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The Fiscal Implications of Population Aging for Hong Kong SAR

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The Fiscal Implications of Population Aging for Hong Kong SAR
Prepared by Henry Hoyle

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SELECTED ISSUES PAPERS

The Fiscal Implications of Population Aging for Hong Kong SAR

Hong Kong SAR

Prepared by Henry Hoyle

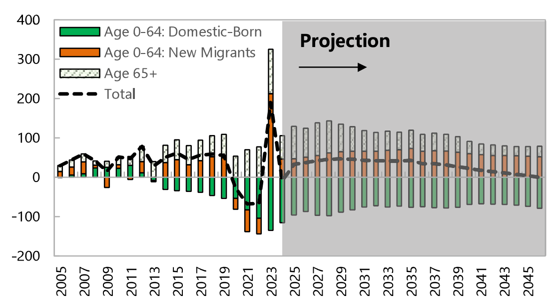
THE FISCAL IMPLICATIONS OF POPULATION AGING FOR HONG KONG SAR[1]

Hong Kong SAR's significant demographic pressures will create fiscal challenges for the authorities. Fiscal expenditure pressures from population aging have already been rising rapidly for over a decade and are expected to increase significantly in coming years, even without factoring in the cost of needed improvements to the social security system. An aging population is also going to adversely affect the economy's potential output growth and fiscal revenue, with the effect larger in a scenario where the working age population shrinks. Revenue-boosting tax reforms and other fiscal measures will be needed to provide a stable funding base for Hong Kong SAR's high-quality development into the medium term.

A. Introduction

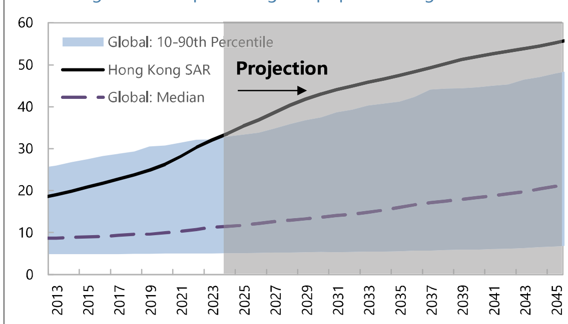
1. **Hong Kong SAR faces significant demographic pressures in the medium term and beyond**. With a fertility rate among the world's lowest, and one of the highest average lifespans, Hong Kong SAR is set to face rapid population aging in the coming decade. The number of older adults (age 65+) is set to increase by 25 percent by 2030 from mid-2024, and by 59 percent by 2045, according to authorities' latest demographic projections. The working age population (ages 15-64) is set to remain roughly stable, although only with significantly increased inward migration to replace the sizeable decline in domestic-born working age adults. Given these trends, the old-age dependency ratio—the share of older adults relative to working age adults—is on track to be among the world's highest by 2045.

Change in Population, by Selected Cohorts
Thousands of people



Source: Hong Kong SAR Census and Statistics Department, IMF staff
Note: Uses authorities' projections. The domestic-born/new migrant breakdown is estimated assuming migrants are below age 65.

Old Age Dependency Ratio: Selected Economies
Adults aged 65+ as percentage of population aged 15-64



Source: Hong Kong SAR Census and Statistics Department, United Nations Department of Economic and Social Affairs, and IMF staff

2. **An aging population will create fiscal challenges for the Hong Kong SAR's government**. The territory's main pension program—the Mandatory Provident Fund (MPF)—is a mandatory defined contribution scheme with the objective of helping the workforce save for basic

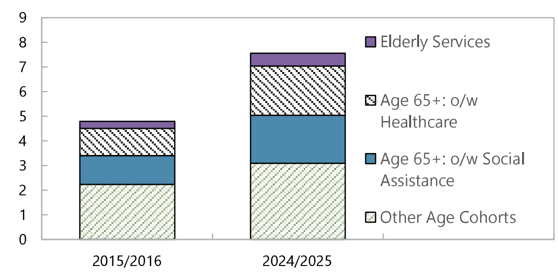
[1] Prepared by Henry Hoyle.

retirement needs. As net replacement rates are low compared in international experience, it is designed to complement other pillars in Hong Kong SAR's multi-pillar retirement protection framework. These include means-tested, non-contributory financial assistance schemes and subsidized healthcare, which in practice form a critical part of the social safety net for lower-income older adults. This spending is set to rise sharply as the population ages. At the same time, slower growth in the working age population, combined with lower labor force participation among the older age cohorts, is likely to limit the territory's economic growth potential and its fiscal revenues.

3. **Fiscal expenditure burdens related to the aging population have already been rising rapidly**. Recurring government spending on social welfare and healthcare budgeted for 2024/2025 stood at 7½ percent of GDP, which is 2.8 percentage points of GDP higher than in 2015/2016. More than two-thirds of that increase is estimated to be driven by spending on older adults. This reflects both the nearly 50 percent growth in that age cohort in the same period as well as increased per capita spending, which rose more than 40 percent. The key components of this older adult-related spending are as follows:

- *Healthcare* (2.1 percent of GDP). As in other countries, older adults are disproportionate users of medical services, accounting for nearly 60 percent of the hospital system's patient days in 2022/2023 (with half of that adults aged +80). Funding for Hong Kong SAR's Hospital Authority accounts for the bulk of this spending, as costs are waived for much of the elderly population. Growth in this segment has been to a large degree driven by the more than 60 percent increase in per capita spending since 2015/2016.

Recurrent Spending on Healthcare and Social Welfare, by Function and Age of Beneficiary
Percentage points of GDP



Source: Hong Kong SAR authorities and IMF staff analysis
Note: Age cohort split for 2024/2025 data is estimated

- *Financial assistance* (1.9 percent of GDP). This accounts for an estimated 40 percent of fiscal expenditure on older adults as of 2024, with most of it through means-tested programs like the Older Adult Living Allowance (OALA) and the Comprehensive Social Security Allowance (CSSA). The coverage ratio of these schemes was 75 percent as of September 2024, and has remained stable over the last decade, with roughly 70-75 percent of older adults benefiting from these programs.[2]

- *Elderly care* (0.5 percent of GDP). This comprises spending on subsidized long-term care services including residential care services, community care services, and other support services. As of 2023, elderly care spending per older adult increased 47 percent in CPI-adjusted terms from a decade earlier.

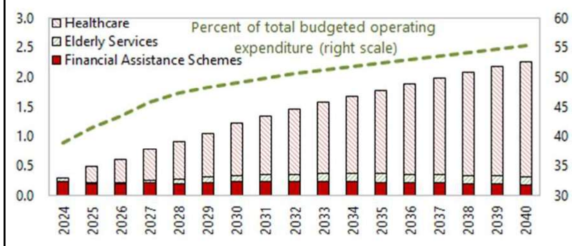
[2] About 21 percent of older adults are receiving the Old Age Allowance (OAA), which is not means-tested and has relatively lower benefits (1,620 HKD per month from February 2024).

B. The Fiscal Implications of Aging in the Coming Years

4. **Aging-related spending is expected to grow significantly in coming years**. Staff's estimates—factoring in the growth in older adults, price inflation, among other assumptions—suggest that such spending will further increase by 0.6 percentage points of GDP by 2027, 1.0 percentage points by 2030, and 1.8 percentage points by 2040. Under these assumptions, total healthcare and social welfare spending would rise to 55 percent of authorities' long-term budget projections for operating expenditure, up from 36 percent in 2023. Healthcare costs are projected to account for the bulk of this increase, reflecting older adults' intensive use of such services and an assumption of medical cost inflation of 1 percent per year. Financial assistance programs and elderly service spending are also likely to continue growing, although only modestly, with per capita benefits for both assumed to grow in line with CPI.[3] Taken together, these assumptions generate annualized growth in CPI-adjusted per capita benefits that are lower than realized growth from 2012-2023, the last period with complete data on elder-related spending.

Total Social Welfare and Healthcare Spending: Projected Cumulative Change from 2023 and Share of Spending

Percent of GDP and percent of total budgeted operating expenditure



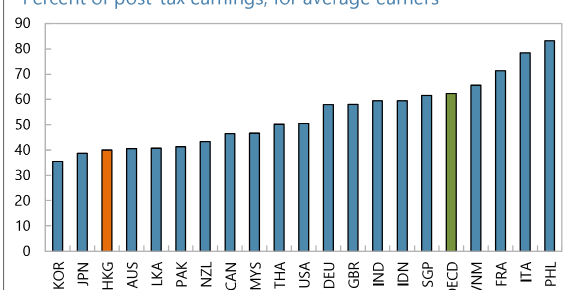
Source: IMF staff analysis.
Note: Budgeted operating expenditure based on 2024/2025 budget. Operating expenditure after 2028 is the 2028 level (17.3 percent of GDP)

5. **Hong Kong SAR's long-closed pension scheme for civil servants may also require increased outlays in the coming decades**. The defined benefit pension scheme for civil servants was closed to new entrants in 2000 but had an additional HKD 1 trillion (32 percent of GDP) of unfunded obligations on a net present value basis as of March 2023. The annual fiscal expenditure on scheme benefits of around 1.5 percent of GDP may rise in the medium term depending on the scheme's maturity.

6. **Needed improvements to the social security system would further increase fiscal costs**. Public social protection expenditure as a share of GDP has been rising in recent years but is low in cross-country context. The net replacement rate of the combined primary social security scheme (OALA) and the individual- and employer-funded MPF system were 40 percent for average earners, about two-thirds the OECD average level of 62.4. Raising the OALA's benefit levels to improve the net replacement rate by

Estimated Net Replacement Rates for Pensioners

Percent of post-tax earnings, for average earners



Source: OECD 2022.
Note: Net replacement rates show post-tax retirement benefits as a percentage of post-tax earnings. Data as of 2022.

[3] Benefit levels for the financial assistance schemes (OALA, CSSA, and OAA) are adjusted based on growth in the Social Security Assistance Index of Prices, which is compiled by the Hong Kong SAR government on a monthly basis to reflect the impact of price changes on CSSA recipients. For the purpose of this analysis, benefit levels for these schemes are expected to grow in line with CPI.

10 percentage points—closing the gap with the OECD average net replacement rate by about half—would add roughly 0.7 percent of GDP to the scheme's annual cost in 2025, gradually increasing to 0.9 percent of GDP by 2040.

7. An aging population will also drag on the economy's potential output and fiscal revenues. The authorities' projections show that the labor force will likely remain relatively stable in coming decades, as inward migration and rising labor force participation among the working age population offset the aging of the domestic-born population. This will represent a slowdown in labor supply growth relative to the 2010-2019 period, when the labor force grew by about 1 percent on average. The annual contribution of labor supply to potential output growth from 2025-2040 is projected to be 0.1 percentage points lower than from 2010-2019 (cf. paragraph 12 in the Staff Report). Absent new fiscal measures, this is expected to limit the growth in fiscal revenues by an equivalent amount, as revenues are assumed grow in line with GDP.

8. The effect of aging on fiscal revenues would be even larger in a scenario where the working age population shrinks. If inward migration does not increase from historically average levels, i.e. just over 30,000 newcomers per annum, the labor force is likely to fall by about 4 percent by 2030 and 10 percent by 2040.[4] The drag on fiscal revenues via lower potential output growth would mean 3 percent lower revenues by 2030 versus the baseline demographic scenario, and a 7.5 percent decline by 2040.[5] Additional long-term impacts on growth could come if aging-related expenditures crowd out productivity-enhancing government investments in infrastructure or education, or other public goods.

9. The links between aging and economic growth are however highly uncertain, and negative impacts could be offset by migration, adaptive investments, or other factors. While labor supply growth is likely to fall to zero or even shrink, the impact on potential growth could be offset by higher productivity. Labor shortages may induce firms to invest more in automation and other labor-saving innovations, boosting profits and growth, as had occurred in Japan and other aging countries. The labor supply may also grow more than expected if older individuals stay in the workforce longer, or if patterns of migration, mortality, and fertility differ substantially from projections.

[4] This demographic scenario is based on the United Nations Department of Economic and Social Affairs (UNDESA) 2024 population projections, using the zero migration variant for Hong Kong SAR. It then assumes each year 32,000 migrants come, evenly distributed through the 20-24, 25-29, 30-34, 35-39 year old age cohorts. This population is assumed to have children at the UNDESA rate of childbirths per 1000 childbearing population.

[5] Potential output estimates are derived by using the assumptions and parameters of the aggregate production function used in paragraph 12 of the Staff Report, but using an alternative path of hours worked. This is based on the demographic scenario described in footnote 5, the age cohort- and year-specific labor force participation rates assumed by Hong Kong SAR's Census and Statistics Department, and an assumption for hours worked based on a gradual recovery in the labor force participation rate from the current historically low levels to those reported in 2017-18 by 2039.

C. Policy Implications

10. Aging-related fiscal pressures will require revenue-boosting tax reforms and other fiscal measures. Hong Kong SAR's low-tax regime has supported its growth as an international financial center and trading hub but will face challenges in funding the cost of caring for its growing population of older adults. A transition to a higher and broader tax revenue base will help Hong Kong SAR absorb aging-related costs while simultaneously adhering to its balanced budget rule, which itself is a key foundation for the territory's macrofinancial resilience. A comprehensive tax reform plan should include the following core elements:

- *Further increases to the progressivity of the personal income tax (PIT).* These will provide a more stable source of revenues compared to land premium and stock market stamp duty revenues, with the additional benefit of reducing inequality.
- *Increases in excise taxes and eventual establishment of a VAT.* These taxes will raise revenues while minimizing impacts on the competitiveness of the business environment.
- *Taxes on dividends and capital.* Taxes on dividends are common in other financial centers. Capital gains taxes could also be considered.

11. Tax reforms should be designed to take into account the impact on the business environment, including from tax competitiveness vis a vis other financial centers. At the same time, these factors must be weighed against the need to provide funding for needed public services and investments over the medium term, which will provide a key foundation for the territory's economic diversification and high-quality growth.