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The 2008-09 Budget

Information Pack for the Financial Secretary's Consultations

November 2007

Information Pack for the
Financial Secretary's Consultations

Introduction

The Financial Secretary is consulting Members of the Legislative Council, representatives from various sectors and the people of Hong Kong on the 2008-09 Budget.

We welcome and value your advice on the Budget. You can provide us with your advice at the budget website **www.budget.gov.hk** or in writing to
5th floor, Main Wing, Central Government Offices,
Lower Albert Road, Hong Kong.

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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.

- These constitutional provisions for financial prudence are integral to maintaining the confidence of the international financial community as well as that of the 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 principles

- Adhere to the principle of “Big Market, Small Government” to promote economic development
- Adhere to fiscal prudence by keeping expenditure within the limits of revenues
- Raise the quality of life and build a family-based harmonious society
- Follow the principle of “from welfare to self-help” to create job opportunities and tackle poverty

- Our economic policies are guided by the principle of “Big Market, Small Government”. The size of public expenditure is kept under 20% of our GDP.
- We will adhere to the principle of keeping expenditure within the limits of revenue in the prudent management of our public finances.
- Consistent with our pro-market economic policy, we will follow the principle of “from welfare to self-help” to tackle poverty, create job opportunities, mobilise business communities to support social initiatives, and improve the lives of low-income people. We will invest heavily in education to enable social mobility and alleviate cross-generational poverty.

Economic strategy

- Drive the economy ahead and secure an essential role in our nation's development
- Build Hong Kong as the international financial centre of our nation
- Strengthen Hong Kong's position as the region's international trade, logistics, shipping and aviation hub, and promote tourism
- Speed up investment on infrastructure
- Improve our "soft" strengths - heritage conservation, cultural and arts development, creativity

- The rapid economic developments in the Mainland have provided and will continue to provide ample opportunities and also challenges to us. We shall position ourselves to capitalise on the rise of the Mainland economy and to secure an essential role in our nation's development.
- It is important to enhance our status as an international financial centre and to develop our trade, logistics, shipping, aviation and tourism. We shall strengthen our competitiveness to rise to the challenge of competition in the region under the backdrop of globalisation, by strengthening our human resources, investing in infrastructure and improving our “soft” strengths.

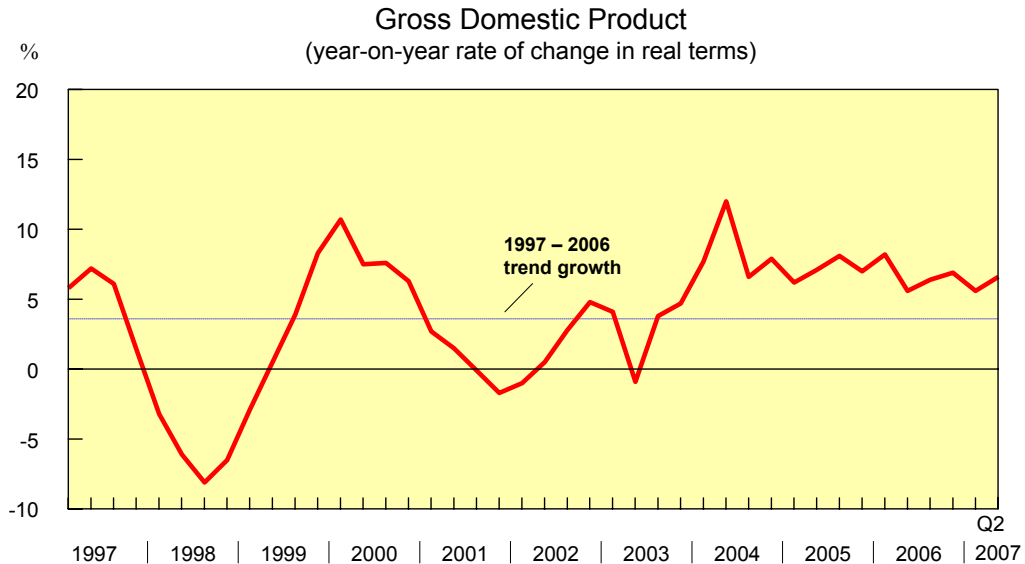
Latest 2007 economic indicators

GDP real growth	First half	6.1% (Second quarter 6.6%)
Unemployment rate	Third quarter	4.1% (down from peak of 8.5%)
CCPI inflation	January to September	1.5% (September 1.6%)

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

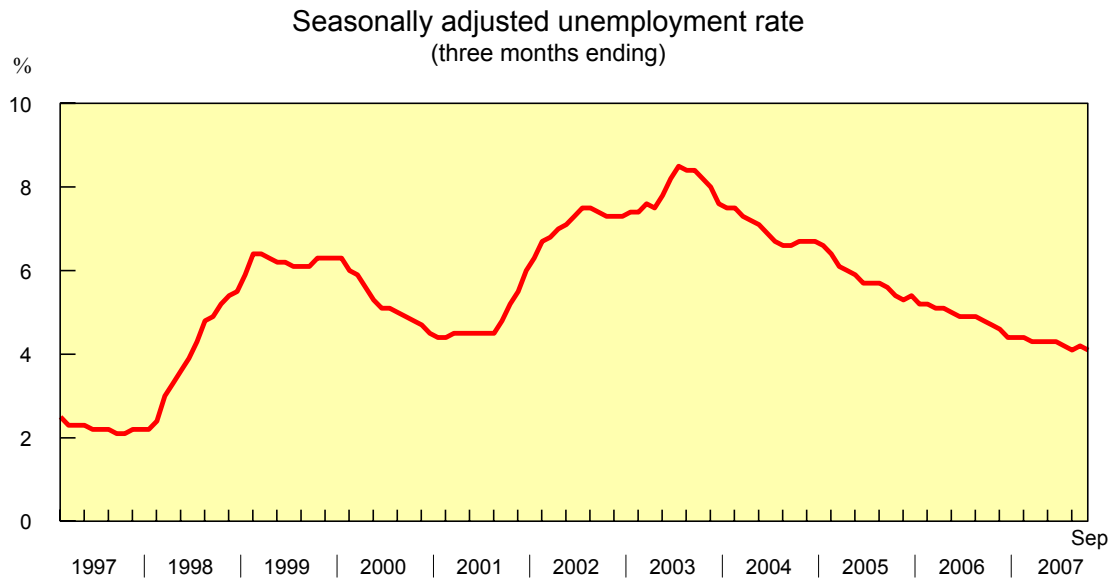
- The Hong Kong economy has been growing at an above-trend pace for fifteen quarters in a row, while consumer price inflation remains moderate. The labour market conditions are also improving along with the economic upturn.

Economy sustaining above-trend growth



- The Hong Kong economy expanded briskly in the second quarter of 2007, with GDP accelerating to a 6.6% growth in real terms over a year earlier, up from the 5.6% growth in the first quarter. This also followed a strong 6.8% growth in 2006.

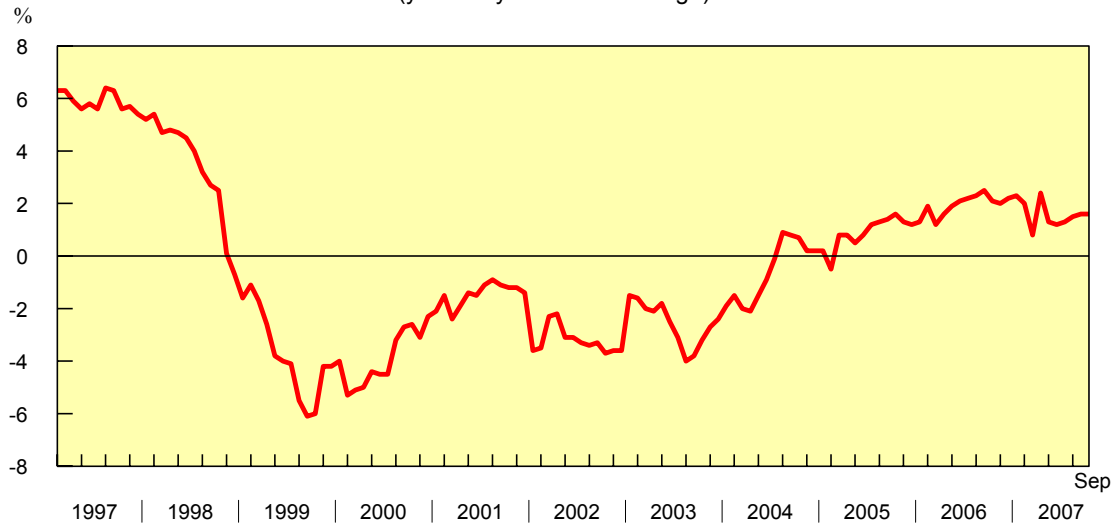
Unemployment trending down amidst brisk economic expansion



- The labour market conditions continue to improve along with the fairly robust economic upturn. The seasonally adjusted unemployment rate fell distinctly from the peak of 8.5% in mid-2003 to 4.1% in the third quarter of 2007, the lowest level since mid-1998.

Inflation on its way up as economy continues to expand

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



- In line with the trend in many parts of the world in recent years, inflation is, indeed, creeping up slowly in Hong Kong as well. Inflation remains potentially a main concern for economic management in the coming years if our economic performance remains strong. Our principal concern lies with the impact of escalating costs on people in the lower economic strata. We are fully cognisant of this development, and we will be doing everything we can to assist this group of people.

Latest forecast for 2007

GDP real growth 5% – 6%

CCPI inflation 1.8% – 2%

- The Hong Kong economy should be able to attain another year of above-trend growth of 5% to 6% in real terms for 2007 as a whole, having taken into account the better-than-expected outturn of a 6.1% GDP growth in the first half of the year and also the range of uncertainty prevailing in the external environment.
- Consumer price inflation is still at a moderate level given that our economy grew by an average of about 7% for the past four years. However, higher food prices, the appreciation of the Renminbi and recent weakness of the US dollar will continue to pose upside risks to inflation. On current indications, consumer price inflation for 2007 as a whole is likely to be 1.8% to 2%.

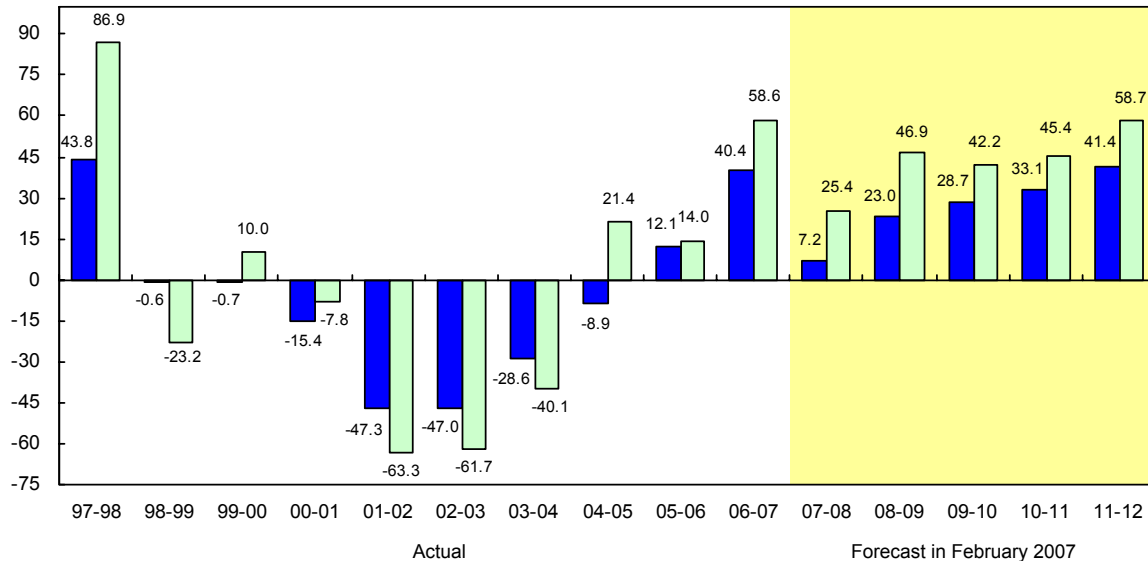
Economic uncertainties

- Possible sharper-than-expected US economic downturn and its impacts on global economic growth
- Increased financial market volatility associated with the US subprime turmoil and yen carry trade
- Persistent current account deficit in the US and the unwinding of global economic imbalances
- Rise of protectionist sentiments and lack of progress in global trade talks
- Higher inflation risks on account of higher food prices and weakness of the US dollar

- Being a small open economy, Hong Kong will inevitably be affected by global events. Are our product, financial and labour markets flexible and resilient enough to respond to external changes? What can we do in terms of better managing risks in the financial market? Are our market institutions, regulatory structures and fiscal positions robust enough to weather the impacts of external shocks if they were to occur?

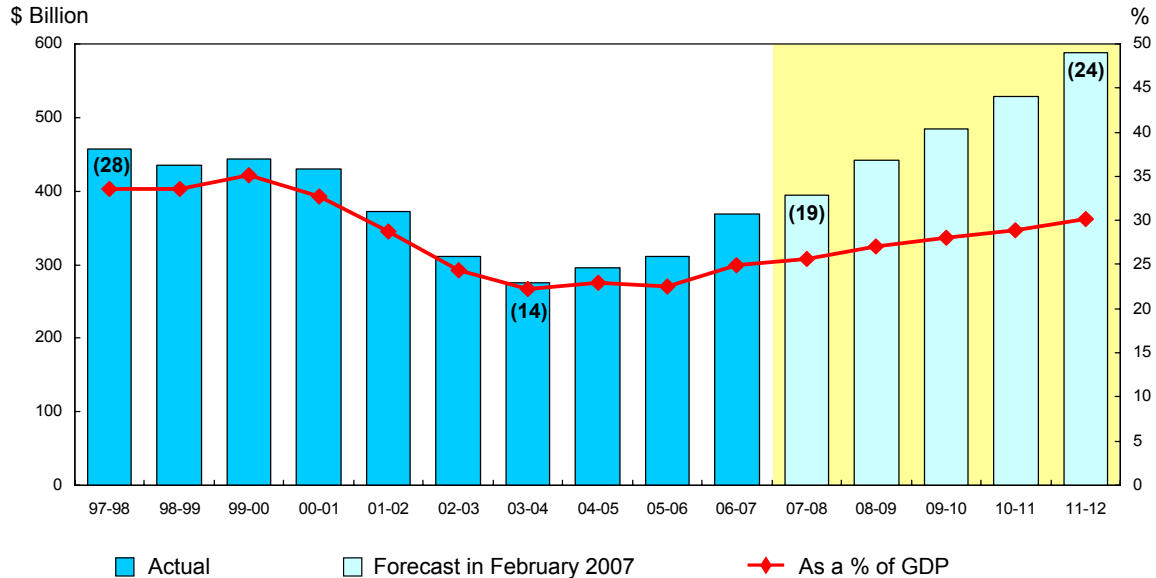
Fiscal health

\$ Billion



- Following the strong economic growth in the past three years with annual GDP growth ranging from 6.9% to 8.6%, the financial position of the Government has markedly improved with a consolidated surplus of \$58.6 billion in 2006-07.
- Premised on an economic growth of around 4.5% a year, we forecast that the government accounts will continue to be in surplus in the coming five years to 2011-12.

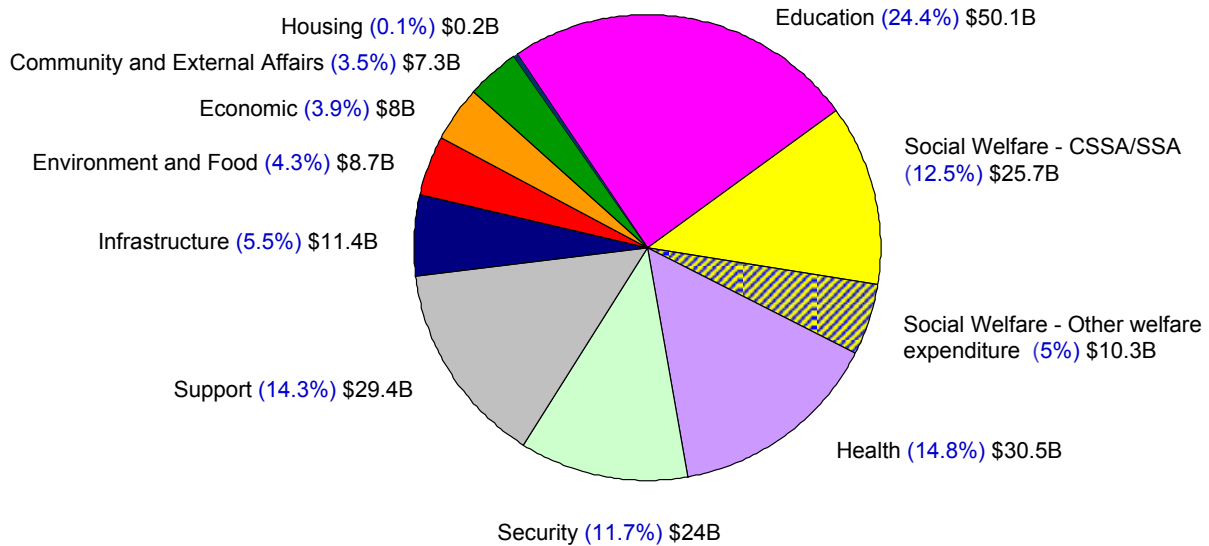
Fiscal reserves



Figures in brackets represent the equivalent number of months of government expenditure.

- Taking into account the actual results for 2006-07 and the forecast in February 2007, fiscal reserves by end-March 2008 would be \$394.7 billion, equivalent to 19 months of government expenditure or 25.7% of GDP, and rise gradually to \$587.9 billion by end-March 2012, equivalent to 24 months of government expenditure or 30.2% of GDP.
- Maintaining adequate fiscal reserves can help ease the impact arising from economic downturns or setbacks caused by external factors, and can improve the ability of the Exchange Fund to maintain, as and when necessary, the stability and integrity of our monetary and financial systems, which is crucial to the economic stability and prosperity of Hong Kong. We shall maintain the fiscal reserves only to the extent necessary to meet our needs.
- What is the appropriate level of fiscal reserves? Could we cope with the global economic uncertainties with a lower level of reserves?

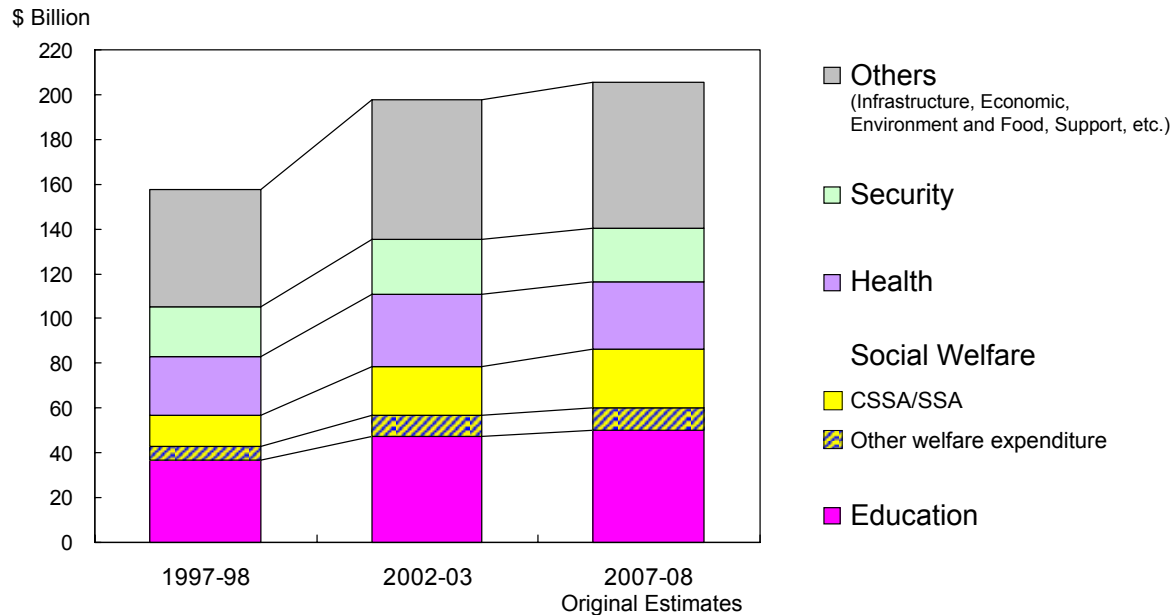
Expenditure profile in 2007-08



Recurrent government expenditure
Total : \$205.6 billion

- Based on the 2007-08 Original Estimates, the spending in Education (24.4%), Social Welfare (17.5%), Health (14.8%) and Security (11.7%) together accounts for about 68.4% of Government's total recurrent expenditure.
- We will ensure optimal allocation and efficient utilisation of resources according to strategic priorities. The Chief Executive has committed in this year's Policy Address that the share of health care expenditure should be increased from the present 15% to 17% in 2011-12. Which policy areas should then be cut back?

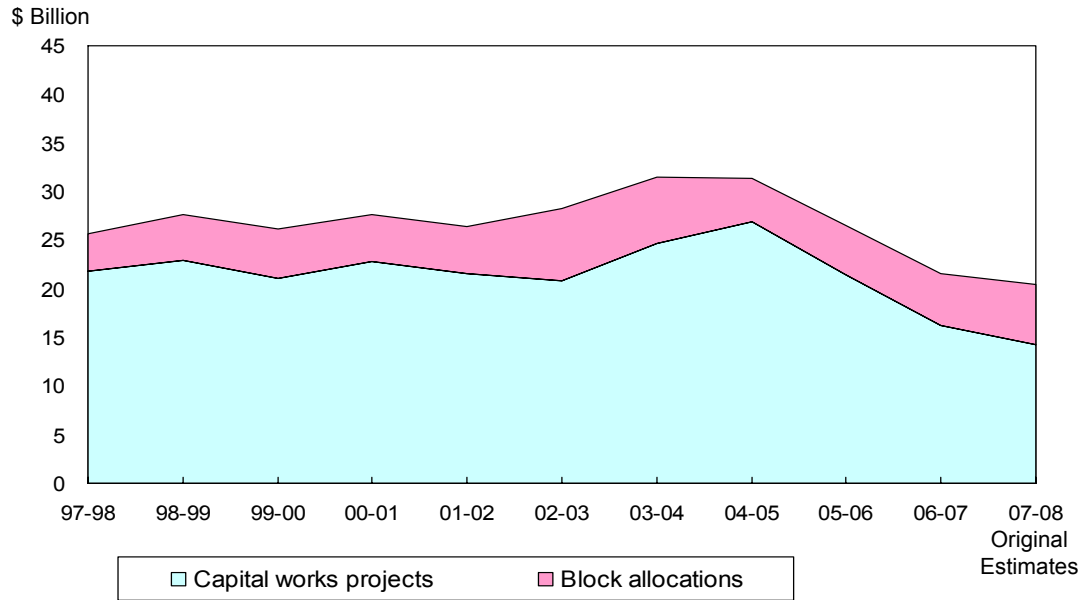
Expenditure profile in past ten years



Recurrent government expenditure

- Total recurrent government expenditure increased by some \$47.8 billion or 30% over the past ten years.
- Education and Social Welfare have outpaced other policy areas in terms of growth in recurrent spending –
 - Education + 35.2%
 - Social Welfare + 80.3%
 - *Comprehensive Social Security Assistance (CSSA) Scheme/ Social Security Allowance (SSA) Scheme* + 85.3%
 - *Other welfare expenditure* + 69%

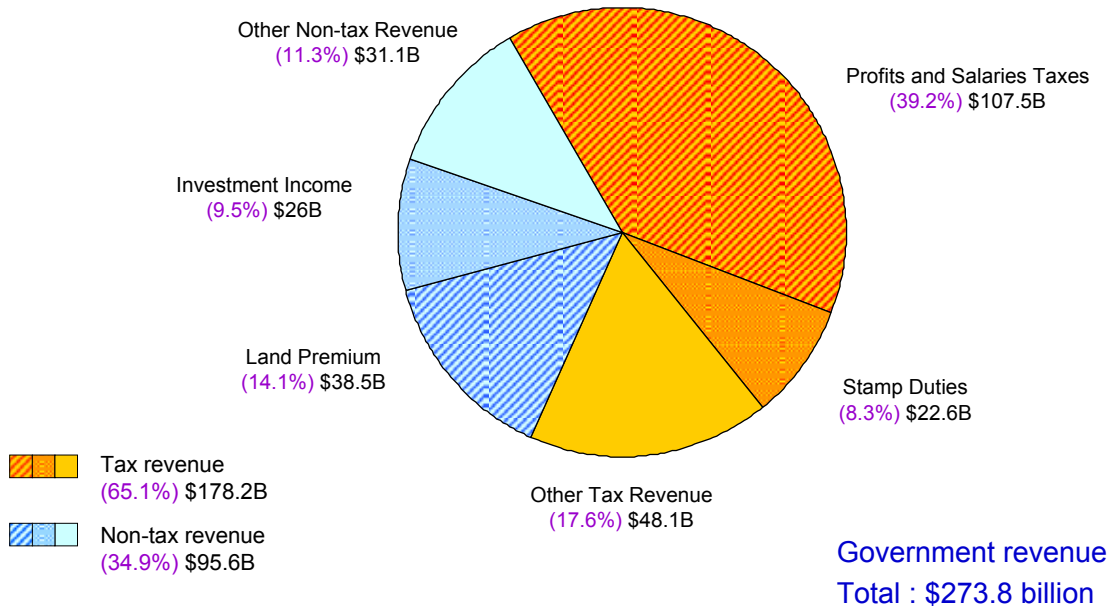
Essential infrastructure



Capital works expenditure

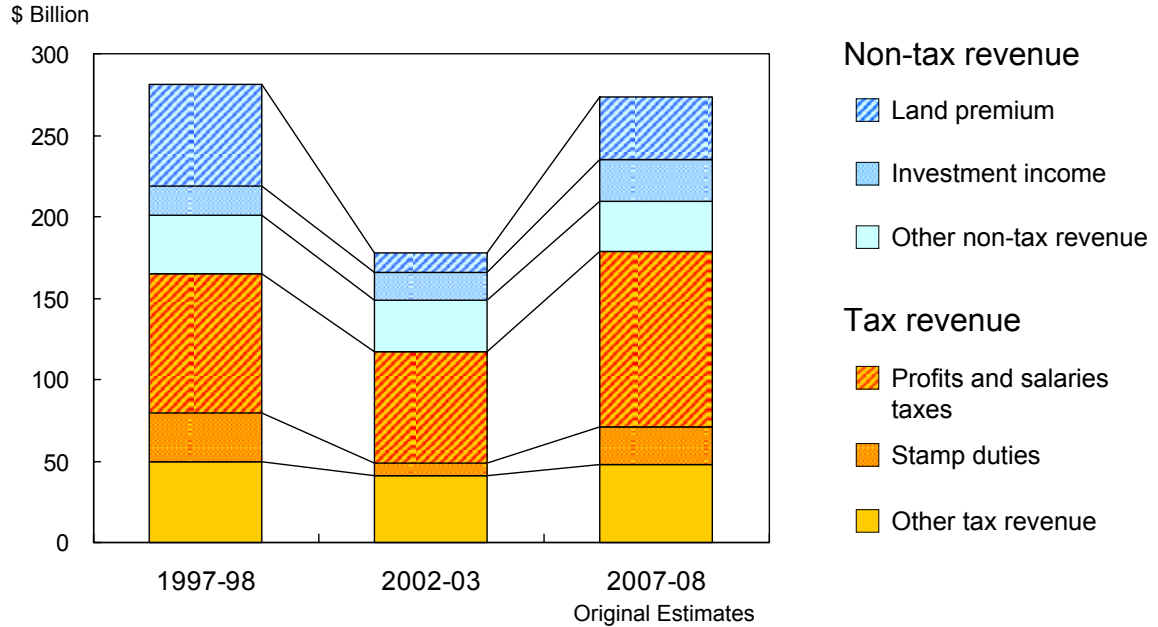
- The Government remains committed to taking forward projects necessary for the future economic development of Hong Kong.
- We will continue to earmark on average \$29 billion a year for spending on public works projects. Where necessary, we will increase the annual provisions for a particular year.
- Capital works expenditure tends to be cyclical in nature. The peak spending period in 2003-04 and 2004-05 coincided with the construction phase of several mega projects. With the next batch of mega projects (such as Central-Wanchai Bypass and Wanchai Development Phase II, Central Kowloon Route and Kai Tak Development) still pending due to the longer time required for preparatory works, including public consultation, the spending in recent years has eased off.
- We envisage the Capital Works Expenditure to pick up gradually in the coming years.

Revenue profile in 2007-08



- Profits and salaries taxes are the major sources of government revenue, accounting for 39.2% of total government revenue in the 2007-08 Original Estimates. The next largest single source is land premium, which accounts for 14.1% of the total.

Revenue profile in past ten years



Government revenue

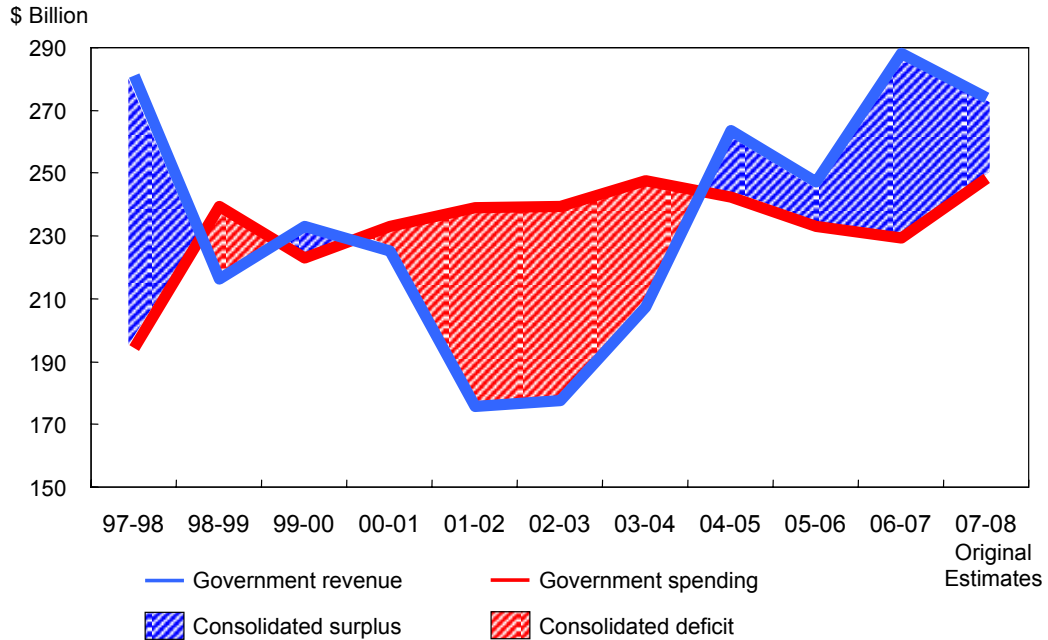
- Profits and salaries taxes together account for about 40% of government revenue. Such reliance on the income taxes would highly expose Hong Kong's public finances to variation in global economic cycles and external shocks.
- Non-tax revenue, which accounts for about 35% of government revenue, is primarily derived from land premium and earnings from the fiscal reserves. To stabilise the earnings from the fiscal reserves, the rate of investment return will be pre-determined effective from 1 April 2007 and the rate for 2007 is 7%. The land premium, however, remains volatile. Over the past ten years, land premium has fluctuated between 3% and 25%.

Maintaining a robust and sustainable fiscal system

- Maintaining fiscal balance and strict fiscal discipline
- Proper use of fiscal surplus
- Leaving wealth with the people
- Meeting the challenges

- 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 and prepare to meet the challenges ahead, including –
 - Volatile revenues
 - Narrow tax base
 - Rising medical costs
 - Ageing population
 - Better environment

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 ten years, government revenue oscillated between \$170 billion and \$290 billion.
- On the other hand, there is a degree of rigidity in government spending. The decrease in government spending in the past few years from \$247.5 billion in 2003-04 to \$229.4 billion in 2006-07 has not come easily.

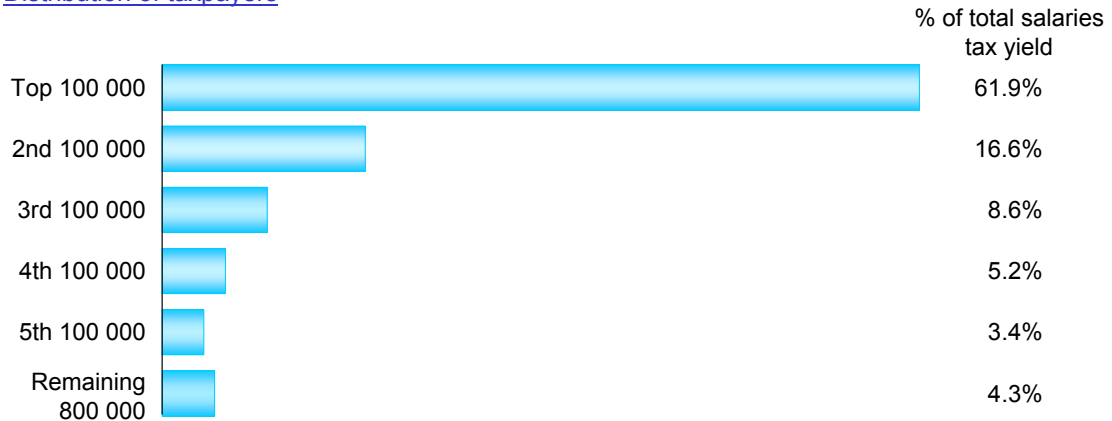
Distribution of taxpayers

Salaries tax

2007-08 (Provisional assessment)

Estimated total working population	3 500 000
- Not paying any salaries tax	2 200 000
- Taxpaying	1 300 000

Distribution of taxpayers

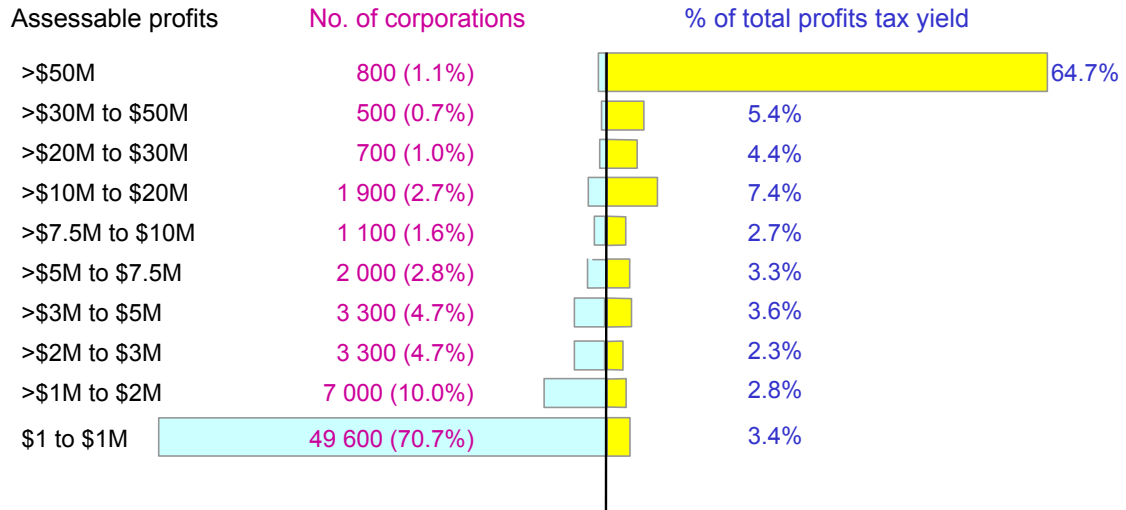


- Among the 3 500 000 total working population, only 1 300 000 people (37%) have to pay salaries tax.
- According to their salaries tax bills, the top 100 000 taxpayers are expected to contribute 61.9% of the total revenue from salaries tax in 2007-08. The share contributed by this group was 54.8% in 1997-98 and 61.4% in 2005-06.

Distribution of taxpayers

Profits tax

2005-06 (Actual revenue)



- In the year of assessment 2005-06, about 65% of our profits tax is contributed by the top 800 taxpaying corporations out of more than 70 000 corporations. Most small businesses pay little or no tax.

Principles of tax reform

- **Taxpayers' perspective:** should be fair, comply with the “ability-to-pay” principle and not widen the wealth gap
- **Social perspective:** can produce stable and substantial revenue to respond to our future needs
- **Economic perspective:** should maintain Hong Kong's simple and low tax regime and international competitiveness

- In considering appropriate tax reform options for Hong Kong, we should take into account the following –
 - Fairness and the “ability-to-pay” principle. The design and accompanying measures should ensure that those with higher capacity to pay would shoulder greater tax burden;
 - Generation of stable and substantial revenue to provide resources to meet the social challenges and increasing needs of the community; and
 - Transparency, predictability and maintenance of Hong Kong’s simple and low tax regime. The arrangements should not undermine our international competitiveness.
- We issued a Consultation Document on Tax Reform in July 2006. During the consultation, the majority of the public does not accept Goods and Services Tax as the main option to address the problems of our narrow tax base. We will continue to study options for broadening the tax base and will engage the public in discussing these options having regard to the above principles at a suitable time in the future.

Scope for review

Views are welcome

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