Consultation
on
2014-15 Budget

2 December 2013

Content

2013 economic indicators

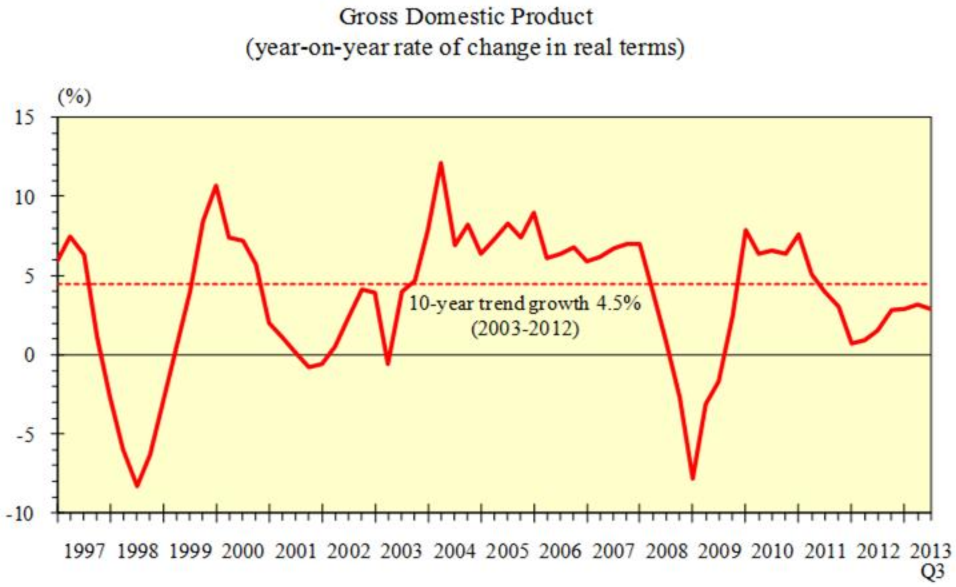
GDP real growth	Q1 – Q3 (Jan – Sep)	3.0%
	Q3	2.9%
Unemployment rate	Aug – Oct	3.3%
Underlying consumer price inflation	Jan – Oct	4.0%
	Oct	4.0%

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

- The Hong Kong economy grew moderately in the first three quarters of 2013, by 3.0% in real terms over a year earlier. While the external sector was constrained by the weak global economic conditions, the domestic sector held firm.

- The labour market remained in a state of full employment on the back of the resilient domestic sector, with the seasonally-adjusted unemployment rate staying at a low level of 3.3% in August-October 2013. Underlying inflation remained broadly stable, averaging 4.0% in the first ten months of 2013, down from 4.7% in 2012.

Economy grew moderately in Q1-Q3 2013



- The Hong Kong economy expanded in the first three quarters of 2013 at a pace below the 10-year average trend, dragged down by weak and unsteady merchandise export performance.

The Economy

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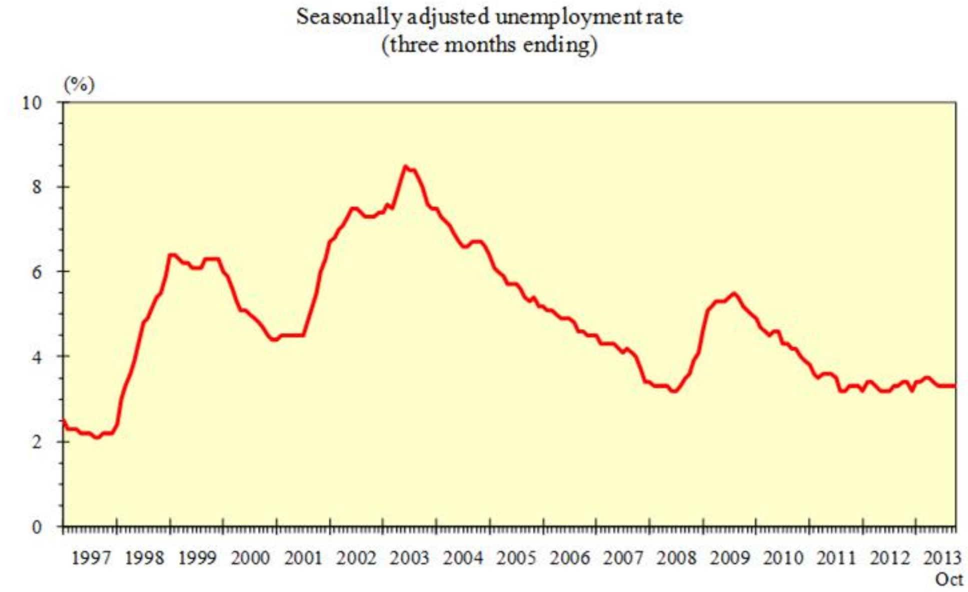
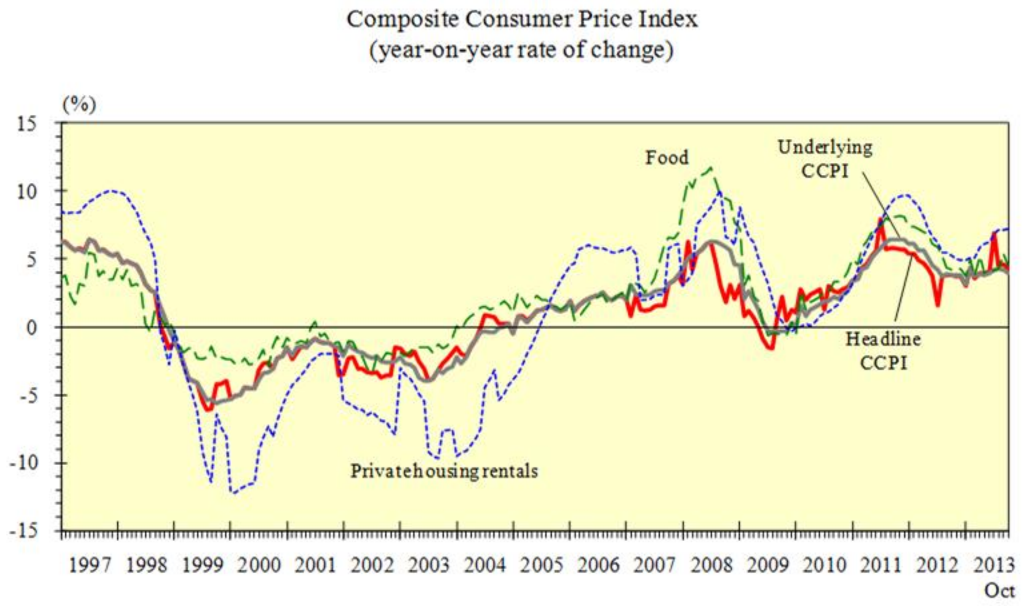
Labour market stayed tight



- The labour market remained in a state of full employment, with the seasonally-adjusted unemployment rate staying low at 3.3% in August-October 2013. Wages and earnings improved further. Average employment earnings for the lowest decile of full-time employees rose notably, due largely to tight market conditions for low-skilled labour, and also the upward adjustment of the Statutory Minimum Wage rate in May this year.

Milder inflation in 2013 compared to 2012



- Netting out the effects of the Government's one-off relief measures, underlying inflation went up slightly to 4.3% in the third quarter but eased back to 4.0% in October, mainly because food prices rose more moderately after the temporary surge in September amid bad weather conditions. The price increase in the private housing rental component also tended to stabilise. Meanwhile, increases in most major components in the consumer price index were moderate. Overall, underlying inflation in the first ten months of 2013 was broadly stable, averaging 4.0%, down from 4.7% in 2012.

Latest forecasts for 2013

GDP real growth	3%
Consumer price inflation	
Headline	4.3%
Underlying	4%

- Hong Kong's merchandise trade performance will likely be constrained by the tepid and uneven recovery of the advanced economies in the rest of the year. However, the solid growth of the Mainland economy should remain a key stabilising force, while resilient domestic consumption, intensive infrastructure works and further expansion of inbound tourism should continue to render support to the local economy.

- Given the actual GDP outturn in the first three quarters of the year and that a further moderate growth is likely attainable in the fourth quarter, the economy is forecast to grow moderately by 3% for 2013 as a whole, representing an improvement over the 1.5% growth in 2012.

- On the inflation outlook, the subdued imported inflation and the milder increases in fresh-letting residential rentals since the beginning of 2013 should help cap the upside risks to inflation in the near term. Headline and underlying consumer price inflation rates for 2013 as a whole are projected at 4.3% and 4% respectively.

Economic uncertainties

- Scale-back of US monetary stimulus
- Fiscal and debt problems in advanced economies
- Weak import demand from advanced economies

- While the acute risks for the global economic outlook have somewhat declined compared with the previous year, uncertainties in the external environment remain notable. As a small open economy, Hong Kong is vulnerable to external shocks. We shall stay vigilant and take pre-emptive measures when necessary to guard against adverse international developments.

The principles of fiscal sustainability are clearly enshrined in the Basic Law

- Basic Law Article 107

  … follow the principle of keeping expenditure within the limits of revenues

  … strive to achieve a fiscal balance, avoid deficits

  … keep the budget commensurate with the growth rate of its gross domestic product

● Fiscal prudence has been the guiding principle of the HKSAR Government. Under the Basic Law (BL), we shall -

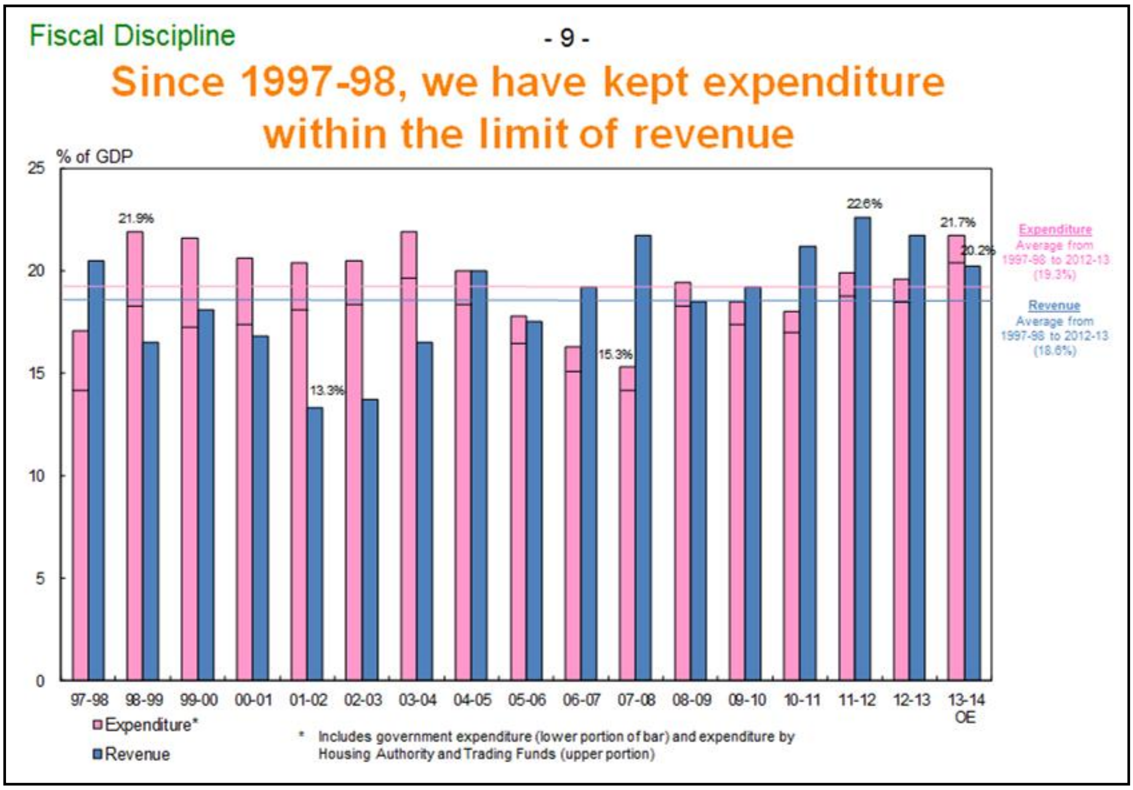
(a) follow the principle of keeping expenditure within the limit of revenue in drawing up the budget;

(b) strive to achieve a fiscal balance, avoid deficits; and

(c) keep the budget commensurate with the growth rate of the Gross Domestic Product (GDP).

● All three prongs of BL Article 107 have to be complied with.

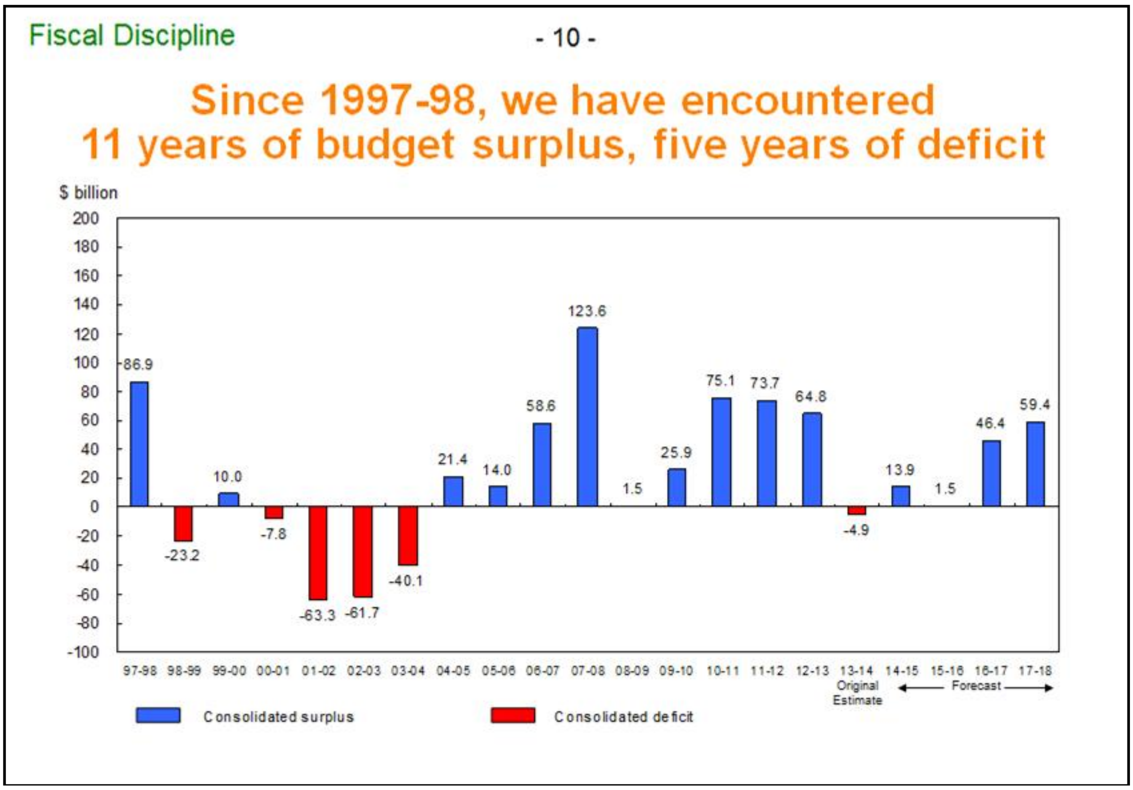
● These principles are integral to sustaining the health of the Hong Kong economy and maintaining the confidence of local and international investors.



- In line with the Basic Law requirement, we need to keep expenditure within the limit of revenue.

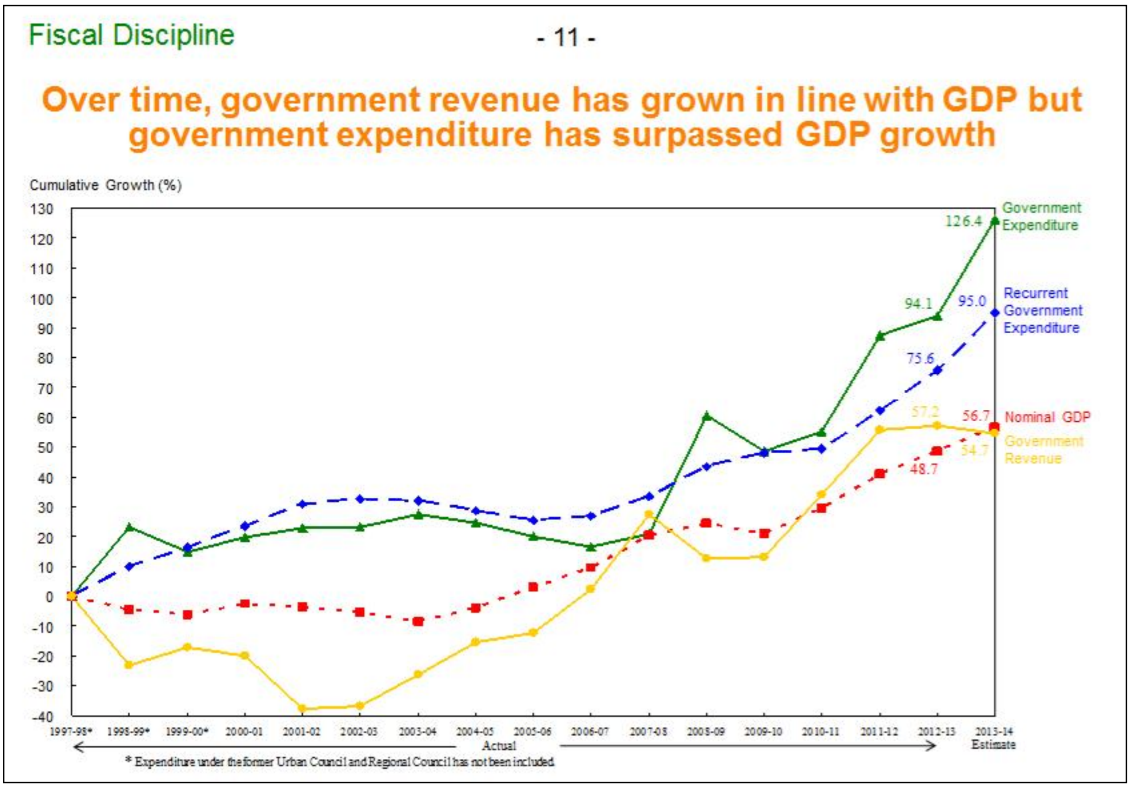
- Our revenue is currently around 20% in terms of GDP and expenditure is at about the same level.

- The Government would need to increase revenue if we were to increase expenditure. This would mean raising taxes or resorting to borrowing.



- The Basic Law requires us to strive to achieve a fiscal balance and avoid deficits.

- We have achieved budget surpluses for 11 years since 1997-98. But budget deficits had beset us for five years between 1998-99 and 2003-04 and the drain on the fiscal reserves was substantial.



- The Basic Law requires us to keep the budget commensurate with the growth rate of the GDP.

- GDP has grown by about 60% since 1997-98.

- Government expenditure has more than doubled from nearly $200 billion in 1997-98 to over $400 billion in 2013-14.

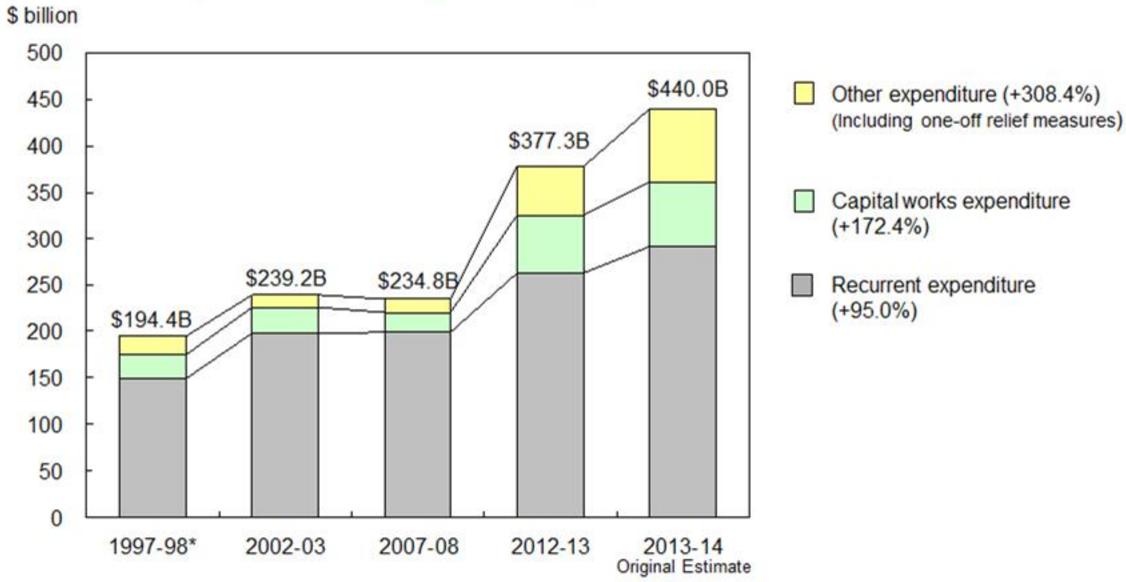
- Recurrent expenditure has almost doubled from $150 billion to over $290 billion.

- Despite year-on-year swings, government revenue has grown broadly in line with GDP since 1997-98.

- There is a clear need to contain the growth of government expenditure.

Expenditure

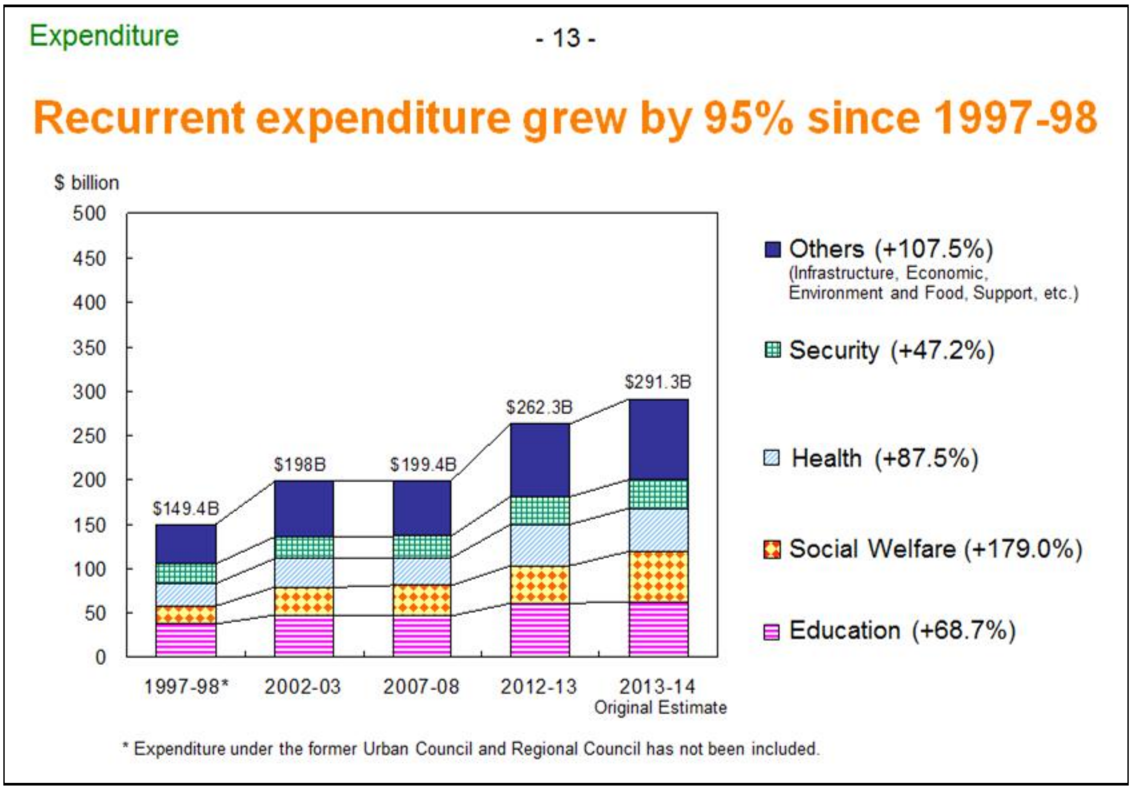
Total expenditure grew by 126.4% since 1997-98



* Expenditure under the former Urban Council and Regional Council has not been included.

- Total expenditure for 2013-14 is estimated to reach $440 billion, representing an increase of $62.7 billion, or 17%, over the actual expenditure for 2012-13, and is more than doubled when compared with 1997-98 —

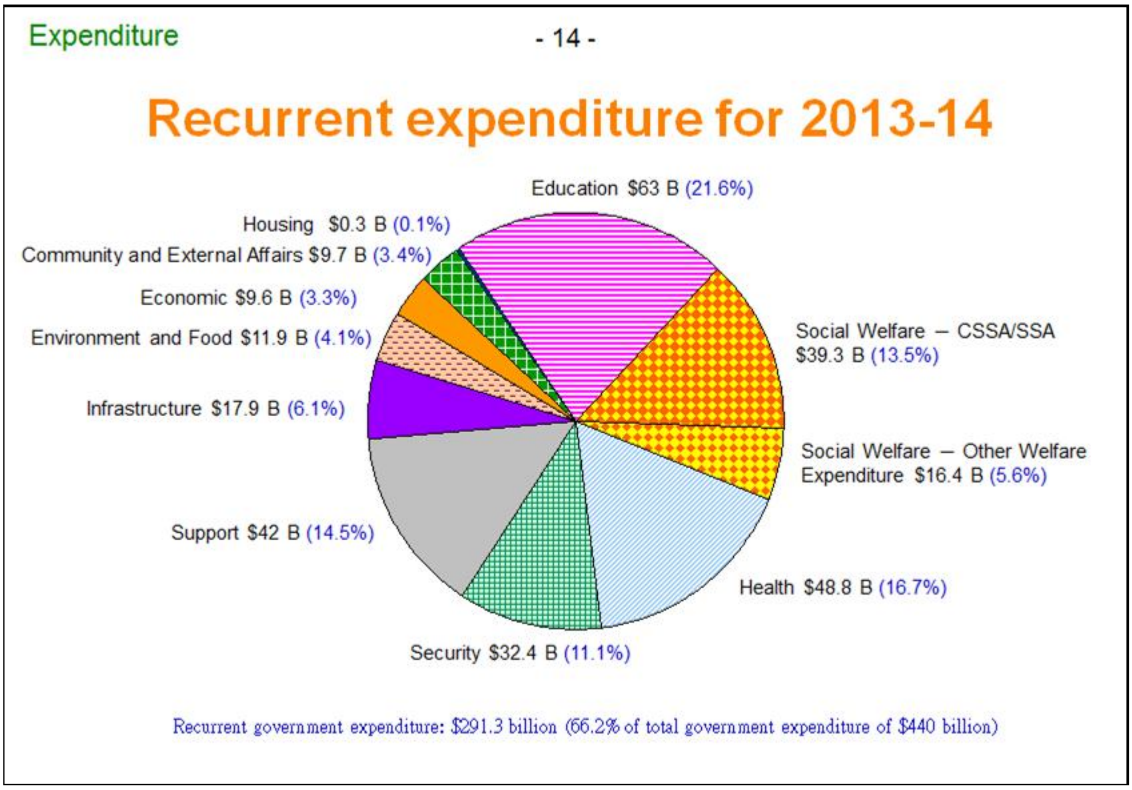
	Compared with 1997-98
➢ Recurrent Expenditure	+95%
➢ Capital Works Expenditure	+172%



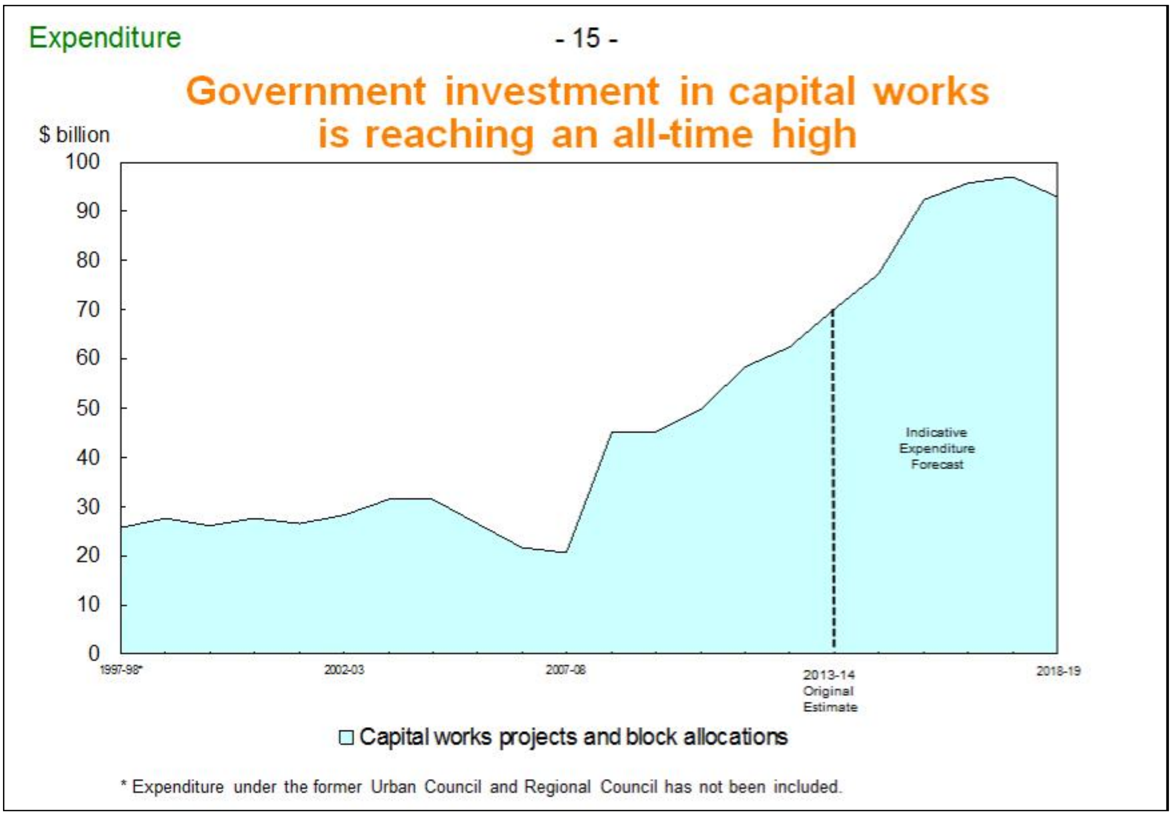
- Recurrent expenditure for 2013-14 is estimated to reach $291.3 billion, representing an increase of $29 billion, or 11%, over the actual expenditure for 2012-13. It is almost doubled when compared with 1997-98. The increase in recurrent expenditure reflects the Government's long term commitment to improving people's livelihood.

- Our recurrent expenditure on education, social welfare and health has been increasing –

	Compared with 1997-98
➢ Education	+69%
➢ Social Welfare	+179%
Comprehensive Social Security Assistance (CSSA) Scheme	*+116%*
Social Security Allowance (SSA) Scheme	*+329%*
Other welfare expenditure	*+168%*
➢ Health	+88%



- Based on the 2013-14 Estimates of Expenditure, the spending on Education (21.6%), Social Welfare (19.1%) and Health (16.7%) together accounts for 57.4% of total recurrent government expenditure.



- The 2013-14 estimated expenditure on capital works under the Capital Works Reserve Fund will reach $70.1 billion (including $8.2 billion allocation for minor works), representing an increase of around 13% over the actual expenditure for 2012-13.

- Compared with the actual expenditure for 1997-98, the level of expenditure has increased by about 170%.

- With the various major infrastructure projects entering their construction peak, capital works expenditure is expected to maintain at the current high level over the next few years.

The unfunded commitment for approved projects amounts to some $400 billion

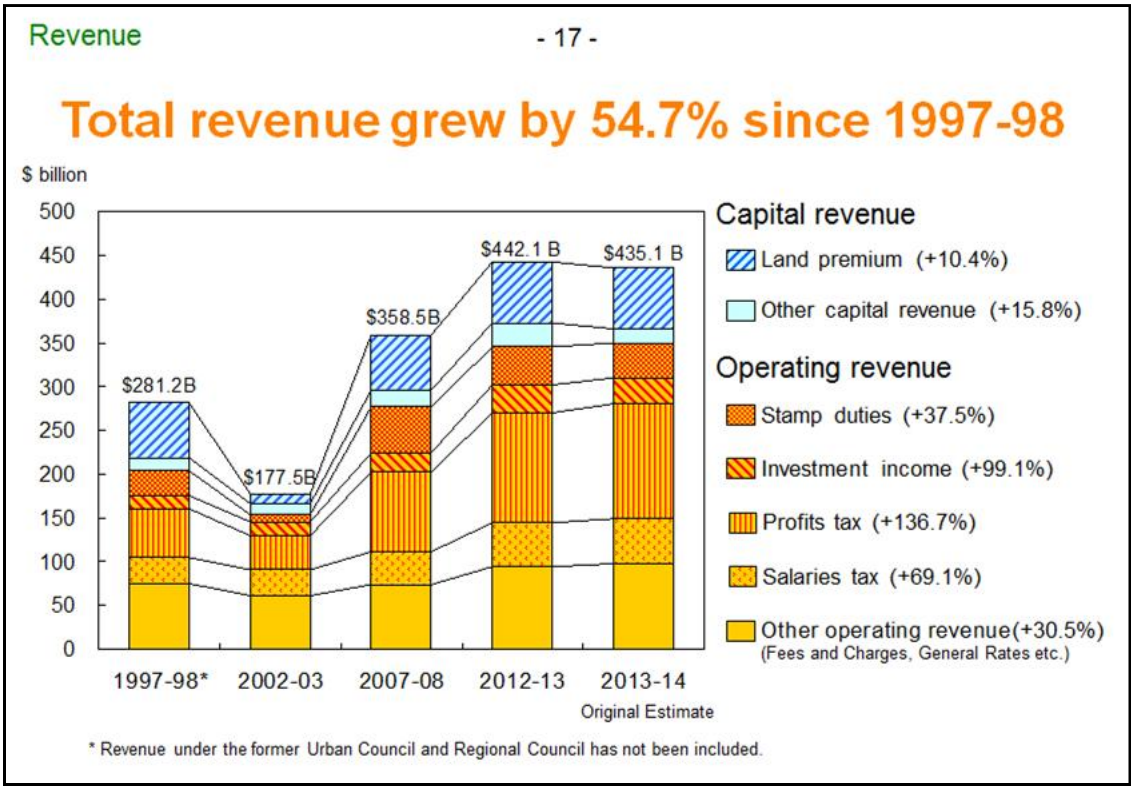
- No provision set aside for future expenditures of projects approved by the Finance Committee

Unfunded commitment =
Approved project estimate – cumulative expenditure

- To foster economic development and enhance the quality of life of the community, our package of capital works projects covers transport infrastructure, hospitals and health-care facilities, welfare facilities for the elderly, cultural and recreational facilities and land production.

- There are over 700 ongoing projects, having received funding approval from the Finance Committee of the LegCo.

- As at end August 2013, outstanding commitment of capital works projects was $398 billion in money-of-the-day prices. This is unfunded.



- Profits tax has been our largest operating revenue. It varied from $37.7 billion (1999-2000) to $125.6 billion (2012-13).

- Salaries tax has been our second or third largest operating revenue. It varied from $24.8 billion (1999-2000) to $51.8 billion (2011-12).

- Since 1997-1998, Stamp duties varied from $7.5 billion to $51.5 billion.

- Since 1 April 2007, we have adopted an arrangement whereby the rate of investment return is pre-determined based on past returns. This has greatly reduced the volatility of investment income. The average annual revenue from this source exceeded $36 billion for the years from 2007-08 to 2012-13.

- As for capital revenue, land premium has been most volatile, fluctuating from $5.4 billion to $84.6 billion in the period.

- The volatility of our revenue income poses challenges to the management of public finances.

Revenue

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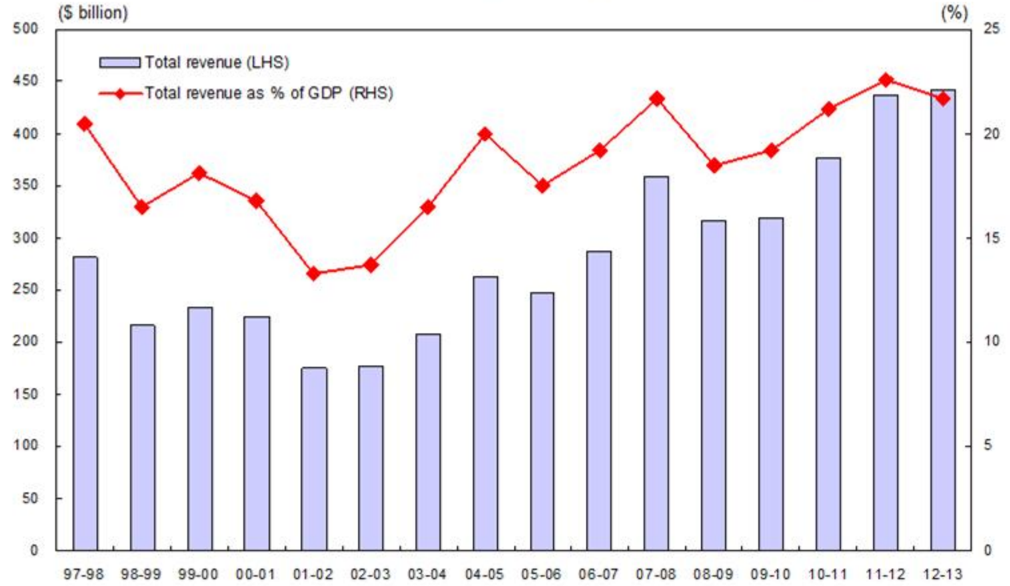
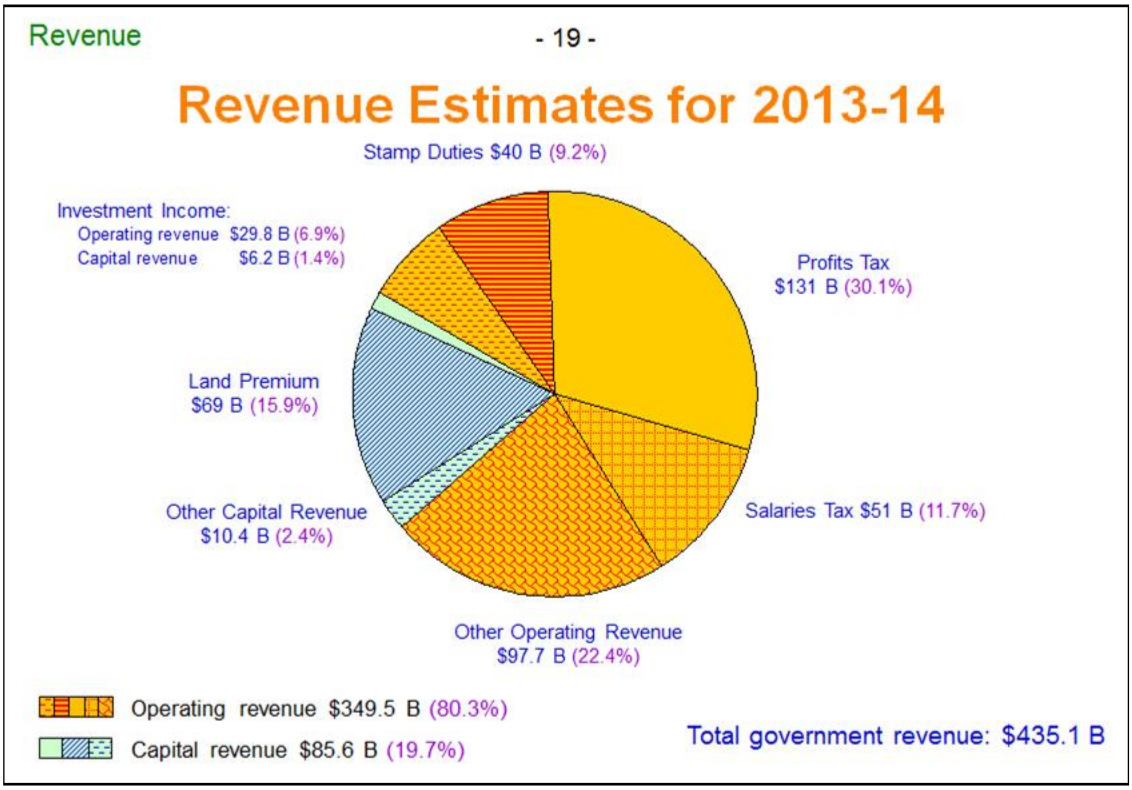
Government revenue tends to be a lot more sensitive to the performance of the economy than government expenditure

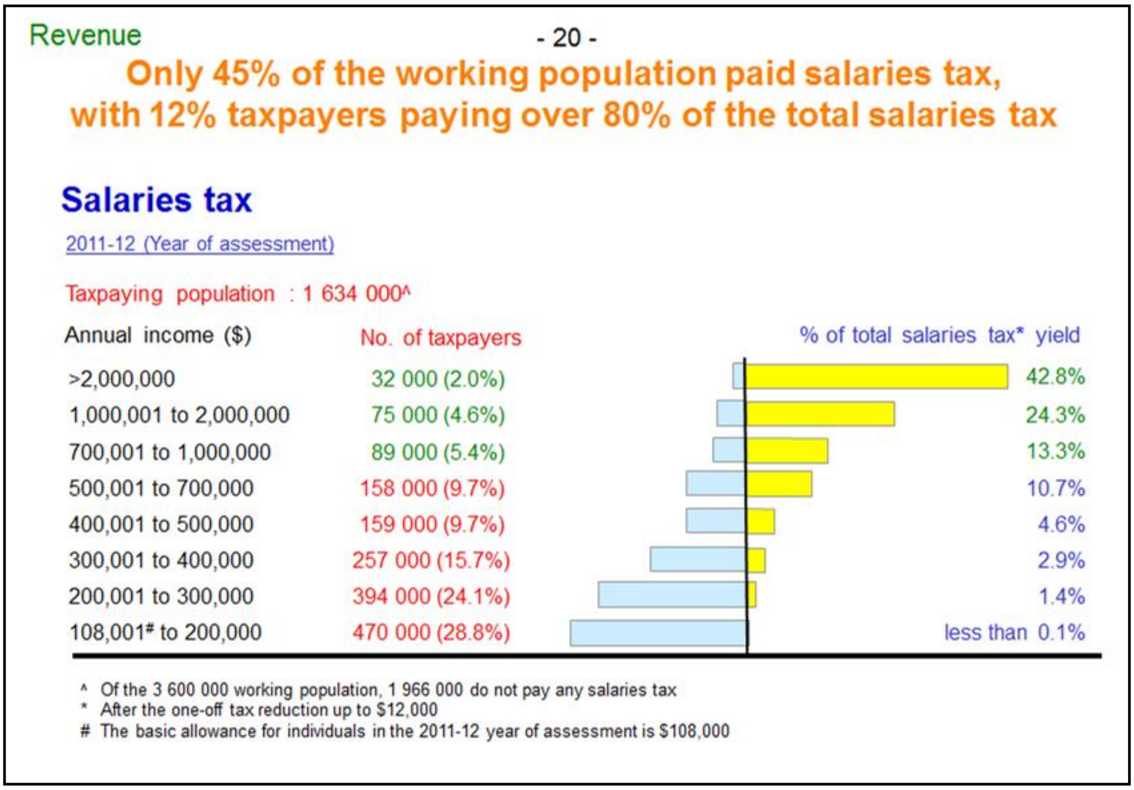


- Hong Kong is a small and open economy. Our tax base is narrow and government revenue is sensitive to economic fluctuations depending on the broader economic changes beyond government's control.

- The volatility of our revenue income poses challenges to the management of public finances. Profits tax, salaries tax, stamp duty and land premium account for 65% of the 2012-13 total government revenue.

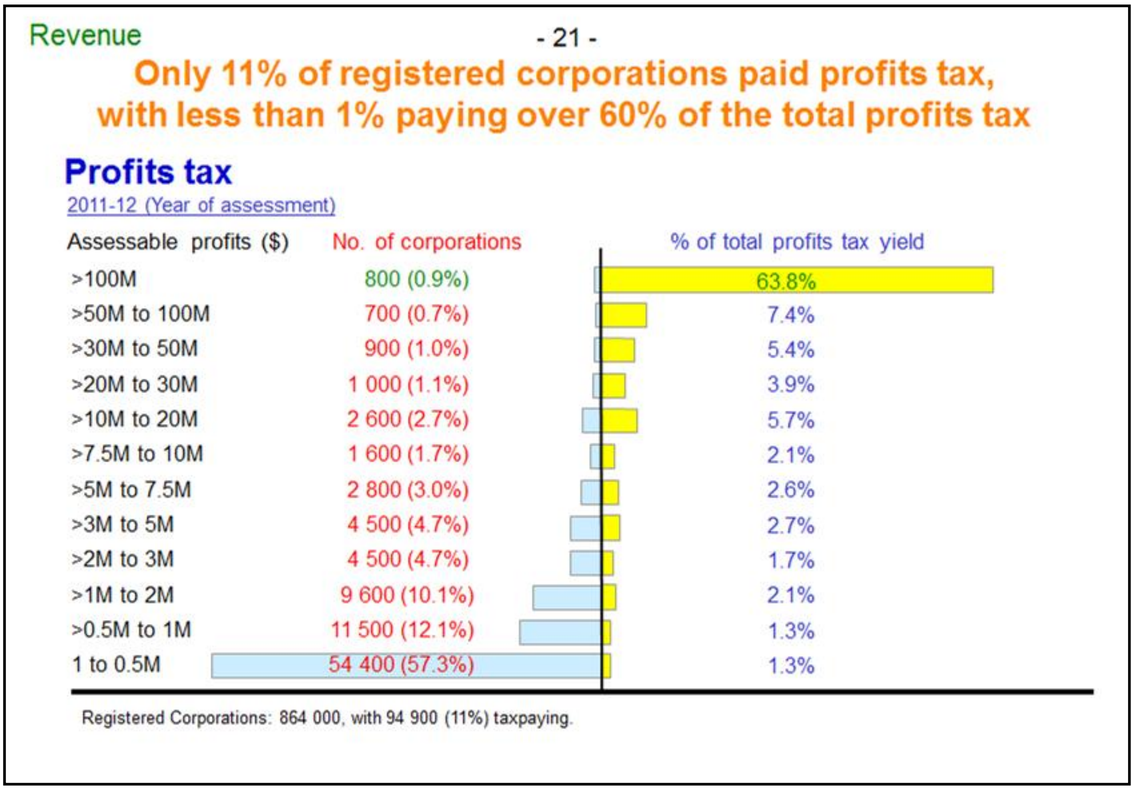


- The five major revenue items are profits tax (30.1%), salaries tax (11.7%), stamp duties (9.2%), investment income (mainly from placement of the fiscal reserves with the Exchange Fund) (8.3%) and land premium (15.9%). Together they account for 75.2% of total government revenue.



- In the year of assessment 2011-12, of the 3.6 million working population, about 2 million or 55% of the working population need not pay any salaries tax.

- Of the 1.6 million who paid salaries tax, about 200 000 (5% of the working population or 12% of the taxpaying population) contributed 80% of the revenue from salaries tax.



- In the year of assessment 2011-12, about 64% of our profits tax is contributed by the top 800 taxpaying corporations out of 94 900 corporations. Over 769 000 registered companies (about 89% of the total registered corporations) do not pay any profits tax.

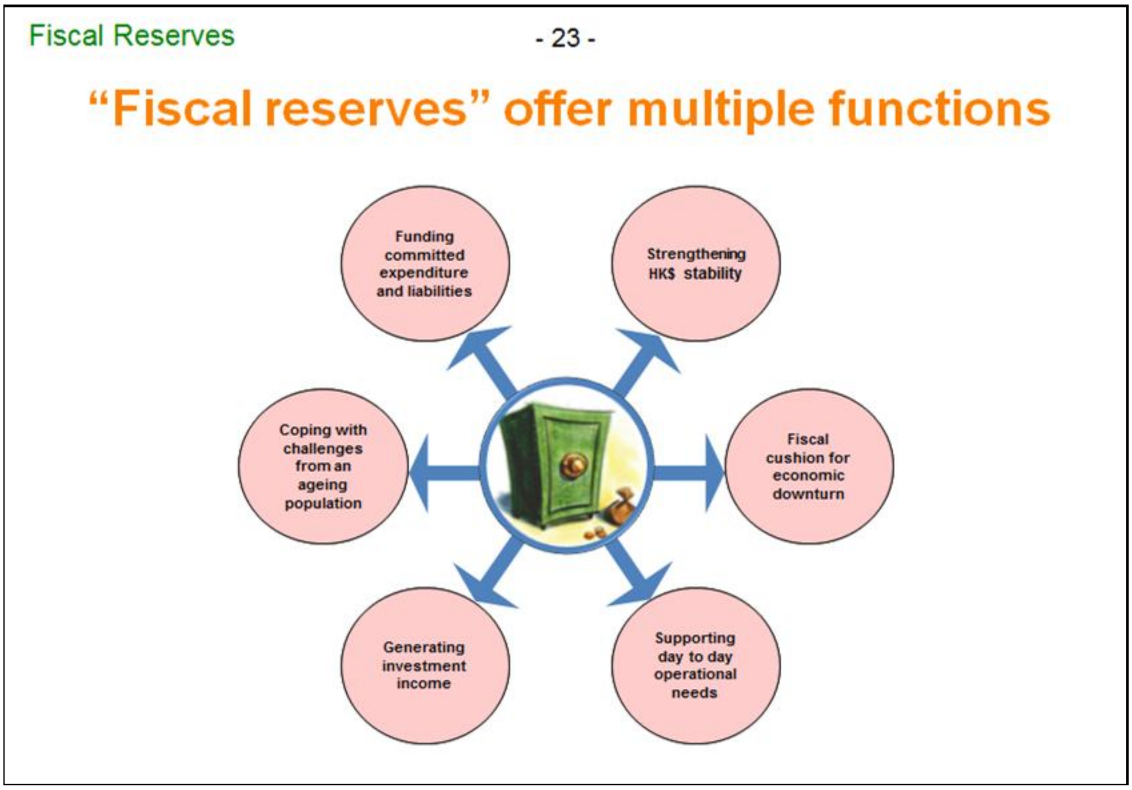
Fiscal Reserves

"Fiscal reserves" reflect our entire cash balance, much of which is locked up in funds with designated use

Fund	Balance as at 31.3.2013 $M
General Revenue Account	404,720
Capital Works Reserve Fund	77,991
Capital Investment Fund	1,396
Civil Service Pension Reserve Fund	25,742
Disaster Relief Fund	6
Innovation and Technology Fund	2,379
Land Fund	209,266
Loan Fund	2,186
Lotteries Fund	10,228
Total	733,914

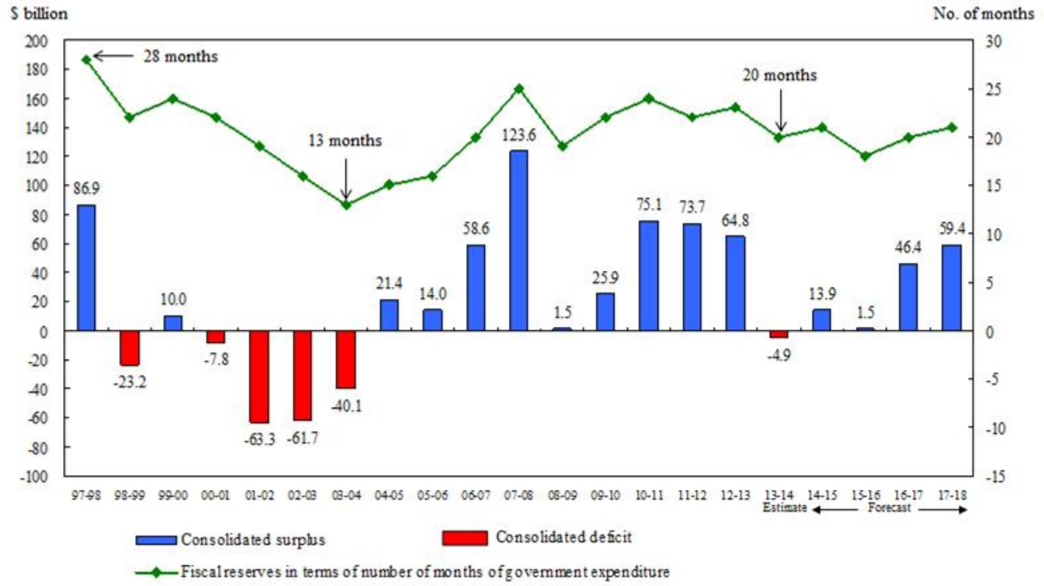
- Fiscal reserves is the total of the balances under the General Revenue Account and eight Funds established for specific purposes under s 29 of the Public Finance Ordinance.

- This is all we have to meet our day-to-day operational needs, outstanding commitments (including some $400 billion for capital works) and liabilities (such as public officers' pensions, the present value of which as at 31 March 2012 was $641.4 billion).

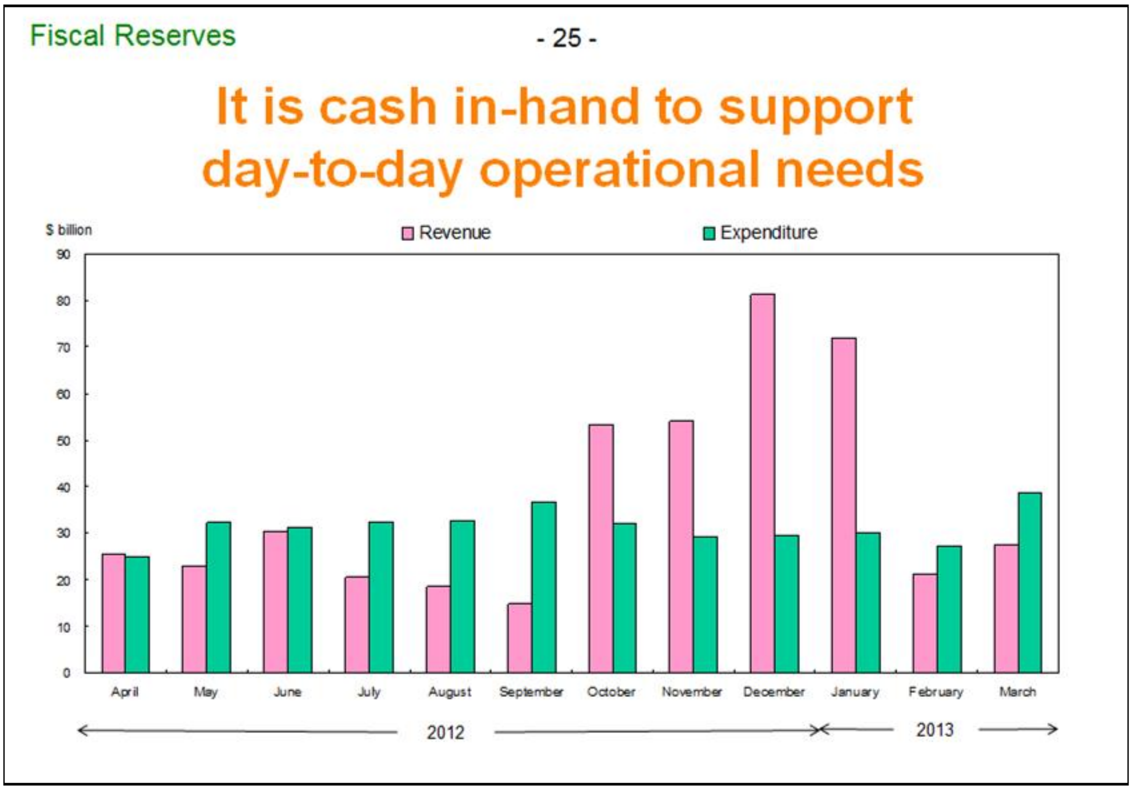


- The fiscal reserves help to strengthen the stability of the Hong Kong dollar. At the end of March 2013, the fiscal reserves constituted a quarter of the Exchange Fund's total assets.

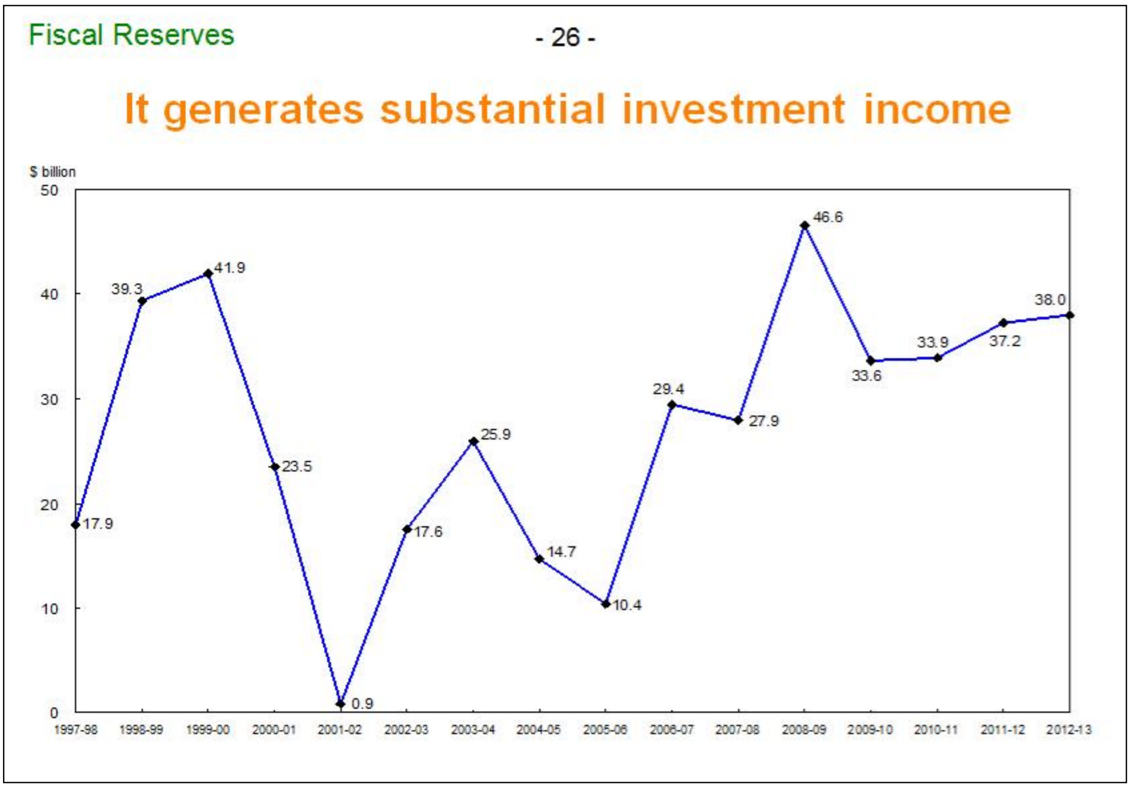
It is a cushion during an economic downturn



- For the six years from 1998-99 to 2003-04, we experienced five years of deficits. Fiscal reserves dropped from 28 months of government expenditure in March 1998 to 13 months in March 2004.



- Government expenditure is relatively evenly spread throughout the year but revenue mostly collected at year end. We need a buffer to meet in-year cashflow needs.



- Investment income from fiscal reserves is a major source of revenue generating some $36 billion in 2013-14, equivalent to around 8% of the total government revenue. Investment income will be reduced if our fiscal reserves are reduced.

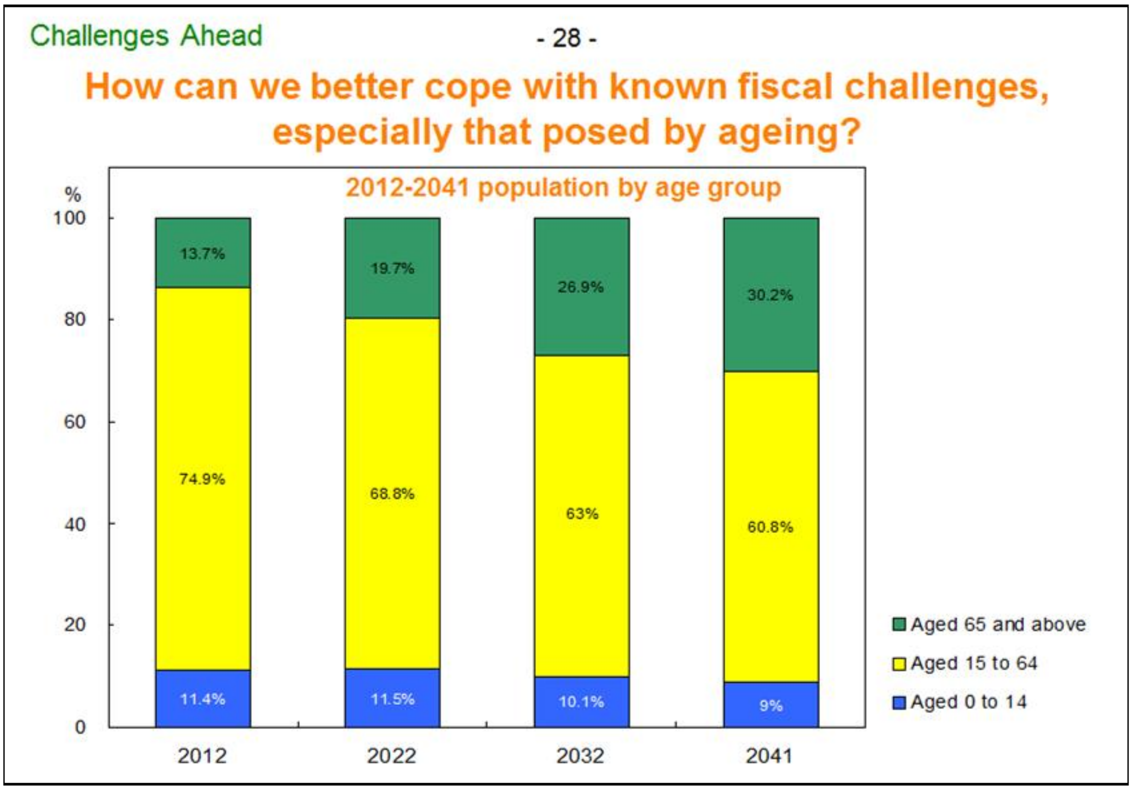
It is all we have to meet unfunded commitments and liabilities, which will hit current and future taxpayers

$398 billion	outstanding commitments on capital works
$80.7 billion	debts guaranteed by Government
$641.4 billion (present value)	unfunded pension liabilities

- As at end August 2013, outstanding commitment of capital works projects approved by the Legislative Council is $398 billion in money-of-the-day prices.

- Government has provided debt guarantees of $80.7 billion as at 31 March 2013.

- Key unfunded liabilities include public officer's pensions and bonds issued in 2004. The 2013-14 pension expenditure is estimated at $25.5 billion and the pension liability at present value as at 31 March 2012 was $641.4 billion.



- In 2012, the number of elderly people aged 65 and over was 980 000, representing 14% of our population.

- According to the latest projection, the number of elderly people will increase significantly to 2.56 million by 2041, representing 30% of our population.

- In the early 1980s, there were ten persons of working age (i.e. people aged 15 to 64) compared to one dependent elderly person.

- Now, the elderly dependency ratio has dropped to five working age persons compared to one dependent elderly person.

- In 2041, the elderly dependency ratio will further reduce to less than two working age persons compared to one dependent elderly person.

Fiscal implications of population ageing

- Pressure on government revenue due to –
  - Lower economic growth
  - Shrinking working population
  - Decline in savings rate
- Pressure on government expenditure, particularly –
  - Healthcare
  - Social welfare
- Long-term sustainability of public finance

- A fall in the proportion of working population will reduce economic vibrancy and slow the momentum of economic growth. Our economic growth will continue to taper off in the 2020s.

- With an increase in the number of elderly persons, a shrinking working population, reduction in the number of taxpayers and decelerated economic growth, the growth of government revenue will drop substantially if our tax regime remains unchanged.

- The increase in the proportion of elderly population will result in a surge of expenditure on healthcare and welfare.

- These developments will have profound implications for the sustainability of government revenue and public expenditure.

Economies round the world are trending towards fiscal consolidation

- Set targets to narrow budget deficits/ restore fiscal balance and control government debt level
- Implement savings plans to fund future expenditure commitments
- Raise revenue through reviewing tax rules and increasing tax rates
- Control expenditure through reviewing spending priorities and limiting expenditure growth

- Looking globally, many economies are also facing the problem of soaring public expenditure in the long run.
- Many overseas economies have pursued fiscal consolidation, struggling to reduce their fiscal deficits and national debts.
- Some countries use the resources available to plan for the future through saving up part of their fiscal surplus or other receipts and assets.

Your views are welcome!

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