

BRIEF FOR THE LEGISLATIVE COUNCIL

2003 CIVIL SERVICE PAY ADJUSTMENT

INTRODUCTION

At the meeting of the Executive Council on 25 February 2003, the Council ADVISED and the Chief Executive ORDERED that –

- (a) we should restore the dollar value of all civil service pay points below Directorate Pay Scale Point 3 (D3) or equivalent to the levels as at 30 June 1997 in cash terms by two adjustments of broadly equal amount to be implemented from 1 January 2004 and 1 January 2005 respectively;
- (b) we should restore the dollar value of all civil service pay points at D3 and above or equivalent to the levels as at 30 June 1997 in cash terms from 1 January 2004;
- (c) we should aim to introduce legislation into the Legislative Council as soon as possible to implement the pay reduction referred to in (a) and (b) above;
- (d) the pay reduction referred to in (a) above should also apply to officers on starting salaries who are offered appointment from 26 February 2003;
- (e) as the pay and conditions of service of judges and judicial officers are determined separately from the civil service, the Judiciary should be consulted on the pay adjustment for judges and judicial officers before a decision is to be made;
- (f) as a separate exercise we should in consultation with staff develop, on the basis of the existing mechanism, an improved civil service pay adjustment mechanism which should comprise the conduct of periodic pay level surveys to compare civil service pay levels with those in the private sector, the conduct of annual pay trend surveys based on an improved methodology and an effective means for implementing both upward and downward adjustments. We should aim to complete this exercise,

- including the conduct of a pay level survey, within 2004; and
- (g) no annual pay trend survey should be conducted for 2002-03 and 2003-04. The 2004-05 pay trend survey will be carried out on the basis of an improved survey methodology to be drawn up.

JUSTIFICATIONS

Broad Policy Considerations

2. In order to demonstrate the Government's resolve in tackling the fiscal deficit, the Government needs to present a credible three-pronged programme of measures in the 2003-04 Budget to be made public on 5 March 2003. The handling of the 2003 civil service pay adjustment is a key factor which would significantly impact on the Government's target to reduce operating expenditure in 2006-07 by \$20 billion. It would also impact on the extent of public acceptance of any revenue-generating measures which may be proposed in the 2003-04 Budget.

3. Under the established annual civil service pay adjustment mechanism, the Government will decide on the size of the annual adjustment having regard to the following factors : the net pay trend indicators derived from the private sector pay trend survey, the state of the economy, budgetary considerations, changes in the cost of living, the staff sides' pay claims and civil service morale. Our considerations concerning the state of the economy and changes in the cost of living are set out in Annex A. The other considerations are highlighted in paragraphs 4-10 below.

Pay Trend Survey

4. In view of increasing public criticisms about the shortcomings of the existing methodology of the annual pay trend survey and public concerns about a perceived pay disparity between the civil service and the private sector, we have held in abeyance the conduct of the 2002-03 pay trend survey based on the existing methodology. Because of its inherent nature, the pay trend survey only gives a broadbrush indication of the average year-on-year movement in the pay of the various salary bands in the surveyed companies, but says nothing about the correctness of the civil service pay levels. To address the perceived pay disparity between the civil service and the private sector,

the Task Force on Review of Civil Service Pay Policy and System¹ (the Task Force) has recommended in its Phase One Final Report that priority should be given in the short term to devising a practical framework and methodology for conducting a pay level survey and to reviewing the pay trend survey methodology. Meanwhile, the Administration should consider the appropriate interim measures for the annual civil service pay adjustment exercise.

5. In the absence of a pay level survey and any improvement to the existing methodology of the pay trend survey, the results of a pay trend survey conducted for 2002-03 on the basis of the existing methodology would lack credibility.

Budgetary Considerations

6. In his 2002 Budget Speech, the Financial Secretary has set three targets to be achieved by 2006-07, which are to restore balance in the Consolidated Account, to attain a balanced Operating Account and to reduce public expenditure to 20% of GDP or below. In pursuit of these targets, the Government has announced a three-pronged approach, i.e. boost the economy, control government expenditure and raise revenue. On measures to control government expenditure, as pledged in the 2003 Policy Address, the Government has set a target to reduce its operating expenditure by \$20 billion by 2006-07. Bureaux and departments have been asked to pursue the “3Rs 1M” – reprioritise our work, reorganise government structures, re-engineer procedures and make the best use of the market and the private sector in the delivery of services with a view to contributing towards this overall savings target.

7. As personnel-related expenses (the civil service and the subvented sector included) currently account for 70% of the Government’s operating expenditure, it is necessary to take measures to contain such expenses in a bid to meet the overall \$20 billion savings target. In this regard, the Government has announced its decision to reduce the establishment of the civil service by 10% to about 160 000 by 2006-07, a general recruitment freeze with effect from 1 April 2003 and the implementation of the Second Voluntary Retirement Scheme (VR) shortly. We expect that through departures under the VR scheme and natural wastage, the 10% establishment cut will be achieved. As a

¹ In December 2001, the Government launched a comprehensive review of civil service pay policy and system with the assistance of the Standing Commission on Civil Service Salaries and Conditions of Service, the Standing Committee on Disciplined Services Salaries and Conditions of Service and the Standing Committee on Directorate Salaries and Conditions of Service. A Task Force was subsequently set up under the three advisory bodies to take forward the review. The Task Force submitted its Phase One Final Report to the Administration in September 2002.

rough ballpark estimate, the 10% cut in establishment would enable bureaux and departments to generate notional gross savings in the order of \$4.7 billion a year.

8. However, having regard to the magnitude of the savings target, the need to maintain the quality and provision level of public service at a reasonable level, the time required for the implementation of major “3Rs 1M” initiatives to make a significant financial impact, and the need to convince the market that the Government has both the resolve and the means to control its operating expenditure, a reasonable civil service pay reduction would be necessary.

Staff Sides’ Pay Proposals

9. The Secretary for the Civil Service (SCS) had been discussing with the staff sides of the four central consultative councils and representatives of the four major service-wide staff unions through the Working Group on Civil Service Pay Adjustment and Related Issues (the Working Group) the approach to be adopted for the handling of the 2003 civil service pay adjustment exercise since September 2002, well ahead of the usual timetable for staff consultation on the annual pay adjustment. A total of six formal meetings were held between September 2002 and January 2003 and various proposals were discussed.

Consensus Reached with the Staff Representatives

10. Following further discussions held on 21 February 2003 and taking account of all the relevant factors under the prevailing annual civil service pay adjustment mechanism, SCS reached consensus with the staff representatives on the following proposal –

- (a) the dollar value of all civil service pay points below D3 or equivalent should be restored to the levels as at 30 June 1997 in cash terms by two adjustments of broadly equal amount to be implemented from 1 January 2004 and 1 January 2005 respectively;
- (b) the dollar value of all civil service pay points at D3 and above or equivalent should be restored to the levels as at 30 June 1997 in cash terms from 1 January 2004;
- (c) the Government would aim to introduce legislation into the Legislative Council within 2003 to implement the proposed pay reduction; and

(d) as a separate exercise the management would in consultation with staff develop, on the basis of the existing mechanism, an improved civil service pay adjustment mechanism which should comprise the conduct of periodic pay level surveys to compare civil service pay levels with those in the private sector, the conduct of annual pay trend surveys based on an improved methodology as well as an effective means for implementing both upward and downward adjustments. We should aim to complete this exercise, including the conduct of a pay level survey, within 2004.

Pay Reduction Decision

11. Taking account of the annual civil service pay adjustments since 1997, the pay reduction decision means that for civil service pay points below D3 or equivalent, their dollar values will be reduced by about 3% from 1 January 2004 and another 3% from 1 January 2005. For civil service pay points at D3 or above, their dollar values are now only marginally above the levels on 30 June 1997. These pay points will be reduced by about 0.33% from 1 January 2004.

12. The decision to restore civil service pay to the levels as at 30 June 1997 in cash terms has taken reasonable account of all the relevant factors under the prevailing annual civil service pay adjustment mechanism. The staggered approach would also minimize the impact on junior-ranking staff. The pay reduction will apply to all civil servants, irrespective of the date of their appointment to the civil service (but see the arrangement set out in paragraph 18 below as regards staff on starting salaries.)

13. In accordance with the pensions legislation, an officer's pension benefits are calculated on the basis of three factors, namely the highest pensionable emoluments, the length of pensionable services, and a pension factor which varies according to his pension scheme and nature of office. The highest pensionable emoluments enjoyed or drawn by an officer in the course of his public service shall be used for computing his pension benefits, except those who have been subject to disciplinary proceedings which result in reduction in rank. Thus, an officer's pension benefits which have accrued immediately before the proposed civil service pay reduction takes effect will not be affected by the reduction.

Need for Legislation

14. Although it is inherent in the existing adjustment mechanism that some of the consideration factors for determining the annual civil service pay adjustment may have a positive or negative impact on the size of the pay adjustment, the contractual employment arrangements between the Government and the vast majority of serving civil servants do not contain an express provision authorising the Government to reduce pay. In the context of the 2002 pay adjustment exercise, legal advice is that it is necessary and appropriate to seek the enactment of legislation to implement with certainty a justified decision on a civil service pay reduction. Accordingly, we have sought the enactment of the Public Officers Pay Adjustment Ordinance.

15. Legal advice is that if we decide to pursue a further civil service pay reduction, legislation would again be necessary. It should be noted that there are pending judicial review cases before the court on the lawfulness of the Public Officers Pay Adjustment Ordinance. The court hearing for two of the cases has been scheduled for 6 – 9 May 2003. The court has adjourned the other two cases until after its judgment in the first two.

16. We have been advised that pending the conclusion of these cases, the Administration is not precluded from discussing with staff the draft legislation for implementing any proposed pay reduction. However, such discussion should not in any way pre-empt the decision of the court. We have been further advised that the Administration is not precluded from introducing a bill into the Legislative Council, pending the judgment of the Court of First Instance, provided the resumption of the second reading debate is deferred until after the judgment is given. In the light of the foregoing, we shall introduce the legislation for implementing the pay reduction into the Legislative Council as soon as possible.

Implications on the Starting Salaries for Civil Service

17. With effect from 1 April 2000, starting salaries have been delinked from the annual civil service pay adjustment. An appointee recruited in a particular year on the delinked starting salary will remain on that salary until he qualifies for an increment after which he will join the respective pay scale and move along the adjusted scale in subsequent years. To ensure that the civil service benchmark pay is in line with private sector pay in future, a full benchmark review would be conducted every three to four years with annual updating carried out in the interim.

Due to the launching of the comprehensive review on civil service pay policy and system in December 2001, the Chief Executive Council decided that the periodic benchmark review, which was due in 2002/2003, should be held in abeyance.

18. To avoid a situation where civil servants on starting salaries are paid higher than officers at equivalent pay points, the pay reduction decision will also apply to the former category of officers who are offered appointment from 26 February 2003.

Implications on Other Public Officers

19. Consistent with our usual practice, following the pay reduction for the civil service, the pay of ICAC officers, other public officers who are not civil servants or ICAC officers but whose pay is determined or adjusted in accordance with or by reference to civil service pay scales or the ICAC pay scale (such as the Director of Audit, members of the auxiliary services, graduate/undergraduate trainees in the Department of Justice and works departments and temporary teachers, etc.) will also be adjusted downwards.

Implications on Allowances

20. Similarly, those allowances payable to civil servants and public officers which are determined or adjusted in accordance with or by reference to a point on the civil service pay scales or the public service pay scales (e.g. Hardship Allowance (Dangerous Duties) is set at 9.3% of Master Pay Scale Point 1), and those allowances which are adjusted in accordance with or by reference to adjustments to the civil service pay scales or the public service pay scales (e.g. Consolidated Overtime Allowance for domestic staff in official residences is adjusted annually in line with the lower salary band of the civil service) will also be reduced following the reduction in civil service pay.

Implications on the Judiciary

21. The Administration has been discussing with the Judiciary for some time the establishment of a new institutional structure and mechanism as well as the appropriate methodology for the determination and revision from time to time of the pay and conditions of service for judges and judicial officers. We are awaiting a proposal from the Chief Justice, which we understand will be submitted to the Administration in early 2003. In view of this development and as the pay and conditions of service of judges and judicial officers are determined separately from the

civil service, the Chief Executive in Council decided that we should consult the Judiciary on the adjustment of judicial pay before a decision is to be taken on this matter.

Implications on the Subvented Sector

22. The established practice is that for subventions whose formula for adjustment includes a factor of civil service pay adjustment, we adjust the subventions in accordance with the formula when we adjust civil service pay.

23. Remuneration for subvented staff is a separate matter from funding for subvented organisations. Generally speaking, the Government will not directly impose a pay reduction in the subvented sector, as it is an established principle that the pay and other appointment matters of staff working in subvented organisations is generally a matter between the organisations as employers and their employees. As a result of a reduction in subvention, some subvented organisations may have to consider reducing the pay of their staff in order to make ends meet. Separately, irrespective of the subventions received, some subvented organisations may have to comply with prevailing policies requiring a link between the pay for their staff and those of the civil service. As the subvented sector is subject to the Employment Ordinance, the subvented organisations will have to comply with statutory provisions on variation of contract terms through mutual consent and on termination of contracts under prescribed conditions. Some subvented organisations will also have to take into account other laws applicable in their cases. We will, through the Controlling Officers, see whether individual organisations will run into management difficulties in trying to implement a pay reduction and offer appropriate assistance. Notwithstanding the possibility of such management difficulties, as with the Public Officers Pay Adjustment Ordinance for last year's pay reduction, we do not propose to legislate for a pay reduction in the subvented sector.

Need for an Improved Civil Service Pay Adjustment Mechanism

24. In recent years, there have been increasing public concerns about a perceived pay disparity between the civil service and the private sector. These concerns are attributable to the fact that the Government has not carried out any pay level survey since 1986 and criticisms about certain aspects of the methodology of the annual pay trend survey.

25. In its Phase One Final Report submitted to the Government in

September 2002, the Task Force pointed out that the pay level surveys should form the foundation of the civil service pay determination mechanism while pay trend surveys should play a complementary role to ensure that civil service pay levels would be updated in the intervals between pay level surveys. To address the perceived pay disparity between the civil service and the private sector, the Task Force recommended that priority should be given in the short term to, among others, devising a practical framework and methodology for conducting a pay level survey.

26. The existing methodology of the annual pay trend survey, although broadly accepted by the management and the staff sides, has been under criticism from various quarters in recent years. These criticisms include -

- (i) The survey does not cover small-and-medium enterprises with fewer than 100 employees, which are the mainstay of the Hong Kong economy;
- (ii) The survey field does not reflect accurately the territory-wide distribution of the economically active population; and
- (iii) The methodology does not take into account the overall payroll cost savings arising from redundancy/streamlining/downsizing exercises undertaken by the surveyed companies, which may have reduced or removed the pressure to reduce the pay of their existing staff.

In its Phase One Final Report, the Task Force referred to similar criticisms about the methodology of the annual pay trend survey and suggested that for the short term, priority should be given to reviewing the survey methodology.

27. Based on the feedback received during the public consultation exercise conducted by the Administration on the Task Force's Phase One Final Report², there is general support for the Task Force's recommendations for the short term. Under the consensus proposal reached between SCS and the staff representatives (see paragraph 10 above), it was also agreed that the Administration should in consultation with staff improve on the existing pay adjustment mechanism.

² Following receipt of the Task Force's Phase One Final Report in September 2002, the Administration conducted an eight-week public consultation exercise on the report to gauge feedback on the recommendations put forward by the Task Force. A total of 135 submissions were received.

28. Taking account of the foregoing, the Chief Executive in Council decided to accept the Task Force's recommendation in this regard and to embark on the development of an improved civil service pay adjustment mechanism based on the existing mechanism. This improved mechanism should comprise the conduct of periodic pay level surveys to compare civil service pay levels with those in the private sector, the conduct of annual pay trend surveys based on an improved methodology as well as an effective means for implementing both upward and downward adjustments. This should be taken forward as an exercise separate from the impending civil service pay adjustments. The aim is to complete the exercise, including the conduct of a pay level survey, within 2004.

29. To enhance the impartiality of the conduct of the pay level survey and the review of the pay trend survey methodology, the Administration will set up –

- (a) a steering committee under the chairmanship of the SCS and comprising members from outside the civil service to oversee the conduct of the pay level survey and the review of the pay trend survey methodology; and
- (b) a consultative group involving staff representatives to effectively gauge their views during the review process and to provide input to the deliberations of the steering committee.

30. The Task Force has also made a number of recommendations on the long-term vision for the civil service pay system, the principles and practices guiding the determination of civil service pay as well as issues for more detailed study in the medium and long term. The Administration will take a view on the way forward for these matters having regard to the comments received during the public consultation exercise on the Task Force's Phase One Final Report and the latest developments.

IMPLICATIONS OF THE PROPOSAL

31. The proposal has Basic Law, financial and staffing, and economic implications as set out at Annex B.

32. The proposal has no productivity, environmental or sustainability implications.

PUBLICITY

33. SCS will make an announcement on 25 February 2003. A press release will be issued on the same day. SCS will also write to all civil servants informing them of the Chief Executive in Council's decision.

SUBJECT OFFICERS

34. Enquiries on this brief should be addressed to Mr. Eddie Mak, Principal Assistant Secretary for the Civil Service (tel: 2810 3112).

Civil Service Bureau

25 February 2003

**Considerations concerning the state of the economy
and changes in the cost of living**

State of the Economy

The Hong Kong economy, after turning around to a modest growth in the second quarter of 2002, picked up visibly in the third quarter and probably more so in the fourth quarter. The growth impetus continued to come from the external sector. On a year-on-year comparison, the Gross Domestic Product (GDP) accelerated to a 3.3% growth in real terms in the third quarter of 2002, from a 0.8% growth in the second quarter. The current forecast of growth rate in real terms of GDP for 2002 as a whole is 2%.

2. Externally, exports of goods continued to benefit from sustained strong demand in the mainland of China, generally increased import intake in the region, and a further gain in external price competitiveness from the earlier weakening in the US dollar. Total exports of goods surged by 11.4% in real terms in the third quarter of 2002 over a year earlier, and further by about 18% in the fourth quarter. Exports of services were also robust, with a 14.1% growth in real terms in the third quarter of 2002 over a year earlier.

3. The domestic sector, whilst still weak, also showed some relative improvement in overall terms. Consumer spending had a lesser year-on-year decline of 1.5% in real terms in the third quarter of 2002. Yet investment spending remained sluggish, falling by 5.0% in real terms in the third quarter of 2002 over a year earlier.

4. In tandem with the pick-up in overall economic activity, labour market conditions improved recently. The seasonally adjusted unemployment rate fell back from a peak of 7.8% in May – July 2002 to 7.4% in the third quarter and further to 7.2% in the fourth quarter. Yet, the underemployment rate edged up from 2.9% in the second and third quarters of 2002 to 3.1% in the fourth quarter.

5. There are uncertainties on both the external and domestic fronts. Externally, a relapse in the US economy, if to come about, would have ramifications on global economic recovery with inevitable spill-over effects on the Hong Kong economy. Plausible military action on Iraq remains a key concern. Domestically, there is concern that the on-going adjustment to economic restructuring and continuing downward pressure

on prices may keep holding back demand.

Cost of Living

6. The changes in the cost of living indices for the period 1 January 2002 to 31 December 2002, over the period from 1 January 2001 to 31 December 2001, are as follows –

Consumer Price Index C [CPI(C)] (i.e. average monthly household expenditure of \$32,500 to \$65,999 at 2002 prices)	- 2.8%
Consumer Price Index B [CPI(B)] (i.e. average monthly household expenditure of \$18,500 to \$32,499 at 2002 prices)	- 3.1%
Consumer Price Index A [CPI(A)] (i.e. average monthly household expenditure of \$4,500 to \$18,499 at 2002 prices)	- 3.2%
Composite CPI (i.e. based on the expenditure patterns of all the above households taken together)	- 3.0%

IMPLICATIONS OF THE PROPOSAL

(i) Basic Law Implications

The Department of Justice has advised that Article 100 of the Basic Law fixes a minimum annual salary (i.e. the salary on 30 June 1997) below which the salaries of civil servants employed on that day could not fall. While it is open to interpretation whether inflation or deflation subsequent to 30 June 1997 may be taken into account in determining if a proposed magnitude of pay adjustment complies with Article 100 of the Basic Law, a pay reduction which does not bring the salary level below that on 30 June 1997 in cash terms would clearly be consistent with the Basic Law.

2. Article 103 of the Basic Law provides, among other things, that Hong Kong's previous system of employment and management for the public service, including special bodies for pay and conditions of service, shall be maintained. The Department of Justice has advised that an annual pay trend survey is not a constitutional requirement and the absence of such a survey in 2002-03 will not make the pay reduction decision unlawful. An improved civil service pay adjustment mechanism will help to uphold the principle of broad comparability with private sector pay, which underpins our civil service pay policy. As such, the Department of Justice has advised that the development of an improved civil service pay adjustment mechanism is consistent with Article 103 of the Basic Law.

3. The pay reduction decision reflects a consensus reached with the staff representatives following thorough discussions. This meets the requirement for staff consultation under the Labour Relations (Public Service) Convention 1978 which applies to Hong Kong under Article 39 of the Basic Law.

(ii) Financial and Staffing Implications

4. If the pay of all civil servants is to be brought back to the 30 June 1997 level in cash terms, our ballpark assessment is that it will bring about total annual savings of \$7.3 billion from 2005-06. As a rough

indication, the estimated savings for the civil service and the subvented sector and the implications for government and public expenditure are set out below¹ –

	2003-04 (\$million)	2004-05 (\$million)	Full-year savings from 2005-06 (\$million)
(a) Civil service	376	1,882	3,009
(b) Subvented sector	481	2,404	3,846
(c) Government expenditure [i.e. (a) + (b)]	857	4,286	6,855
(d) Civil servants working in public bodies (e.g. Housing Authority and Trading Funds)	51	255	408
(e) Public expenditure [i.e. (c)+(d)]	908	4,541	7,263

5. The Civil Service Bureau will develop the improved civil service pay adjustment mechanism in consultation with staff. We will engage a consultant to assist in carrying out the pay level survey. The Civil Service Bureau will absorb the additional cost from within its global allocation.

(iii) Economic Implications

6. The reduction in civil service pay in itself might cause only very little dampening effect on private consumption and henceforth overall GDP in the economy. Yet the dampening effect might become very much magnified, though relatively speaking still not large in aggregate terms, if the measure should lead to corresponding pay reduction in the private sector. Nevertheless, it might be pondered that such a spill-over effect to the private sector is in practice not necessarily material, as the private sector is more expeditious in its pay adjustment and if indeed the

¹ We have used the salary portion of the public expenditure as the basis of calculation and have assumed that there will be no change in the number and profile of staff during the period from 2003-04 and 2005-06.

level of private sector pay is, as suggested in some quarters, already below that in the civil service. Also, the dampening effect could be offset somewhat where, within the overall target of Government expenditure cut, a reduction in civil service pay would imply lesser cuts being necessitated in other expenditure areas.

7. The development of an improved civil service pay adjustment mechanism comprising the conduct of periodic pay level surveys and annual pay trend surveys will help to ensure that civil service pay is broadly comparable to private sector pay. This would be commensurate with the need to attract personnel of the right calibre for the respective civil service posts on the one hand, yet not to an excessive degree as to breed wastage in financial resources on the other.

8. Currently, the civil service makes up about 5% of the total workforce and civil service emoluments account for about 10% of the overall employment remuneration in the economy. Taking account of the subvented sector, the civil service and employees in subvented organisations together account for about 20% of the overall employment remuneration in the economy. A well-constituted civil service pay adjustment mechanism compatible with the functioning of the labour market as a whole, whilst recognising the characteristics of specific civil service appointment, is conducive to a robust and efficient civil service and sound deployment of manpower resources for the economy at large.