

Motion Debate on
“Reviewing public finances policies”

Progress Report

At the Legislative Council meeting of 19 January 2011, the motion on “reviewing public finances policies” moved by Hon Paul CHAN Mo-po as amended by Hon Ronny TONG Ka-wah was carried. The motion reads as follows:

“That in the Budgets of the HKSAR Government in recent years, there have been big discrepancies in the forecasts of government revenue, budget surpluses and fiscal reserves, resulting in the incessant accumulation of fiscal reserves, but there are no clear criteria on what an appropriate level of fiscal reserves should be; at the same time, there are substantial accumulations in the Exchange Fund year over year, and the Government has set up, in different forms (e.g. fund), quite a number of ‘small vaults’ and owns many valuable assets (e.g. the shares of the MTR Corporation Limited and the Airport Authority), and that the financial strength of the Government can be described as enormous; however, despite the sustained economic growth of Hong Kong in the past decade or so, quite a number of low-income earners and the grassroots are completely unable to enjoy the benefits, giving rise to the phenomenon of the poor getting poorer and even the emergence of ‘three have-nots’ and ‘five have-nots’ in the society; in the past, the Government usually adopted across-the-board and one-off measures to return part of the surpluses to members of the public, but the relevant measures lacked long-term policy objectives and specific focuses, resulting in those who need help finding the measures insufficient to address their needs, and those who do not need help simply treating the measures as nice-to-haves and not caring at all; the increasing hardship of the livelihood of low-income persons has

created social grievances and conflicts; with the Mainland's acceleration of full scale opening up and intensification of reforms as well as economic globalization, the economy of Hong Kong needs to be restructured, but the tax policy of Hong Kong has lagged behind the changes in business and competitive environment, thus threatening Hong Kong's competitiveness as an international financial, commercial and trade centre; moreover, Hong Kong's narrow tax base and the Government's over-reliance on land-related revenue poses the risk of instability to public finances; in this connection, this Council urges the Government to conduct a comprehensive and in-depth review of the existing high land-price policy as well as Hong Kong's policies and measures on taxation, social welfare and public finances, to clearly specify that generally, it will already be sufficient to only maintain fiscal reserves at a level of not exceeding 15 months of government expenditure, to study relaxing the restriction that the Government's recurrent expenditure shall not exceed 20% of the Gross Domestic Product, and to set up within the government structure a tax policy group with the employment of full-time tax experts to study the use of tax measures to dovetail with the Government's policies on economy and industries, upgrade Hong Kong's competitiveness as an international financial, commercial and trade centre, address the problem of poverty and eradicate social and economic inequalities."

2. This note informs Members of the follow-up actions taken by the Administration in respect of the motion.

3. On land policy, it is the Government's policy to facilitate Hong Kong's progressive development by ensuring a steady and sufficient supply of land to meet the needs of various sectors in the community. Other than supplying housing land, the Government also provides land for different sectors and fields. For example, the Government has provided land for industrial estates and the Hong Kong Science Park to facilitate industrial and technological developments in Hong Kong. In recent years, apart from the

revitalization of industrial buildings which provides the required land, the Government has reserved sites for private hospitals and tertiary institutions to facilitate medical services and tertiary education developments in Hong Kong to support the development of the six industries identified by the Task Force on Economic Challenges where Hong Kong enjoys clear advantages.

4. On the sale of housing and commercial/business sites, the Government does not have the so-called “high land premium policy”. The Government all along sells land at its market value and does not deliberately impede land sale by setting the land premium too high. In similar vein, the Government does not boost land sale by deliberately setting the land premium too low. Developers bid for each site based on its development potential and the market situation. The land is sold only when the reserve price set by the Government is reached.

5. As regards tax policy, the designated unit under the Treasury Branch of the Financial Services and the Treasury Bureau has adopted an ongoing approach to consider the need to enhance the tax system and tax laws in the light of the changing social and economic environment.

6. The tax rates of Hong Kong are very low already. Our tax regime has also reflected the equity of “earning more, paying more”. To address various social and economic problems, it is necessary to count on policies in different aspects, and to strive for wealth creation for the society through, more importantly, inducing a sustainable growth of the overall economy, other than relying solely on tax measures.

7. Over the past few years, after examining and considering jointly with relevant bureaux, various tax measures have been introduced to promote the development of relevant industries, thereby consolidating Hong Kong’s position as an international financial, business, tourist and logistics centre. These measures include waiving hotel accommodation tax, waiving the duties on wine, beer and other alcoholic beverages except spirits, exempting offshore funds from profits tax and abolishing estate duty. Besides, the

Inland Revenue (Amendment) Ordinance 2010 passed last year enables Hong Kong to align its exchange of information arrangement with international standard, thereby facilitating the conclusion of Comprehensive Agreements for the Avoidance of Double Taxation between Hong Kong and many of our major trading and investment partners. This is conducive to enhancing the competitiveness of Hong Kong as an international business and financial centre.

8. To cope with social development, we have from the year of assessment 2007-08 onwards raised the maximum amount of tax deduction for self-education expenses from \$40,000 to \$60,000 so as to encourage employees to seek continued self-advancement through learning and to satisfy the needs of Hong Kong for development into a knowledge-based economy. Moreover, in order to alleviate the financial burden in supporting parents and raising children, the 2011-12 Budget has suggested increasing the parent/grandparent allowances, the child allowances and the deduction ceiling for elderly residential care expenses for salaries tax and tax under personal assessment.

9. Regarding the competitiveness of Hong Kong's tax regime, we note that some international studies on tax burden of enterprises and individuals have demonstrated that Hong Kong's tax system still upholds its advantages over our competitors in areas of maintaining competitiveness, facilitating business operations and attracting investment.

10. On broadening the tax base, government revenue is sensitive to economic fluctuations but there is not much flexibility in expenditure. We have adopted the strategy of containing government expenditure while using our fiscal reserves as a buffer for deficits in individual years. In doing so, we are able to achieve a fiscal balance and keep expenditure within the limits of revenues over a period of time. At the same time, we need to prepare for the future. We have to ensure that we have adequate amount of reserves to meet future challenges, including the long-term financial pressure brought about by an aging population as well as possible economic downturn.

11. In July 2006, the Government issued a consultation document on tax reform. Through the consultation, the public generally gained a better understanding of the problem with our narrow tax base, and agreed that the issue had to be addressed. However, as to which option or options should be adopted to broaden our tax base, the public did not have any clear inclinations or mainstream views. Nevertheless, we will encourage different sectors of the community to continue to discuss this issue with a view to building consensus gradually.

12. As for section 39E of the Inland Revenue Ordinance (IRO), since the proposal involves relaxation of the restriction in that provision and would affect the completeness of the anti-avoidance provisions, it is imperative for the proposal to be considered carefully by the designated unit under the Treasury Branch responsible for reviewing and formulating tax policies in collaboration with the Inland Revenue Department which has ample experience in the implementation of the IRO. It is also necessary to examine whether the proposal is in line with the established fundamental taxation principles of Hong Kong and whether it is effective to plug possible tax avoidance loopholes.

13. We have examined whether there is room for relaxing section 39E. During the course of deliberations, we have already taken into consideration the views of the industrial and commercial sector, the accounting sector and tax experts. We have to take into account the overall interests of Hong Kong and all the taxpayers in making each and every policy decision. Our review has come to a conclusion that there are no justifiable grounds to relax the existing restriction in section 39E. We have already explained in detail to the Legislative Council the reasons for not relaxing the relevant restriction.

14. On social security, to help ease the pressure of inflation and rising prices on people's livelihood, the Financial Secretary proposed in his 2011-12 Budget to provide an extra allowance to the Comprehensive Social

Security Assistance (CSSA) recipients, equal to one month of the standard rate CSSA payments; and an extra allowance to Old Age Allowance and Disability Allowance recipients, equal to one month of the allowances. Regarding employment assistance, to better serve job seekers' needs, along with the implementation of the statutory minimum wage, the Labour Department (LD) will strengthen employment services for young and middle-aged people and those with disabilities. At the end of last year, the LD launched a two-year Pilot Employment Navigator Programme, providing a total of 22 000 places, to help the unemployed secure employment. Participants will receive customised employment counselling services and will be granted a cash incentive if they subsequently secure and stay in a job. At the end of this year, the LD will set up a pioneer one-stop employment and training centre in Tin Shui Wai to provide integrated services of the LD, Social Welfare Department and Employees Retraining Board, with a view to offering more targeted employment assistance. As for retirement protection, the Central Policy Unit (CPU) is studying the sustainability of the present model of retirement protection. During the process, CPU will make reference to opinion in the community, and tap the views of academics, professionals, think tanks and interested parties as appropriate through its established channels.

15. On public finances policy, we have been managing public finances in accordance with Article 107 of the Basic Law which states that the Special Administrative Region Government shall follow the principle of keeping the 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 (GDP).

16. We believe that market mechanism is the most effective way to raise economic efficiency. We uphold the principle of "Big Market, Small Government". To maintain Hong Kong's competitiveness, we aim to keep public expenditure at 20% or below of our GDP to prevent the public sector from sharing too much social resources as to hindering development of the private sector. A big market can increase the share of the private sector in

the economy and allow market forces to allocate and deploy our limited resources in the most efficient way for the maximum benefit of the community as a whole. A small government can prevent the public sector from acquiring excessive resources and thus reducing efficiency in the allocation and use of resources. Moreover, a small government can minimise regulation, thereby facilitating business operations and attracting overseas investment. However, as the Chief Executive said at the Question and Answer Session in the Legislative Council on 13 January 2011, the 20% is just a reference target. The public expenditure for 2011-12 is estimated to be equivalent to 21% of our GDP.

17. The forecast fiscal surplus is different from the actual outturn as huge revenue and expenditure and thousands of items are involved in the government accounts. Even though the actual differs from the estimate for some parts of the estimates only, considerable deviations will be resulted in the consolidated figures. Forecasting has never been an absolutely precise science. For instance, the estimate of revenue is only the best possible assessment based on the information in hand when we compile the budget.

18. When we prepared the 2010-11 Budget early last year, both the economic situation and external environment have not yet fully stabilised. With the implementation of our stimulus measures, the economic recovery has become more entrenched. This, coupled with the better-than-expected rebound of the global economy, particularly that of the Mainland, has enabled Hong Kong to achieve a GDP growth of 6.8% in 2010, which was higher than the original expectation. Income levels also rose in parallel, leading to better revenue from profits tax and salaries tax. With the inflow of funds, the stock and the property markets were buoyant, bringing in much higher than expected revenues from stamp duty. In 2010-11, developers were active in triggering the sale of sites, bidding for land and applying for change of land use. These also accounted for a higher revenue from land premium for the year than originally estimated. Very often, all these are not controllable by the Government.

19. As our revenue is susceptible to fluctuations and the flexibility in expenditure is low, it is necessary for us to have a buffer to alleviate the impact economic cycles have on people's livelihood. Our fiscal reserves serve as such a buffer. Fiscal reserves are our provisions for rainy days. Apart from being used to meet daily operational requirements, fiscal reserves can also be drawn on in contingencies, allowing us to maintain our expenditure at a relatively steady level when government revenue is affected by economic downturns. With the reserves, we will be able to adopt when necessary a counter-cyclical fiscal strategy to increase government expenditure, promote economic growth and improve people's livelihood, thus helping our citizens tide over their difficulties.

20. Fiscal reserves are also an important component of the Exchange Fund. The fiscal reserves placed with the Exchange Fund help reinforce public confidence in the Hong Kong dollar and our monetary stability. It is estimated that the investment income of the fiscal reserves will account for about one-tenth of government revenue in 2011-12. Investment income is an important source of revenue for us, providing part of the recurrent resources for supporting government services.

21. Hong Kong adopts a cash-based accounting system with no provision for our liabilities, such as civil service pensions and government bonds issued in 2004. We rely on the fiscal reserves as a means of paying our liabilities and the expenditure on large-scale infrastructure projects already launched. Our ageing population will also place pressure on the expenditure on health care and social welfare. Making use of our fiscal reserves, we can build a solid financial foundation for our next generation.

22. Recently, the credit ratings of Hong Kong have been upgraded to the highest level, allowing local companies to raise funds at relatively low interest rates. This is of crucial importance to the overall economic development of Hong Kong. The relevant rating agencies indicated clearly that one of Hong Kong's strengths lies in its adequate fiscal reserves. Any drop in the fiscal reserves will put pressure on our ratings.

23. In view of the above, we have made it our target to maintain adequate fiscal reserves. This is in line with the principles of commitment to society, sustainability and pragmatism, and will help strengthen our financial foundation in the long run. That said, maintaining adequate fiscal reserves does not mean that we are reluctant to increase expenditure. We will make good use of our valuable fiscal reserves to respond positively to the aspirations of the community and lay a solid foundation for our economy to meet future challenges.

24. When preparing the 2011-12 Budget, we took into account the prevailing circumstances, and adhered to the principles of managing public finances prudently and committing our resources as and when needed. We aim at keeping government expenditure in line with economic growth to ensure that our services can cope with the prevailing needs and changing situations in the community. We will promote the economic development of Hong Kong, build a cohesive community and improve people's livelihood through proper allocation and effective management of public resources.

25. Taking into account the proposed adjustments announced by the Financial Secretary on 2 March 2011, the government expenditure for 2011-12 is estimated to reach \$378.2 billion, representing an increase of \$74.7 billion, or 25%, over the revised estimate for 2010-11. It is 61% higher when compared with 2007-08. This increase far exceeds the 15.8% nominal GDP growth over the same period. The recurrent expenditure for 2011-12 is estimated to reach \$242.1 billion, representing an increase of about \$18 billion, or 8%, over the revised estimate for 2010-11. It is more than 20% higher when compared with 2007-08. The increase in recurrent expenditure reflects that the Government is always committed to caring for people's livelihood. In the 2011-12 Budget, our proposed recurrent expenditure on education, social welfare and health account for 56.4% of recurrent government expenditure. Compared to 2010-11, expenditure on these three policy area groups will increase by over \$10 billion.

26. The estimated recurrent expenditure on education for 2011-12 will be \$54.5 billion, representing an increase of around \$3 billion, or 6%, over the revised estimate for 2010-11. Apart from providing additional funding to continue implementing the new senior secondary academic structure and small-class teaching, we have also proposed to increase the subsidies and assistance to students from low-income families.

27. The estimated expenditure on social welfare for 2011-12 will be \$42.2 billion, representing an increase of \$4.2 billion, or 11%, over the revised estimate for 2010-11. We have proposed to provide additional funding to better meet the needs of elders for residential care places, community care services, nursing care and treatment. We will also increase the subsidies and assistance for persons with disabilities, persons of ill-health and elders so that more disadvantaged groups can be assisted.

28. The estimated recurrent expenditure on health for 2011-12 will be \$39.9 billion, representing an increase of nearly \$3.2 billion, or 9%, over the revised estimate for 2010-11. Additional recurrent funding of \$2.74 billion will be allocated to Hospital Authority for meeting new and increasing demands, such as strengthening mental health services, expanding the services for persons with psychosis and children with autism or hyperactivity disorder, incorporating more drugs into the Hospital Authority Drug Formulary, offering stronger support to chronic patients, and reinforcing such services as cataract operations, joint replacement, computerised tomography scanning and magnetic resonance imaging etc. We will also allocate additional funding to enhance the regulation of pharmaceutical products.

29. On non-recurrent expenditure, we also allocate additional funding of over \$40 billion to improve services, increase subsidies and assistance, provide seed money to set up funds for specific purpose funds so that the investment income therefrom can provide recurrent resources, and pilot some new government services etc.

30. Facing the threat of inflation, we propose measures worth about \$20 billion to help ease the pressure on our citizens. They include such one-off measures such as electricity charge subsidy, rates waiver, government payment of public housing rents, extra allowance to recipients of CSSA, Old Age Allowance and Disability Allowance, and expansion of food assistance services, as well as recurrent tax concessions.

31. Regarding the funds for specific purposes and enterprise investments mentioned in the motion, we would like to point out that these funds and investments are to meet specific policy needs. It is for these needs that the Legislative Council approved the use of public money to allocate resources for such funds and investments.

32. On accounting, revenue from land premium is classified as capital revenue because a piece of land will not be available for sale for a long period of time once its right of use has been sold. Despite that revenue from land premium is credited to the Capital Works Reserve Fund, revenue from land sale can be used to meet expenditure for general government services. As set out in the Legislative Council resolution, any balance in the Capital Works Reserve Fund which is not required for the purposes of the Fund may be transferred from the Fund to the General Revenue Account.

Financial Services and the Treasury Bureau

March 2011