



The 2006-07 Budget

Information Pack for The Financial Secretary's Consultations

November 2005

Introduction

The Financial Secretary will soon be consulting Members of the Legislative Council and representatives from various sectors on the 2006-07 Budget. We have prepared this pack, available also on the budget website (www.budget.gov.hk), to facilitate discussion.

We welcome and value advice on the Budget, whether tendered through the consultation sessions, the website or written submissions.

Chart 1

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The Basic Law

Article 107

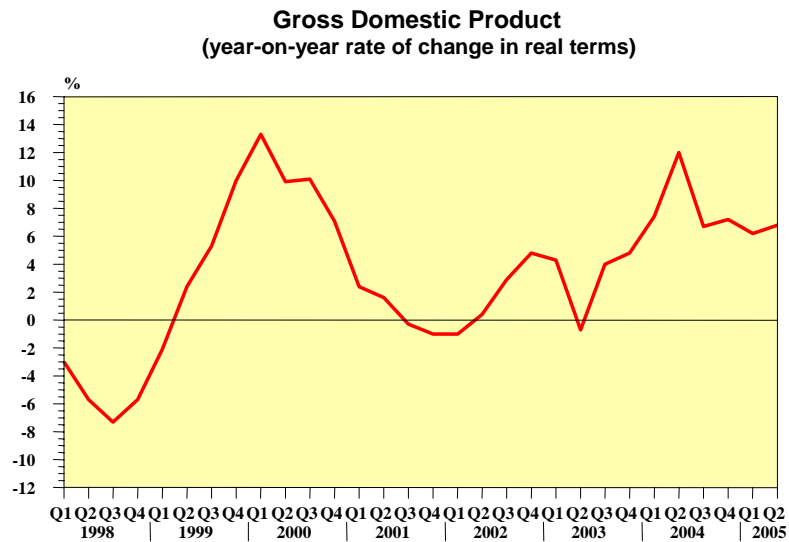
The Hong Kong Special Administrative Region shall follow the principle of keeping expenditure within the limits of revenues in drawing up its budget, and strive to achieve a fiscal balance, avoid deficits and keep the budget commensurate with the growth rate of its gross domestic product.

- The Basic Law (Article 107) requires the Government to “follow the principle of keeping expenditure within the limits of revenues in drawing up its budget, and strive to achieve a fiscal balance, avoid deficits and keep the budget commensurate with the growth rate of its gross domestic product.”
- These constitutional provisions for financial prudence are integral to maintaining the confidence of the international financial community as well as local and overseas investors in Hong Kong.
- We also adhere to a low and simple tax regime and always work towards maintaining the stability and integrity of the monetary system.

Economic positioning

- Accessing the Mainland market, fostering economic co-operation, capitalising on CEPA
- Market leads, Government facilitates
- Building on Hong Kong's strengths, enhancing competitiveness of our key industries
- Developing our human resources, promoting employment
- Maintaining a robust market structure, promoting fair competition

Economy on a firm footing



- The economy continued to expand at a brisk pace in the second quarter of 2005, with Gross Domestic Product (GDP) growing by 6.8% in real terms, up from the 6.2% growth in the first quarter. In the first half of 2005, there was an upbeat outturn of a 6.5% growth in GDP. The expansion is broad-based, with contributions coming from both the external and domestic fronts.

Latest 2005 economic indicators

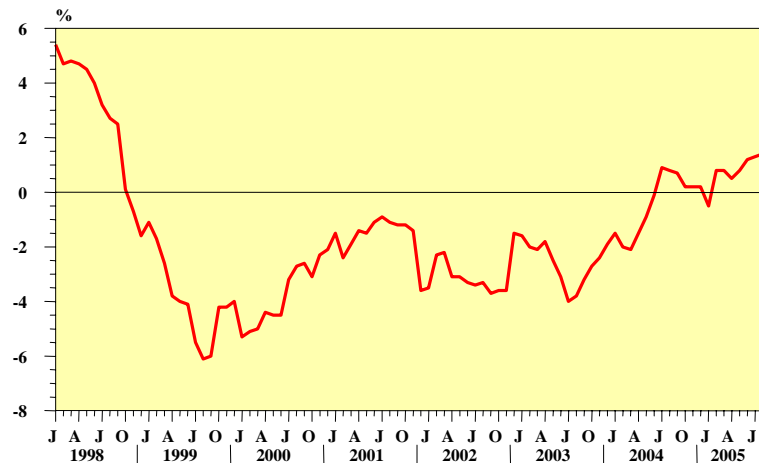
Gross Domestic Product	1 st Half	+6.5%
Unemployment rate	3 rd Quarter	5.5% (down from peak of 8.6%)
Volume of exports of goods	First 8 months	+10.5% (August +13.3%)
Volume of exports of services	2 nd Quarter	+7.8%
Outbound container cargoes	First 7 months	+0.4% (July +7.7%)
Outbound air cargoes	First 9 months	+13.1% (September +10.4%)
Incoming visitors	First 8 months	+7.8% (August +2.6%)
Volume of retail sales	First 8 months	+6.7% (August +5.3%)
Investment expenditure	2 nd Quarter	+3.5%

Except for unemployment rate, the above percentages represent year-on-year changes.

- The current economic recovery has continued to deepen, as evident in many economic indicators.
- Externally, the trade outlook for the rest of the year is still largely positive although the growth momentum may moderate somewhat in the months ahead amidst a more uncertain external environment.
- Domestically, improving job opportunities and recovery of labour income should lend support to consumer demand. Investment demand in overall terms is expected to perform rather well, as continued activity expansion should stimulate machinery and equipment acquisition. But construction and building activity may still be slack in the near term.

Modest consumer inflation even with strong economic growth

Composite Consumer Price Index
(year-on-year rate of change)



- Consumer price inflation has edged up in recent months, along with the increasingly entrenched economic recovery. Yet overall inflationary pressure remains moderate. The Composite Consumer Price Index (CCPI) rose by 1.6% in September over a year earlier. For the first nine months of 2005 as a whole, consumer price inflation averaged at 0.9%.
- Consumer price inflation is expected to rise further in the coming months, in the course of an increasingly entrenched economic recovery, and as high oil prices and the recent 2% renminbi revaluation would feed through to lift import prices. Still, on the whole, local price pressures are expected to be well contained through the end of 2005.

External uncertainties

Short-term

- Surging oil prices
- Rising US interest rates
- US asset prices and consumer confidence
- Movements of US dollar and Renminbi

- Although the global economy looks set for further expansion in the period ahead, creating a fairly favourable environment for sustaining Hong Kong's economic recovery, there are still a number of uncertainties.
- The surge in oil prices to successive new highs continues to pose a key risk that could impinge on global and regional demand. This may have a dampening effect on Hong Kong's export growth in the period ahead.
- Given the HK\$ link, rising US interest rates will lead to higher local interest rates, which may then impinge on the momentum in local asset prices.
- US house prices rose sharply in recent years (11% in 2004 and 13% in the first half of 2005, the fastest increases in decades). A sharp correction of the US housing market, if occurs, would curtail US consumption and GDP growth and hence have significant repercussions on Hong Kong's external trade. It could also lead to much volatility in the financial markets.
- Movements of the US dollar against other major currencies, as well as the future pace and scale of the renminbi exchange rate reform, will affect the price competitiveness of Hong Kong's exports.

External uncertainties

Beyond the short-term

- Persistent current account deficit in the US and on-going trade tension with Asia/Mainland
- Sustainability of Japan's economic recovery
- Success in steering a soft-landing in the Mainland economy

- A robust US economy is crucial to global economic growth. The persistent global imbalance, as manifested by the huge current account deficit in the US and on-going trade tension with Asia/Mainland, is to a large extent the results of the low saving rate and over-indebtedness of American consumers. If left unresolved, this may result in abrupt adjustments in the exchange rate of the US dollar, US asset prices and economic growth. There could be significant repercussions on the rest of the world.
- Being the world's second largest economy, Japan plays a key economic role in the region. Japan's economy, though improved recently, has yet to show clearer signs of a sustained recovery, reversing the past stop-go pattern.
- The success in steering a soft-landing in the Mainland economy is crucial to the long-term stability of the Mainland economy, and hence also important to the Hong Kong economy in the long term.

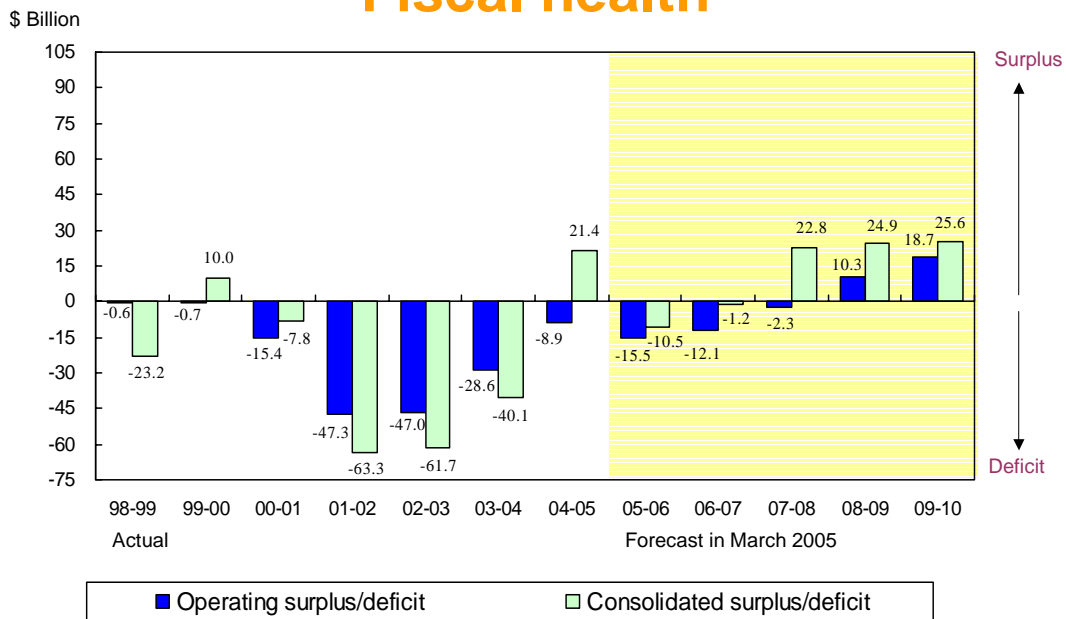
Forecasts for 2005

GDP real growth 4.5% - 5.5% (same as March 2005 forecast)

CCPI 1.5% (same as March 2005 forecast)

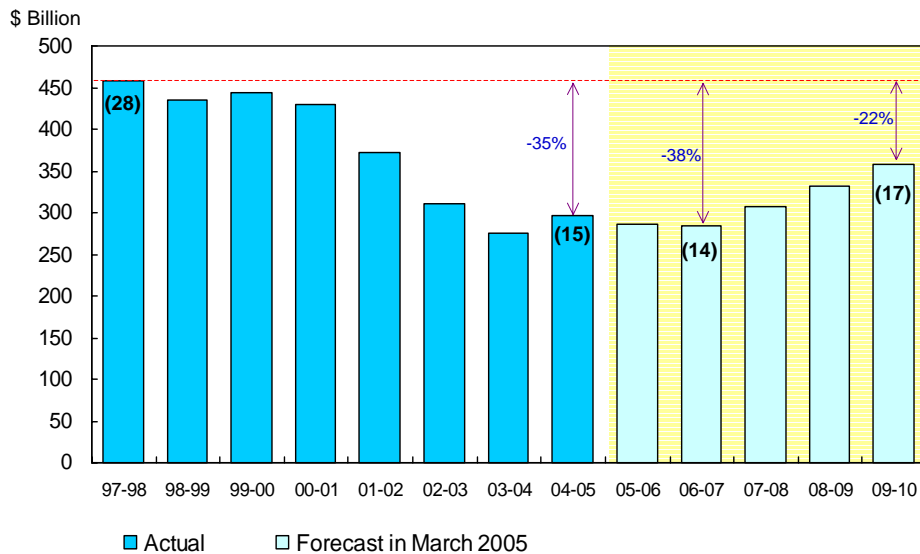
- With the upbeat outturn of a 6.5% growth for the first half of 2005, GDP growth in real terms for the year as a whole is likely to be closer to the upper end of the range forecast of 4.5%-5.5% as released in August.
- With the outturn so far broadly in line with the earlier expectations, the forecast rate of change in the CCPI for 2005 remains at 1.5%.

Fiscal health



- As our economy put in a strong performance in 2004-05, the financial position of the Government has gradually improved.
- For the first time since 1999-2000, the Consolidated Account for 2004-05 recorded a surplus of \$21.4 billion, equivalent to 1.7% of GDP. Nonetheless, a deficit of \$4 billion, or 0.3% of GDP, remained after discounting the proceeds from bond issuances.
- The Operating Account remained in deficit in 2004-05 for the seventh consecutive year. The deficit was \$8.9 billion, or 0.7% of GDP.

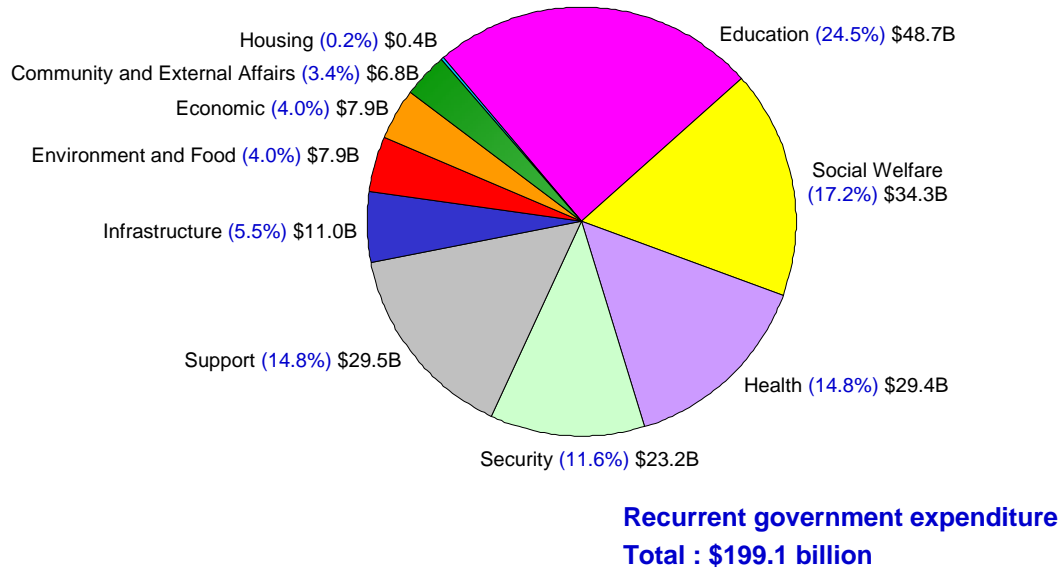
Fiscal reserves



Figures in () represent the equivalent months of government expenditure.

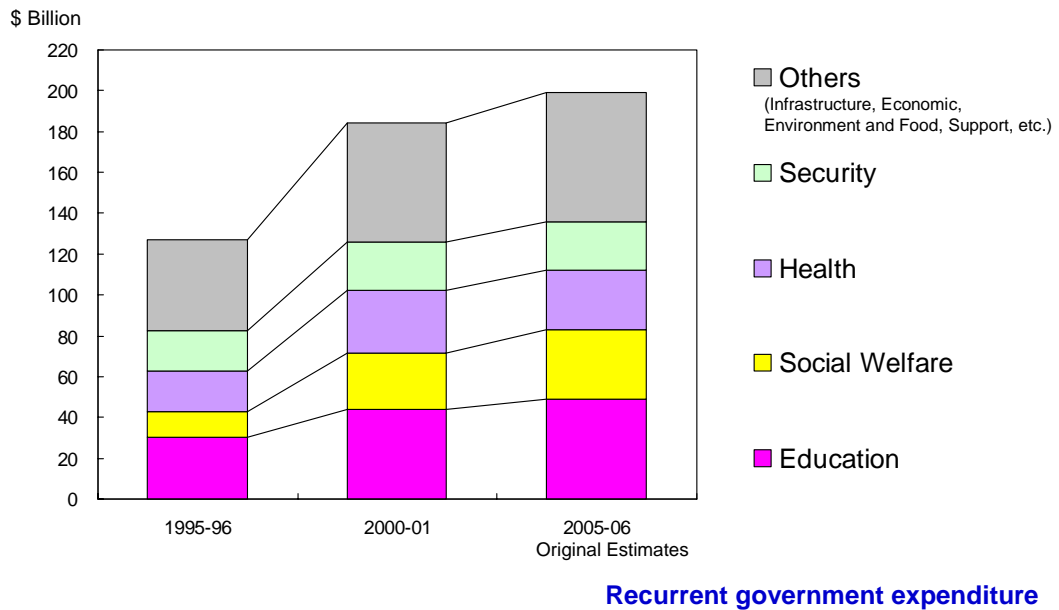
- Fiscal reserves have shrunk by 35% over the past seven years, from \$457.5 billion as of 31 March 1998, equivalent to 28 months of the then government expenditure, to \$296 billion as of 31 March 2005, equivalent to 15 months of government expenditure.
- Based on the forecast in March 2005, fiscal reserves would drop to \$284.2 billion by end 2006-07, equivalent to 14 months of government expenditure, and rise gradually to \$357.5 billion by end 2009-10, equivalent to 17 months of government expenditure.

Expenditure profile in 2005-06



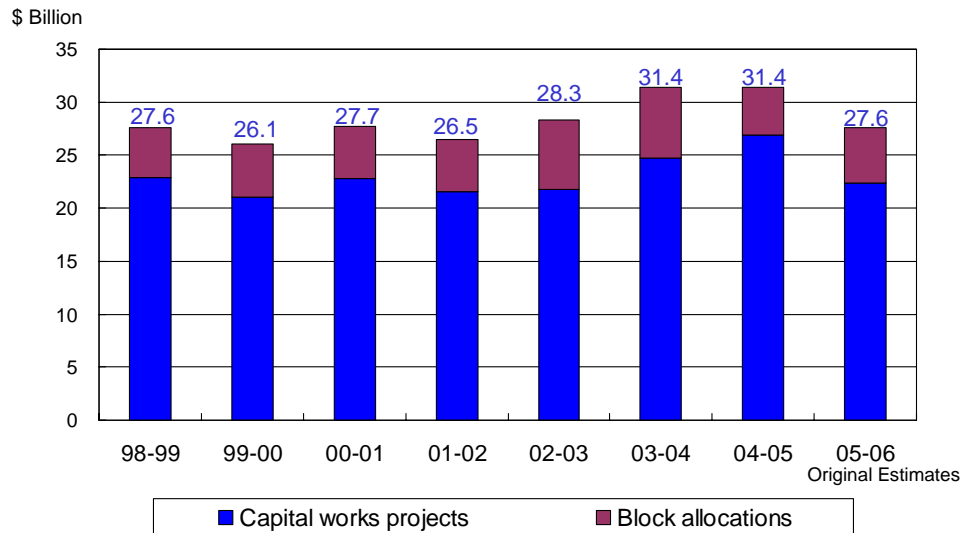
- This chart shows the Government's recurrent expenditure by policy areas as set out in the 2005-06 Original Estimates. Education (24.5%), Social Welfare (17.2%), Health (14.8%) and Security (11.6%) together account for about 68.1% of the total government recurrent spending.

Expenditure profile in past ten years



- Total recurrent expenditure increased by some \$72.1 billion or 56.8% over the past ten years.
- Education and Social Welfare have outpaced other policy areas in terms of growth in recurrent spending -
 - Education +61%
 - Social Welfare +172%

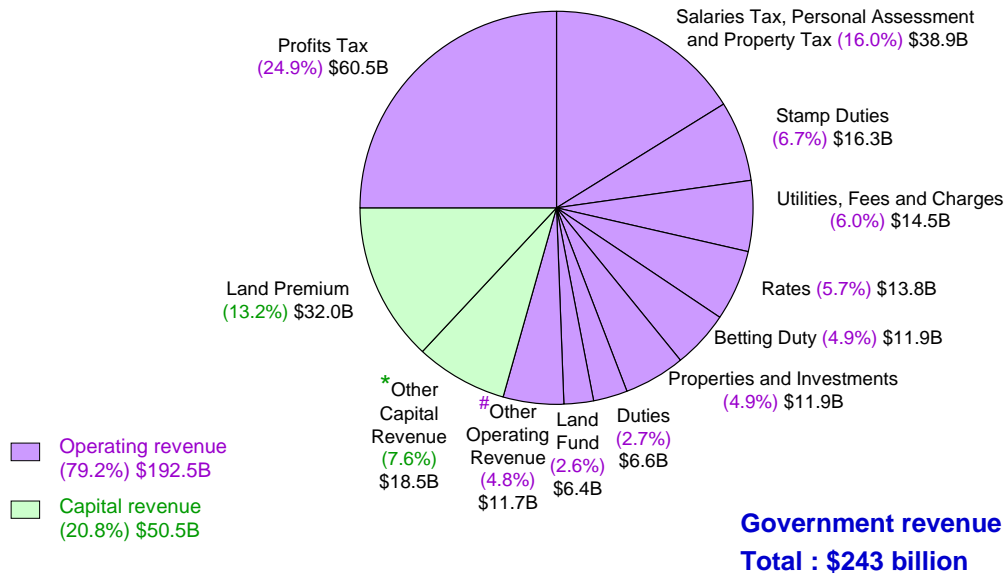
Essential infrastructure



Capital works expenditure

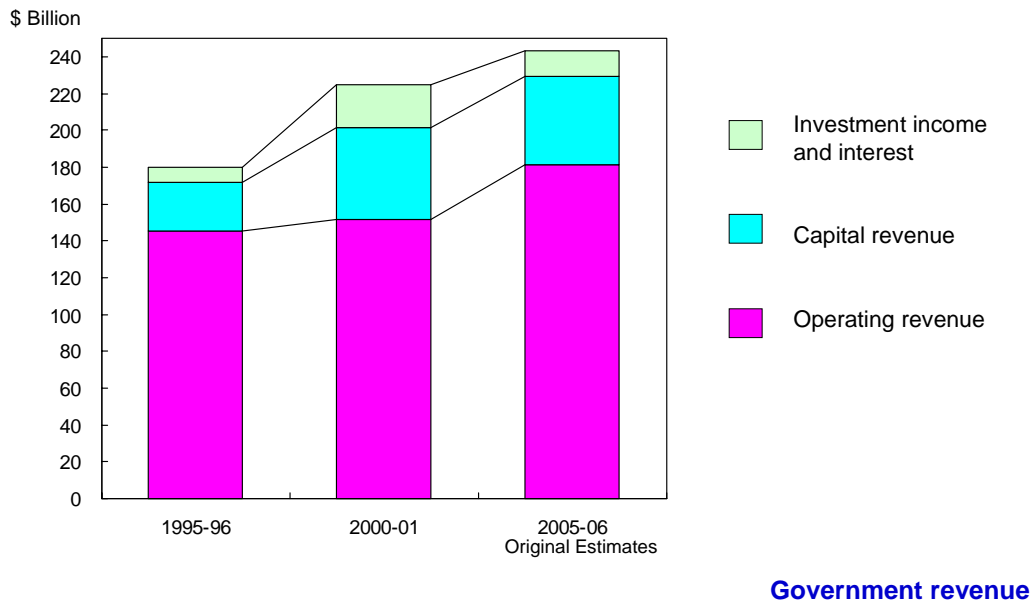
- The Government remains committed to taking forward justified projects necessary for the future economic development of Hong Kong. We will also do our utmost to expedite the project delivering process.
- We are delivering our pledge in the 2004-05 Budget to make provision for an average annual allocation of about \$29 billion a year for works projects in the next few years.

Revenue profile in 2005-06



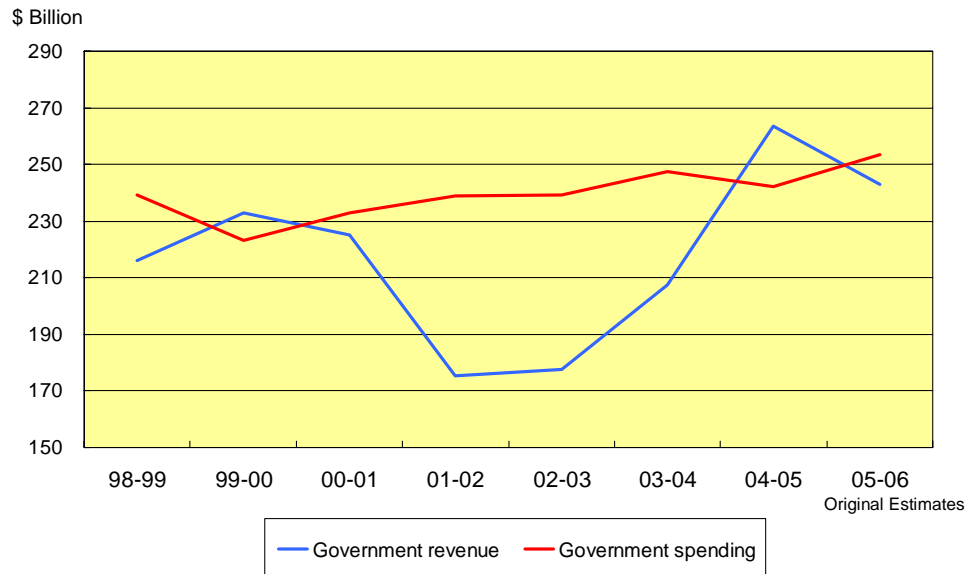
- This chart gives an overview of Government's operating and capital revenue sources based on the 2005-06 Original Estimates.
- Income tax on companies and businesses (i.e. profits tax) and income tax on individuals (i.e. salaries tax, personal assessment and property tax) are the two most important sources of revenue for 2005-06. They account for some 40.9% of Government's total revenue.
- Other operating revenue(#) comprises -
 - Motor Vehicles First Registration Tax (\$3.9B)
 - Loans, Reimbursements and Others (\$2.8B)
 - Returns on equity investments (\$1.8B)
 - Air Passenger Departure Tax (\$1.4B)
 - Fines, Forfeitures and Penalties (\$0.9B)
 - Royalties and Concessions (\$0.6B)
 - Hotel Accommodation Tax (\$0.3B)
- Other capital revenue(*) comprises -
 - Loan Fund (\$6.7B)
 - Innovation and Technology Fund, taxi concessions and other receipts (\$4.0B)
 - Capital Investment Fund (\$2.7B)
 - Capital Works Reserve Fund (\$1.8B)
 - Lotteries Fund (\$1.2B)
 - Estate Duty (\$1.0B)
 - Civil Service Pension Reserve Fund and Disaster Relief Fund (\$0.8B)
 - Repayment of loans and advances (\$0.2B)
 - Recovery from Housing Authority (\$0.03B)

Revenue profile in past ten years



- Total operating revenue, covering taxes, stamp duties and over 4 000 government fees and charges items, increased by only \$36.4 billion or 25.1% over the past ten years.
- On the other hand, capital revenue, with land premium being a key component, and investment income, fluctuated a lot over the period.
- Over the past ten years, land premium fluctuated within the range of 2.6% to 22.6% of the total government revenue while investment income varied from 0.5% to 18.2%.
- Capital revenue and investment income **cannot** be relied upon to resolve the operating deficit problem.

Living within our means



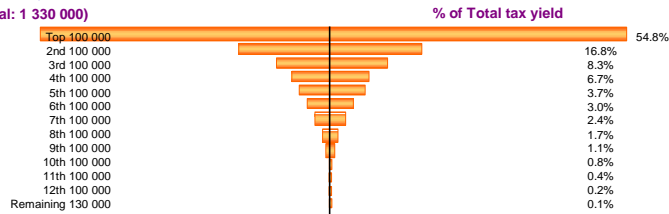
- The extent to which Government can increase spending in future years depends, inter alia, on how much revenue Government can generate.
- Over the past seven years, government revenue oscillated around \$170 billion to \$270 billion.
- On the other hand, there is a degree of rigidity in government spending and it is generally difficult to cut expenditure even in deflationary settings. The drop in actual government spending from \$247.5 billion in 2003-04 to \$242.2 billion in 2004-05 has not come easily.

In line with the principle of affordability?

Salaries tax

1997-98 (Actual revenue)

Taxpaying population (Total: 1 330 000)



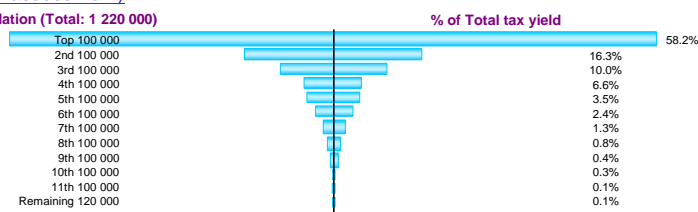
Working population which does not pay any salaries tax
(Total : 1 830 000)

0%

* 2% of the working population pay at the standard tax rate of 15% and contribute about 43.9% of total salaries tax receipts

2005-06 (Provisional assessment)

Estimated taxpaying population (Total: 1 220 000)



Estimated working population which does not pay any salaries tax
(Total : 2 150 000)

0%

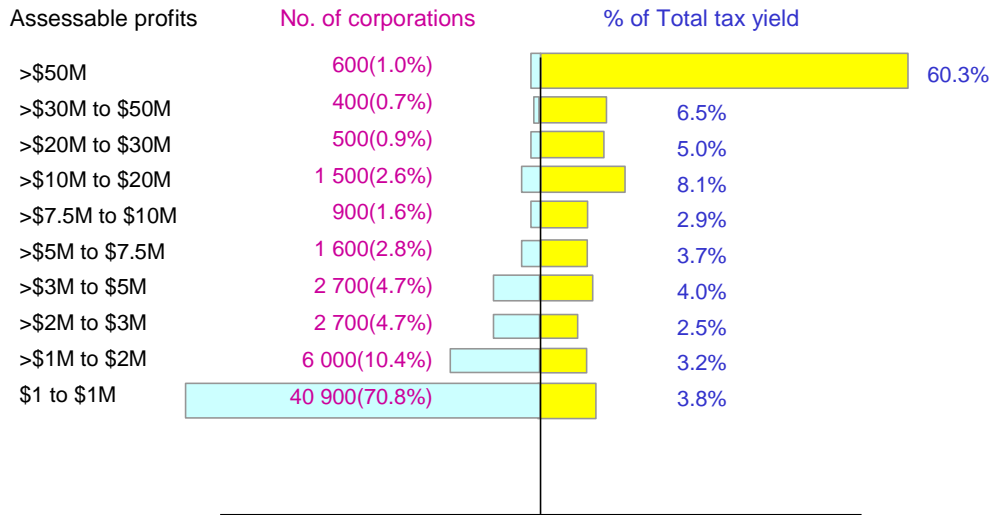
* 1.4% of the estimated working population pay at the standard tax rate of 16% and contribute 38.3% of total salaries tax receipts

- The taxpaying population is expected to drop from 1.33 million in 1997-98 to 1.22 million in 2005-06 although the working population has increased from 3.16 million to 3.37 million over the same period.
- This chart also arranges salaries taxpayers in 1997-98 and 2005-06 in steps of 100 000 each according to their salaries tax bills, and measures their respective contributions to the salaries tax yield.
- The top 100 000 taxpayers contributed 54.8% of the total revenue from salaries tax in 1997-98. The share contributed by this group was 61% in 2003-04 and is estimated to be 58.2% in 2005-06.

In line with the principle of affordability?

Profits tax

2003-04 (Actual revenue)



- This chart shows the distribution of our profits tax burden among the corporate taxpaying population in the Year of Assessment 2003-04.
- 60% of our profits tax was contributed by the top 600 taxpaying corporations out of more than 57 000 corporations. Most small businesses pay little or no tax.

Maintaining a robust and sustainable fiscal system

- Yet to restore fiscal balance
- Divergent views of the community
 - End the persistent fiscal problem
 - Maintain Hong Kong's fundamental economic strengths
 - Save for the rainy days
 - Increase government spending
 - Help the poor and address their needs
 - Reduce taxes and give the middle class a respite

- With the steady economic upturn, the financial position of the Government has gradually improved. Nonetheless, we have yet to restore fiscal balance.
- A robust and sustainable public finance system is one of Hong Kong's fundamental economic strengths. We must observe strict fiscal discipline and avoid substantially increasing expenditure and reducing taxes just because of the good results in one or two years.
- On the other hand, the Government should respond promptly to the reasonable calls of the community.

Goods and Services Tax

- Should this be introduced?
- If so, should it be as all-embracing as possible?
- Exemptions to be contemplated?
- Need for relief/offset package?
- Time frame for introduction?

- The Government requires a broader, sizeable and steady income source to underpin its revenue and meet its expenditure requirements. A broad-based Goods and Services Tax (GST) is a reasonable and equitable way to smooth our bumps in revenue stream and secure fiscal stability for the future.
- The Government has already completed its study on the implementation of a GST in Hong Kong. We will launch a public consultation on whether and how best it should be implemented. We will strive to build a consensus with the community on this important issue before deciding the next step forward.

Sale and securitisation of government assets

- Principle of “Big Market, Small Government”
- Plans for 2005-06 include
 - Disposal of Government’s shareholding in the Tradelink Electronic Commerce Limited
 - Sale of student loans
- Divestment being considered
 - Merger of MTRC and KCRC
 - Privatisation of Airport Authority

- The Government will, in accordance with the principle of “Big Market, Small Government”, continue to identify suitable assets for sale or securitisation in order to reduce the share of the public sector in the economy and give more scope for the private sector to develop.
- In the process, we shall endeavour to ensure that the interests of the stakeholders will not be adversely affected.
- Plans for 2005-06 include downsizing the Government’s shareholding in the Tradelink Electronic Commerce Limited and selling part of the student loans to interested parties.
- As regards the possible merger of the two railway corporations, the discussion is on-going.
- On the proposed partial privatisation of the Airport Authority, the public consultation ended on 31 May 2005 with a total of 69 written submissions received. The Government will continue to discuss with stakeholders, and ensure that the various concerns raised during the public consultation are addressed satisfactorily before privatising the Airport Authority.

Views are welcome

www.budget.gov.hk

- The Government welcomes advice and suggestions on how to reposition the Hong Kong economy and achieve a fiscal balance. Views on the 2006-07 Budget can be presented to the Financial Secretary through consultation sessions, written submissions or the dedicated website. We will take all advice into account when drawing up the 2006-07 Budget.