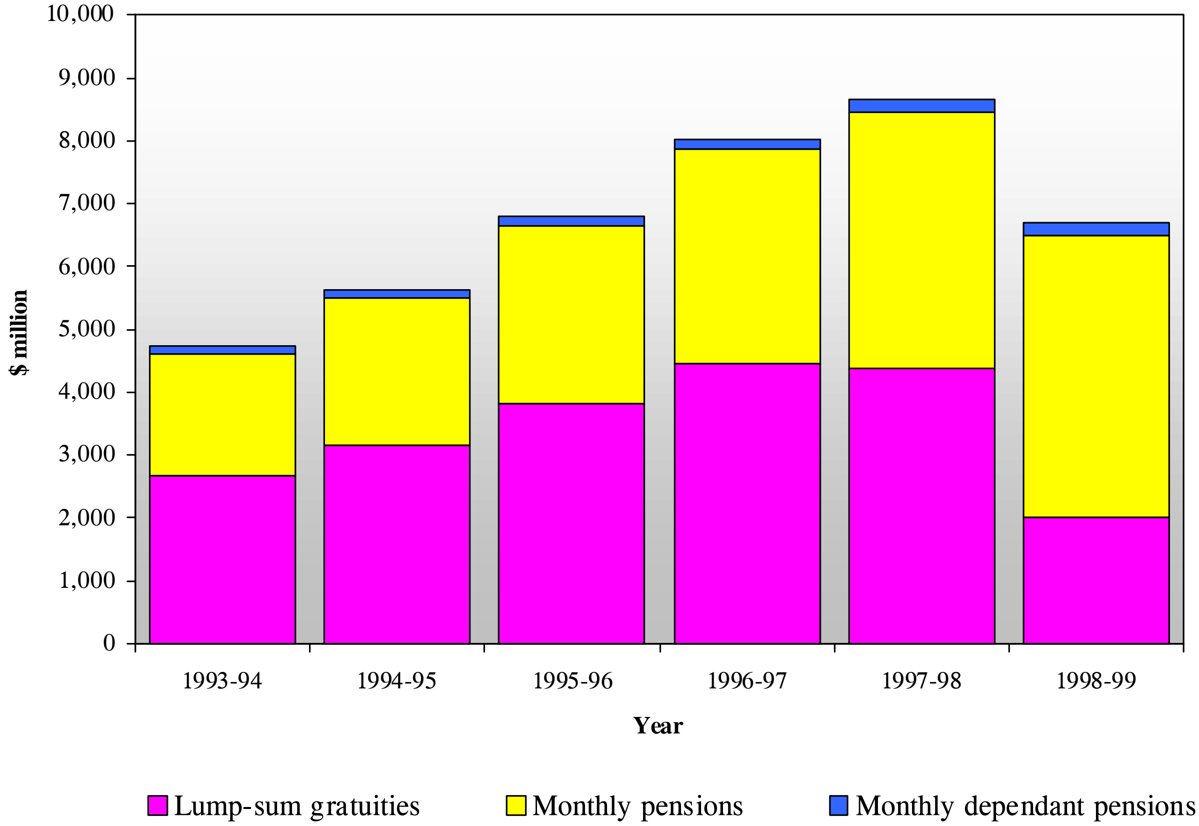
— deferred pensioners and early retirees who are accumulating pension increases until they reach the normal retirement age.

Financial implications for existing pensioners

30. With the projected downward movement in CPI(A) by 3.8% as mentioned in paragraph 23 above, Audit estimates that the financial implications to the Government for freezing the level of pensions in 2000-01 are about $160 million. If the average monthly CPI(A) in 2000-01 rebounds to 116.6, this upward movement in the CPI(A) will cause the monthly pensions to be adjusted upwards, in accordance with the present pension adjustment mechanism, by 3.9% (i.e. $(116.6 - 112.2) \div 112.2 \times 100\%$) at a cost of $166 million in 2001-02 for the existing pensioners. Based on the Treasury's records on the age profile of the existing pensioners and the general life expectancy of people in Hong Kong, Audit estimates that the total financial implications of providing pensions at an enhanced level of purchasing power to the existing pensioners are $3,048 million. Details are given in Table 3 below.

Figure 1

Expenditure on pension payments
for the years 1993-94 to 1998-99
(paragraph 6 refers)

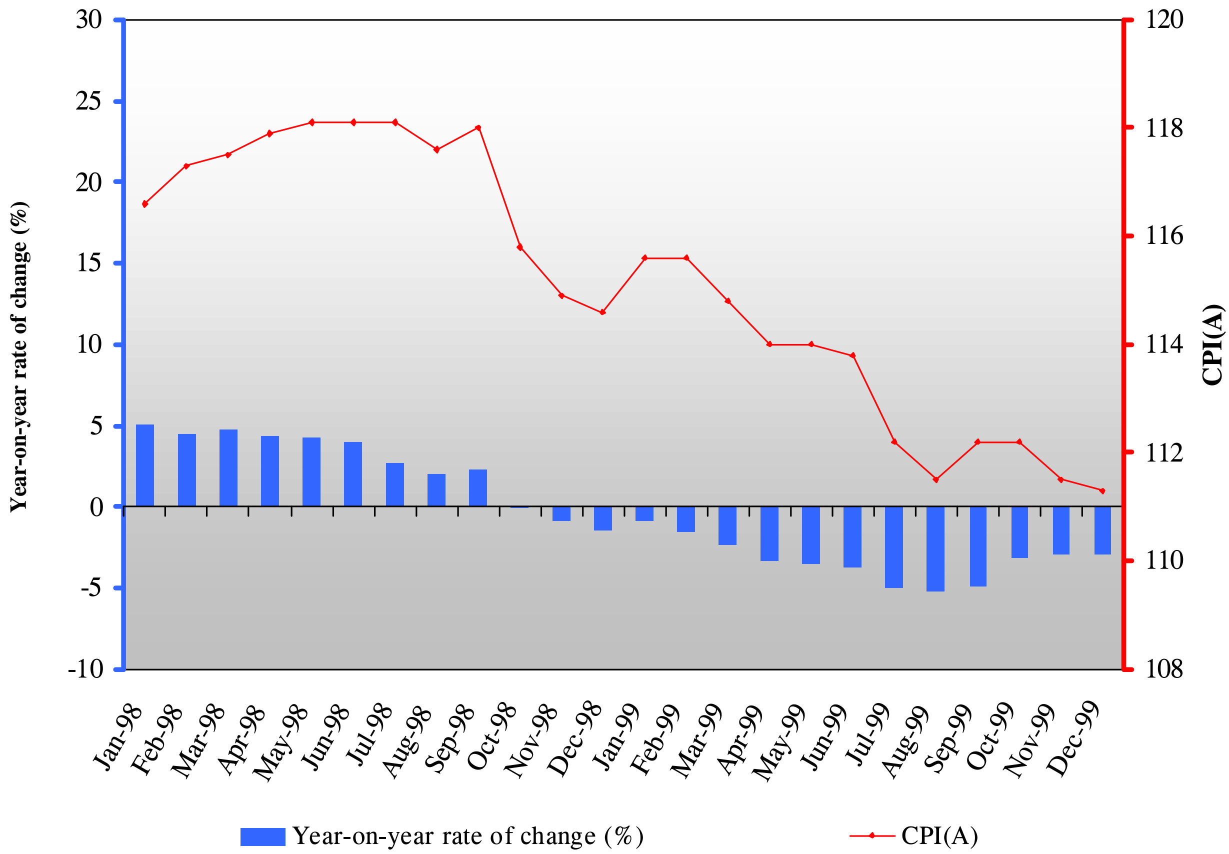


Year	Civil service pensions		Monthly dependant pensions	Total
	Lump-sum gratuities	Monthly pensions		
	($ million)	($ million)	($ million)	($ million)
1993-94	2,666	1,953	116	4,735
1994-95	3,147	2,347	133	5,627
1995-96	3,810	2,844	151	6,805
1996-97	4,447	3,410	172	8,029
1997-98	4,384	4,074	191	8,649
1998-99	2,001	4,487	212	6,700

Source: Treasury's records

Figure 2

Monthly CPI(A) for the period January 1998 to December 1999
(paragraph 20 refers)

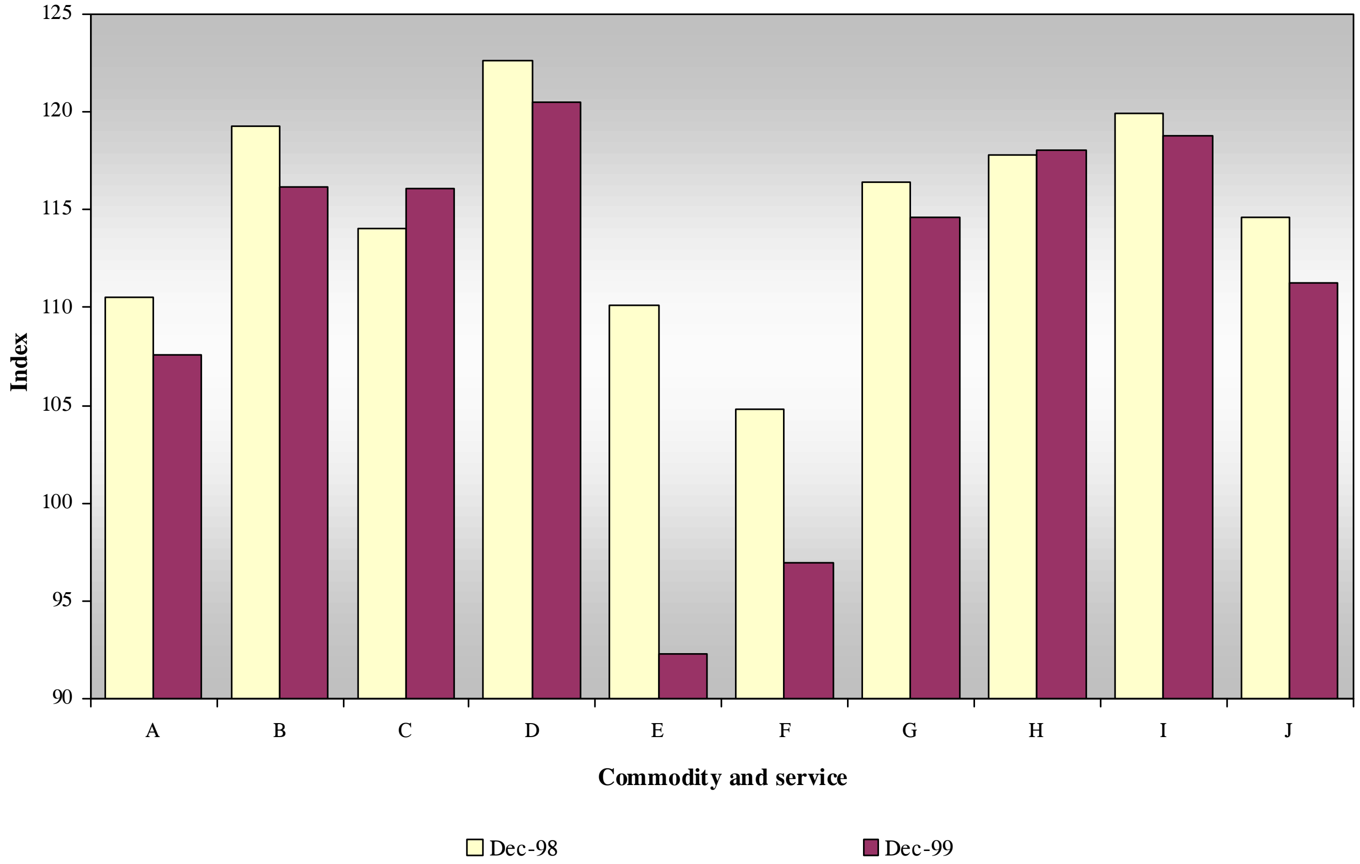


	1998			1999	
Month	**CPI(A)**	**Year-on-year rate of change (%)**	**Month**	**CPI(A)**	**Year-on-year rate of change (%)**
January	116.6	5.1	January	115.6	(0.9)
February	117.3	4.5	February	115.6	(1.5)
March	117.5	4.8	March	114.8	(2.3)
April	117.9	4.4	April	114.0	(3.3)
May	118.1	4.3	May	114.0	(3.5)
June	118.1	4.0	June	113.8	(3.7)
July	118.1	2.7	July	112.2	(5.0)
August	117.6	2.0	August	111.5	(5.2)
September	118.0	2.3	September	112.2	(4.9)
October	115.8	(0.1)	October	112.2	(3.1)
November	114.9	(0.9)	November	111.5	(2.9)
December	114.6	(1.4)	December	111.3	(2.9)

Source: Census and Statistics Department's records

Figure 3

Changes in the CPI(A) at commodity and service level (paragraph 21 refers)

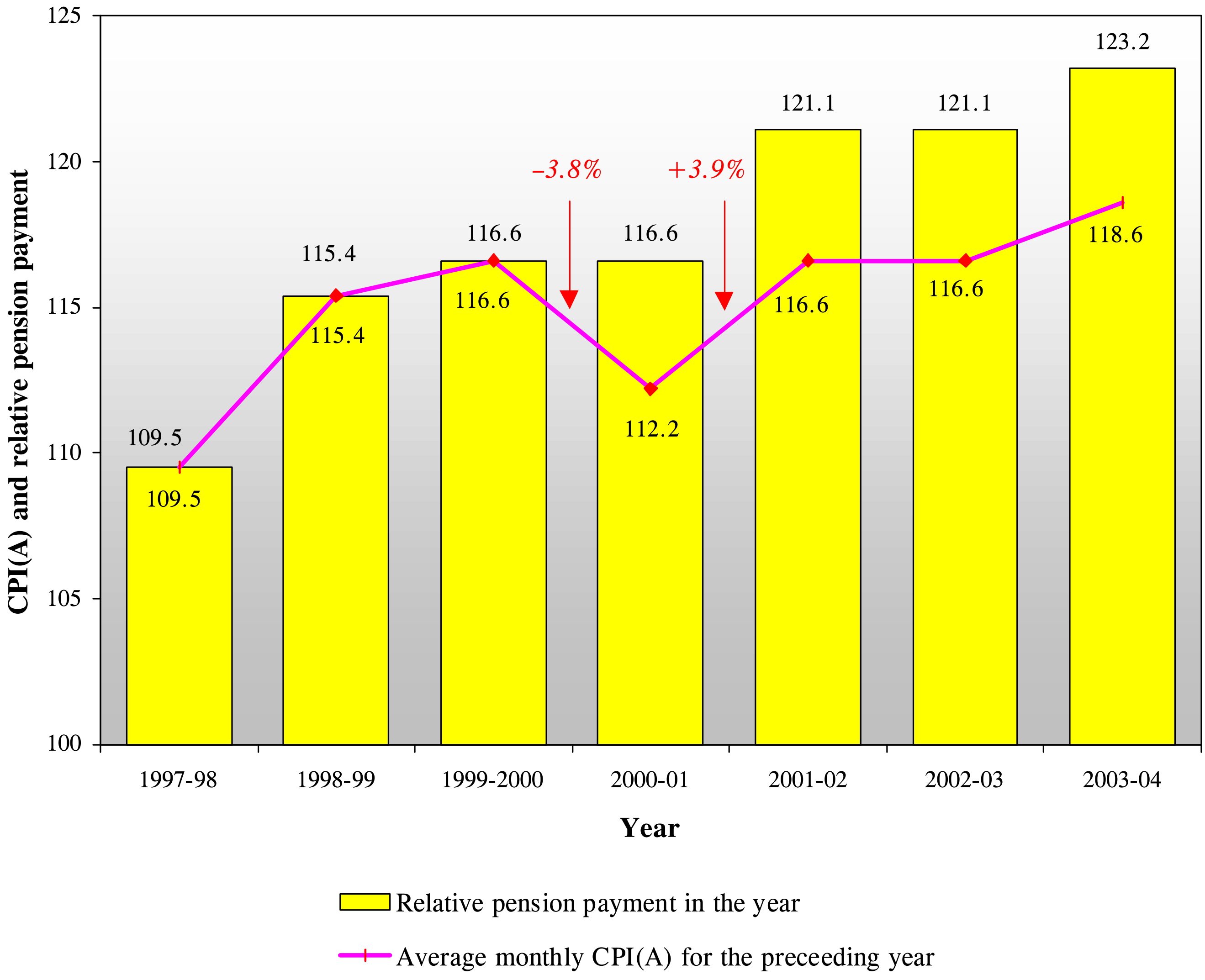


	Commodity and service	Weight	December 1998	December 1999	Rate of change
			(a)	(b)	$(c) = \frac{(b) - (a)}{(a)} \times 100\%$
		(%)	Index	Index	(%)
A	Food	37.3	110.5	107.6	(2.6)
B	Housing	25.3	119.3	116.2	(2.6)
C	Fuel and light	3.4	114.0	116.1	1.8
D	Alcoholic drinks and tobacco	2.1	122.6	120.5	(1.7)
E	Clothing and footwear	5.1	110.1	92.3	(16.2)
F	Durable goods	4.3	104.8	97.0	(7.4)
G	Miscellaneous goods	6.0	116.4	114.6	(1.5)
H	Transport	7.2	117.8	118.0	0.2
I	Miscellaneous services	9.3	119.9	118.8	(0.9)
J	**All items**	**100.0**	**114.6**	**111.3**	**(2.9)**

Source: Census and Statistics Department's records

Figure 4

Adjustment of pension under the present mechanism in the event of deflation (paragraphs 26 and 27 refer)



Source: *Census and Statistics Department's records*

Note: *The CPI(A) figures for the year 1999-2000 are based on the Census and Statistics Department's records. Those figures for the years 2000-01 to 2002-03 are Audit's projections.*

Table 3

Estimated financial implications to the Government for the existing pensioners

Adjustment basis	1999-2000 (Note 1) ($ million)	2000-01 Adjustment factor	2000-01 ($ million)	2001-02 and after Adjustment factor	2001-02 and after ($ million)
		Pension payment for the year			
(A) Upward adjustment for inflation only under the present adjustment mechanism	4,204	0%	4,204	3.9%	4,368
(B) Upward or downward adjustment for inflation or deflation	4,204	(3.8%)	4,044	3.9%	4,202
(C) Financial implications for a year			160		166
(D) Multiplier for total financial implications (Note 2)			× 1		× 17.4
(E) Financial implications			160		2,888

Total financial implications are $3,048 million ($160 million + $2,888 million)

Source: Treasury's records

Note 1: According to the Treasury's records, as at 1 October 1999, the monthly pensions and dependant pensions for the 53,540 pensioners and dependants eligible for pension increase amounted to $4,204 million for a year.

Note 2: Based on the Treasury's records, as at 1 October 1999, Audit estimated that the average life expectancy of existing pensioners was about 18.4 years. Hence, Audit applies a multiplier of one to 2000-01 and a multiplier of 17.4 to 2001-02 and after.

31. It should be noted that if the average monthly CPI(A) for 2000-01 does not rebound back to 116.6, the financial implications of providing pensions at an enhanced level of purchasing power in 2001-02 will be the sum of part of the financial implications of the 3.8% deflation and part of the financial implications of the 3.9% inflation. The financial implications for 2001-02 are between $160 million and $166 million. The financial implications for a year will reach

$166 million if the average monthly CPI(A) rebounds back to or above 116.6. Therefore, the total estimated financial implications to the Government in 2001-02 and after are $2,888 million as indicated in Table 3 of paragraph 30 above. If the average monthly CPI(A) for 2000-01 dips further below the 1999-2000 level of 112.2, the financial implications to the Government of providing pensions at an enhanced level of purchasing power will be further increased.

Financial implications for deferred pensioners and early retirees

32. For deferred pensioners and early retirees, they are not eligible for immediate pension increases. However, they are entitled to accumulating pension increases which will take effect on their reaching the normal retirement age. For this category of pensioners, their pensions will be enhanced by the 3.9% factor mentioned in paragraph 27 above. The financial implications to the Government are $74.2 million on an annualised basis. The estimated total financial implications to the Government for this group of pensioners are $1,855 million. Details are given in Table 4 below.

Table 4

Estimated financial implications to the Government for deferred pensioners and early retirees

	($ million)
(A) Basic pensions for pensioners accumulating pension adjustments	
(i) 10,874 deferred pensioners as at 1 October 1999	1,012
(ii) 6,628 early retirees as at 1 October 1999	891
Total	1,903
(B) Adjustment factor	× 3.9%
(C) Financial implications for a year	74.2
(D) Multiplier for total financial implications (Note)	× 25
(E) Total financial implications to the Government	**1,855**

Source: Records of the Treasury and the CSB

Note: Based on the information supplied by the Census and Statistics Department to the CSB, Audit estimated that the average life expectancy of deferred pensioners and early retirees at the normal retirement age was 25 years.

Total financial implications to the Government

33. **Based on the estimated average monthly CPI(A) of 112.2 for 1999-2000 and under the present pension adjustment mechanism, Audit estimates that the total financial implications to the Government for the provision of pensions at an enhanced level of purchasing power in respect of pensioners, deferred pensioners and early retirees are $4,903 million (i.e. $3,048 million + $1,855 million).**

34. **If deflation recurs in subsequent years (i.e. 2000-01 and after), there will be further financial implications to the Government on top of the financial implications arising from the deflation in 1999-2000. The financial implications of providing pensions at an enhanced level of purchasing power due to deflation under the present pension adjustment mechanism are therefore very substantial, bearing in mind that the total financial implications due to deflation in a year are already $4,903 million.**

CSB's review of the pension adjustment mechanism

Staff side's concern and the legal advice

35. In November 1998, in response to an enquiry from the staff side, the CSB sought legal advice from the Department of Justice on the issue of pension adjustment in the event of deflation. The Department of Justice advised that pension increase was provided for in law and there was no provision for pension decrease in the event where the average monthly CPI(A) of the succeeding year fell below that of the previous year.

Finance Bureau's concern

36. In early May 1999, during the drafting stage of the ExCo Memorandum on the proposed pension increase of 1% for 1999-2000, the Secretary for the Treasury wrote twice to the Secretary for the Civil Service stating that:

— in view of the deflationary environment in 1999, it would be advisable to put in the draft ExCo Memorandum whether the current legislation only permitted an increase in pension payments based on legal advice sought, and whether the CSB was contemplating any amendment to the law; and

— she wished to be informed of the CSB's policy view on the question of pension decrease in the event of a deflation.

ExCo's concern

37. In the ExCo Memorandum of 20 May 1999, ExCo was informed that the provisions of the ordinances only provided for an increase in pensions and that there was no provision for a decrease in pensions in the event of deflation.

38. At the ExCo meeting held on 25 May 1999, the proposed 1% pension increase for 1999-2000 was approved. In response to a question about pension adjustment in the event of deflation, the Secretary for the Civil Service said that:

— it was the Government's established policy, as provided under the law, that the percentage increase in pensions and dependant pensions should be pegged to the annual percentage increase in the average monthly CPI(A) over a year. The relevant ordinances did not provide for a decrease in pensions in the event that the average monthly CPI(A) of a year fell below that of the previous year; and

— **in the light of the change in economic circumstances, the Government was reviewing the policy on pension adjustment in the event of deflation. Any change to the existing mechanism would require legislative amendments.**

CSB's review

39. On 17 May 1999, the CSB Strategy Group (Note 1) discussed an internal paper which raised the question of whether and how the CSB should revise the pension adjustment mechanism to cater for deflation. The paper stated that legislative amendments would be required for the implementation of any changes to the current pension increase mechanism.

CSB's enquiries about pension adjustment mechanisms in other countries

40. From May to November 1999, the CSB made enquiries about the pension adjustment mechanisms of the United Kingdom, Canada, Australia and New Zealand. The results of the CSB's research are shown at Appendix B.

Consultation with the Department of Justice

41. On several occasions, the CSB sought the advice of the Department of Justice. The Department of Justice gave advice to the CSB in June, July and December 1999.

Note 1: *The CSB Strategy Group is a senior management group in the CSB chaired by the Secretary for the Civil Service.*

Advice on financial implications from the Treasury

42. In September 1999, the CSB sought the advice of the Treasury to assess the financial implications if pension level remained unchanged when there were a 1% decrease in CPI(A) in a year and if subsequent pension adjustment did not take into account the 1% decrease. In October 1999, the Treasury advised the CSB that the financial implications to the Government would be $772 million if:

— the CPI(A) for 1999-2000 dropped by 1% (hence pension for 2000-01 would be frozen) and rose by 1% in 2000-01 (pension for 2001-02 would be increased by 1%);

— there would be no change in the CPI(A) from 2001-02 onwards; and

— the general life expectancy of the pensioners receiving pension increase would follow that of the population at large.

Audit observations on CSB's review of the pension adjustment mechanism

43. Audit noted that the CSB was aware of the potential effects of the pension increase mechanism in the event of deflation as early as November 1998. The CSB undertook to carry out a policy review of the pension adjustment mechanism at a meeting of ExCo held in May 1999.

44. Audit noted that the Treasury's calculation was in line with Audit's estimate of financial implications for existing pensioners (see paragraph 30 above). Details are shown in Table 5 below.

Table 5

Estimate of financial implications for existing pensioners

	($ million)
Treasury's figures at 1% deflation in 1999-2000 and 1% inflation in 2000-01	772
Treasury's figures at 3.8% deflation in 1999-2000 and 3.8% inflation in 2000-01	2,934
Audit's estimate at 3.8% deflation in 1999-2000 and 3.9% inflation in 2000-01	3,048

Source: Treasury's records and Audit's computations

However, the CSB and the Treasury have not estimated the financial implications of $1,855 million for deferred pensioners and early retirees (see paragraph 32 above).

45. In Audit's view, the pension policy objective of maintaining the original purchasing power is stated clearly in the relevant ExCo Memoranda. **Audit notes that at the time the policy decisions were made, relevant information about the pension adjustment mechanism and the financial implications in the event of deflation was not included in the two ExCo Memoranda dated 22 November 1975 and 7 May 1990 (see paragraph 9 above) and considers that such crucial information should have been included in the policy papers.** Audit does not question the merits of the existing policy and does not suggest that an alternative policy should be formulated for reduction of pension in the event of deflation. However, under the present pension adjustment mechanism as prescribed by legislation, pensions at an enhanced level of purchasing power will be granted to the pensioners in the event of deflation, despite the fact that the objective of the pension increase policy is to maintain the original purchasing power of the monthly pensions.

46. **Based on the present trend of the CPI(A) movement and the Census and Statistics Department's figures, Audit noted that a 3.8% deflation would be recorded by 31 March 2000 (see paragraph 23 above). In January 2000, Audit informed the CSB of the audit observations including the total financial implications of $4,903 million to the Government under the existing pension adjustment mechanism (see paragraph 33 above). Audit also informed the CSB that this was a fundamental issue with substantial financial implications which required the Administration to take action to review the present arrangement. There was a need to seek clarification by ExCo and inform the Finance Committee of LegCo of the outcome.**

Audit recommendations

47. **In January 2000, Audit *recommended* that the Secretary for the Civil Service should, in consultation with the Secretary for the Treasury and the Director of Accounting Services:**

— **as soon as possible, review the arrangement for pension adjustment in the event of deflation and put up the issue to ExCo for consideration; and**

— **inform the Finance Committee of LegCo of the outcome and seek its funding approval if there were additional financial implications for dealing with pension adjustment in the event of deflation.**

Response from the Administration

48. In late February 2000, the **Secretary for the Civil Service** informed Audit that, in consultation with the Secretary for the Treasury and the Director of Accounting Services, he had

completed the review of the effect of deflation under the current pension increase policy and mechanism as enshrined in the pension increase legislation. On 22 February 2000, the CSB made a submission to ExCo. After considering the outcome of the review (including the Administration's estimated financial implications — see Appendix C) and having noted the movement of CPI(A) in 1999, ExCo advised and the Chief Executive ordered that the current pension increase policy and mechanism as prescribed in the pension increase legislation should be maintained and re-affirmed. The Secretary for the Civil Service has also said that:

— increases of pensions are currently made in full compliance with the pension increase legislation which provides that pensions shall be increased annually by reference to the increase in cost of living as reflected by the increase in the CPI(A). Reduction of pension is not a feature in the current pension increase policy and mechanism, as reflected by the pension increase legislation, both in title and detailed provisions; and

— the current pension increase policy and mechanism have been prescribed in the pension increase legislation and pension payment has been a statutory charge on the general revenue since 1975. No separate submission to the Finance Committee is required for compliance with the existing pension increase legislation.

49. The **Secretary for the Treasury** has said that she shares the Secretary for the Civil Service's general comments on the discussion of the pension increase policy. She has also said that the re-affirmation by ExCo of the existing pension increase mechanism provided for in the pension legislation does not require separate approval by the Finance Committee. However, in line with the good practice of keeping LegCo informed of significant matters concerning government expenditure, she would advise that the Administration should brief the relevant LegCo Panel on the review. She understands that the CSB is planning to do this in due course.

50. The **Director of Accounting Services** has said that he has no comments to make on the audit report.

51. The **Government Economist** has provided figures on the consumer price indices which have been incorporated into the audit report. He has no other comments on the audit report.

Appendix A
(paragraph 17 refers)

Background information about civil service salary adjustments

A1. The Government's policy on salary adjustment is that annual adjustment in civil service salary should be broadly comparable to salary adjustment in the private sector. **There is no statutory provision for civil service salaries to be adjusted.** For the purpose of salary adjustment, a survey of pay trends of the previous year in the private sector is conducted. The results of the survey, after discounting the payroll costs of civil service increments, provide the basis for considering the size of the annual salary adjustment. Other factors, including increases in the cost of living, the state of the economy, budgetary considerations, civil service morale and pay claims of the staff side, are also taken into account. Each salary adjustment is a separate annual exercise based on circumstances prevailing at the time.

A2. The prevailing practice (following a recommendation of the 1988 Committee of Inquiry) is that, where the net Pay Trend Indicator for the lower pay band is below that of the middle pay band, it should be brought up to the same level, unless there are overriding reasons for not doing so. As for the directorate pay band, their salary adjustment has followed that of the upper non-directorate pay band since 1990.

A3. In 1998-99, the salary adjustment for officers at or above Directorate Pay Scale Point 3 and equivalent was frozen, instead of the 6.03% increase in line with that of the upper non-directorate pay band. The decision was taken as part of the Government's response to the economic downturn to demonstrate that those responsible for decision-making in the Government understand and are prepared to share the hardship caused by the then economic turmoil.

A4. The budgetary situation was a significant consideration in the 1999-2000 pay adjustment. At the time when the Financial Secretary announced in the 1999 Budget Speech that civil service pay would be frozen in 1999 for fiscal reasons, the provisional deficit for 1998-99 was $32.3 billion. Having regard to the results of the pay trend survey (ranging from –0.54% to 0.84%), movement in the cost of living, the state of the economy, budgetary considerations, the pay claims of the staff side and civil service morale, in June 1999 ExCo advised and the Chief Executive ordered that the civil service salaries should be frozen across-the-board from 1 April 1999 to 31 March 2000.

A5. The departure from the results of the pay trend surveys for the salary adjustments in 1998-99 and 1999-2000 has demonstrated the flexibility of the salary adjustment mechanism to respond to economic situation and budgetary considerations.

Appendix B
(paragraph 40 refers)

Results of the CSB's enquiries about other countries' pension adjustment mechanisms

		United Kingdom	**Canada**	**Australia**	**New Zealand**
1.	Pension adjustment in the event of deflation	No adjustment	No adjustment	No adjustment	No adjustment
2.	Pension adjustment in the years subsequent to a period of deflation	Up to the "Government of the day" to decide	Does not take previous deflation into account	Takes previous deflation into account	Takes previous deflation into account
3.	Incidence of deflation in recent years	Nil (since 1971)	Not mentioned in reply	1998	Not mentioned in reply

Appendix C
(paragraph 48 refers)

The Administration's estimated financial implications of pension payments in the event of deflation

C1. The estimated total annual expenditure on recurrent monthly pensions in 1999-2000 is $5,046 million. For every 1% change in CPI(A), the financial implications would be about $50 million. If the pension increase mechanism is not revised and assuming deflation of 4% in 1999-2000 and inflation of 2.5% in 2000-01 and 2001-02, the amount of expenditure that would otherwise have been saved if the pension adjustment mechanism had been revised to an index-linked one would be in the order of $202 million in 2000-01, $207 million in 2001-02 and $212 million in 2002-03. The corresponding net change in CPI(A) is –1.6% by the end of 2000-01, and 0.9% by the end of 2001-02.

Appendix D

Acronyms and abbreviations

CPI	Consumer Price Index
CSB	Civil Service Bureau
ExCo	Executive Council
LegCo	Legislative Council
PIO	Pensions (Increase) Ordinance
Standing Commission	Standing Commission on Civil Service Salaries and Conditions of Service
WOPIO	Widows and Orphans Pension (Increase) Ordinance