Consultation
on
2016-17 Budget

7 December 2015

Content

The Economy

Latest forecasts for 2015

GDP real growth	2.4%
Consumer price inflation	
Underlying	2.5%
Headline	3%

- The global economic growth in 2015 is likely to be the slowest since 2009, with notable downside risks in the near term. The austere external environment will continue to restrain our export performance.

- With continued impact from weak external demand, the major impetus to overall economic growth in the period ahead will have to count on domestic demand. Consumer sentiment may continue to be underpinned by the stable job and income conditions. Yet, as the US is prepared to hike interest rates and as the global outlook is still subject to various downside risks, the possible adverse repercussions on local asset prices and economic sentiment need to be watched closely. Overall, the Hong Kong economy is forecast to grow by 2.4% in real terms in 2015.

- On prices, the upside risks to inflation in the near term should remain well contained given the mild external price pressures and growth slowdown of the local economy. The underlying and headline consumer price inflation rates for 2015 as a whole are forecast at 2.5% and 3% respectively.

Economic uncertainties

- Prolonged sluggishness in global demand
- Possible shocks from US interest rate normalisation
- Gyrations in local asset markets
- Geopolitical tensions in various parts of the world
- Slowdown in inbound tourism

- The global economic recovery has been slow and patchy, still constrained by the weak demand conditions and heightened financial market volatility in the aftermath of the global financial crisis. Asian economies, including the Mainland economy, have seen setback in exports and production so far this year, and any further deterioration would add downward pressure on our exports.

- The large fluctuations in the global financial market in the third quarter is a timely reminder of the possible shocks from the future normalisation of US interest rates, especially against the subdued global macro backdrop. Emerging markets have been severely hit by significant capital outflows. We need to stay vigilant to how the situation will play out and its ramifications on local asset markets and economic growth prospect.

- Also, the slowdown in inbound tourism and possible impacts on employment creation warrant concern.

- With sound fundamentals and Government's pre-emptive measures in the past few years, the Hong Kong economy will be able to withstand the challenges and fare better once the external environment improves. Yet, we still need to continue to consolidate our competitive edges and be nimble in seizing new development opportunities, particularly those from the Belt and Road Initiative and the 13th Five-Year National Plan.

Fiscal Discipline

Fiscal Discipline

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 -

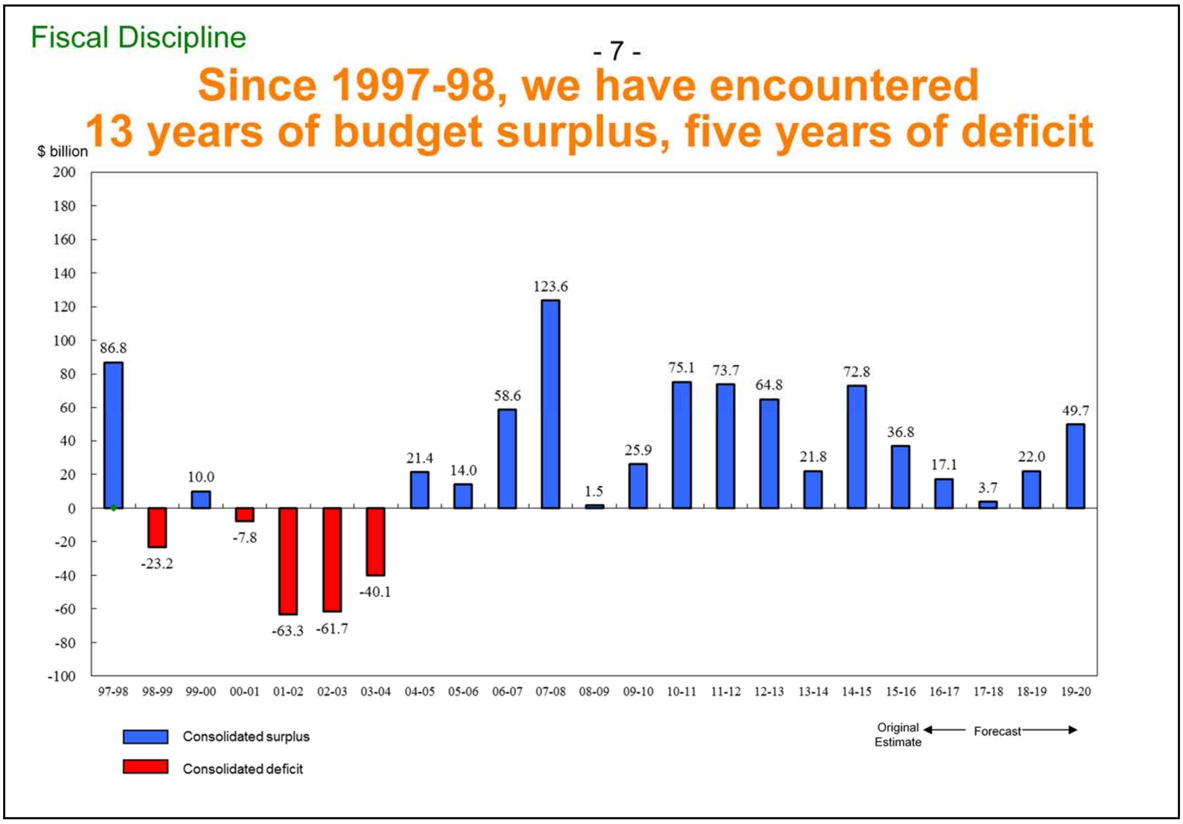
  (a) follow the principle of keeping expenditure within the limits of revenues in drawing up the budget;

  (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.



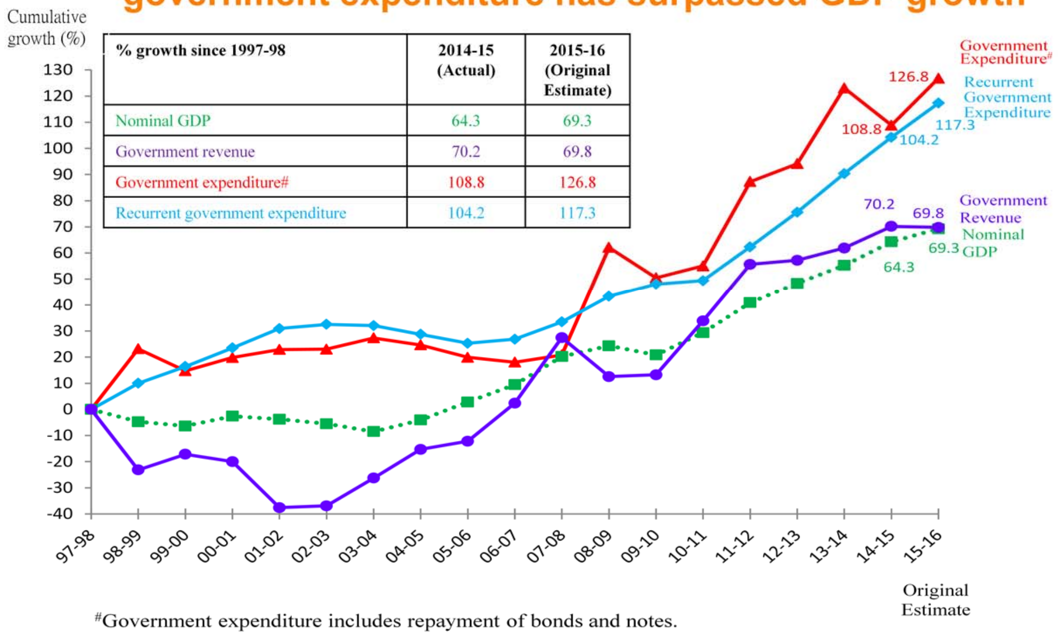
- The Basic Law requires us to strive to achieve a fiscal balance and avoid deficits.

- We have achieved budget surpluses for 13 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.

Fiscal Discipline

Over time, government revenue has grown in line with GDP but government expenditure has surpassed GDP growth

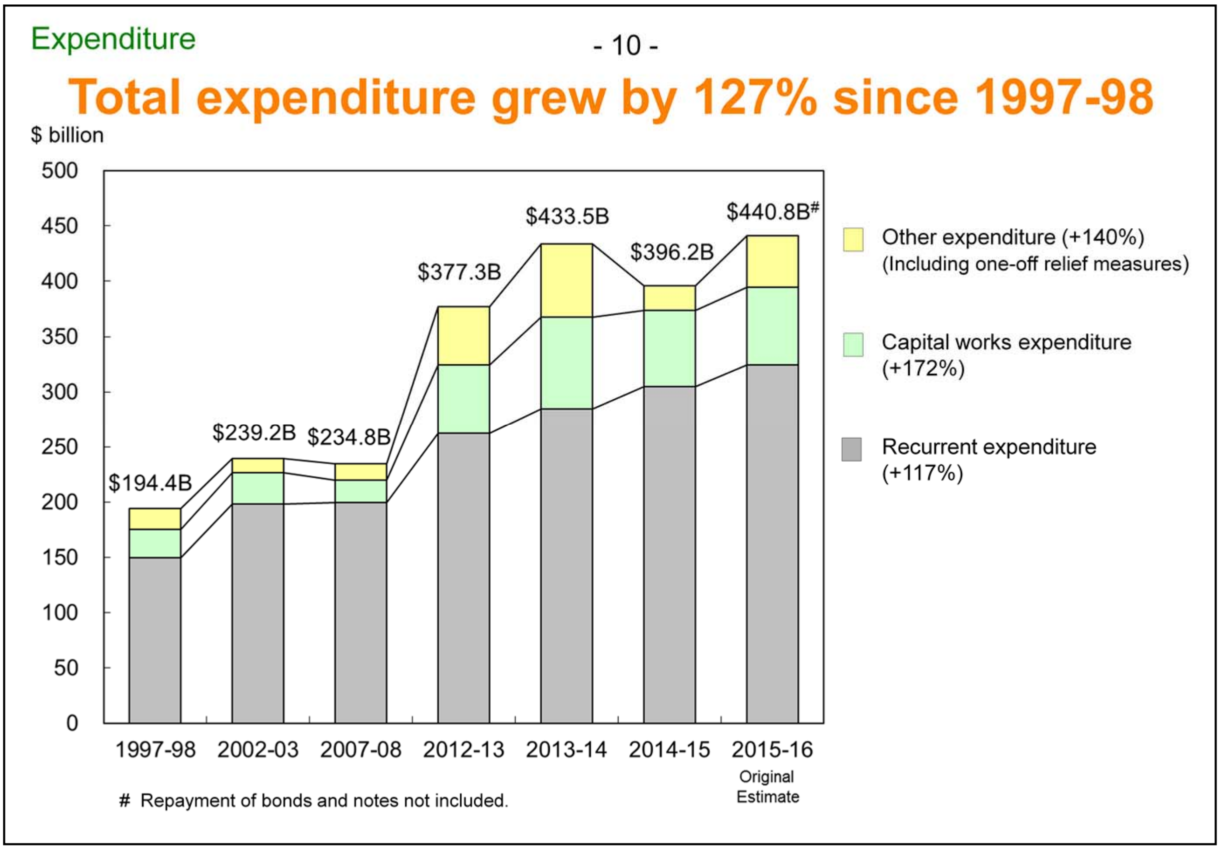
% growth since 1997-98	2014-15 (Actual)	2015-16 (Original Estimate)
Nominal GDP	64.3	69.3
Government revenue	70.2	69.8
Government expenditure#	108.8	126.8
Recurrent government expenditure	104.2	117.3



#Government expenditure includes repayment of bonds and notes.

- The Basic Law requires us to keep the budget commensurate with the growth rate of the GDP.
- GDP has grown about 70% since 1997-98.
- Government expenditure has more than doubled from nearly $200 billion in 1997-98 to about $440 billion in 2015-16.
- Recurrent expenditure has more than doubled from about $150 billion in 1997-98 to about $325 billion in 2015-16.
- On the other hand, 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

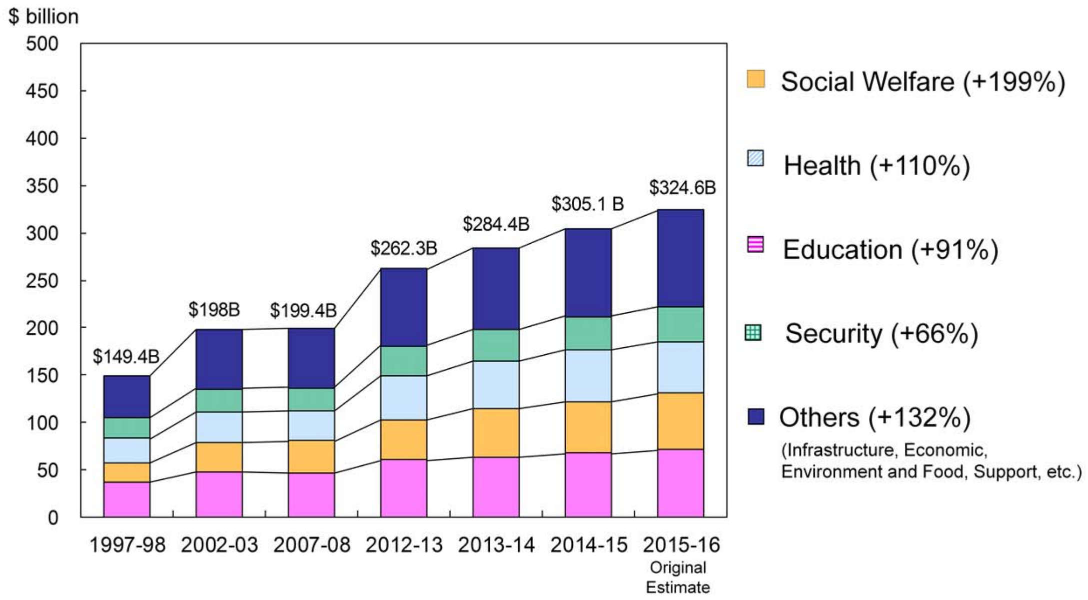


- Total expenditure for 2015-16 is estimated to reach $440.8 billion, representing an increase of $44.6 billion, or 11.3%, against the actual expenditure for 2014-15, mainly due to the increase in provisions for recurrent expenditure and $10 billion for supporting healthcare reform and provisions of one-off relief measures. It is more than doubled when compared with 1997-98 –

	Compared with 1997-98
➢ Recurrent Expenditure	+117%
➢ Capital Works Expenditure	+172%

Expenditure

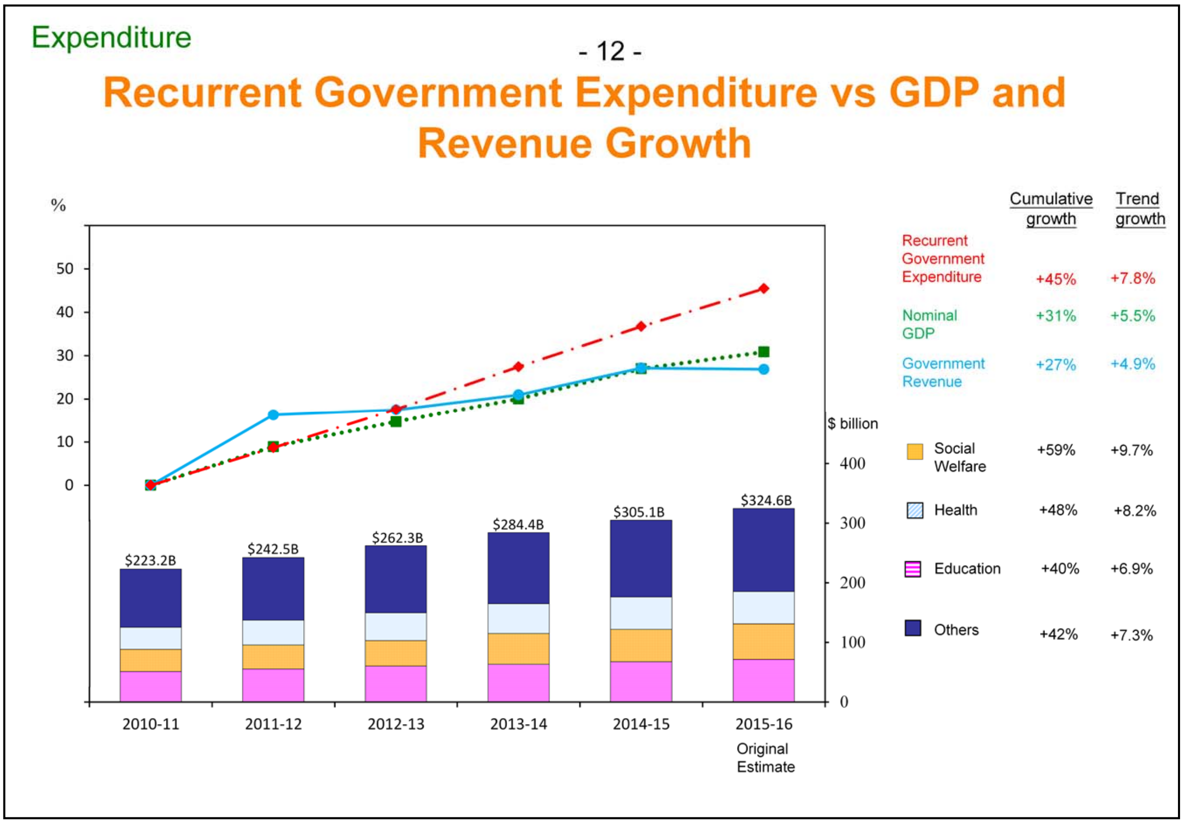
Recurrent expenditure grew by 117% since 1997-98



- Recurrent expenditure for 2015-16 is estimated to reach $324.6 billion, representing an increase of $19.5 billion (or 6.4 %) over the actual expenditure for 2014-15. It is more than doubled when compared with 1997-98. The increase in provisions for recurrent expenditure reflects the Government’s long term commitment to improving people’s livelihood.

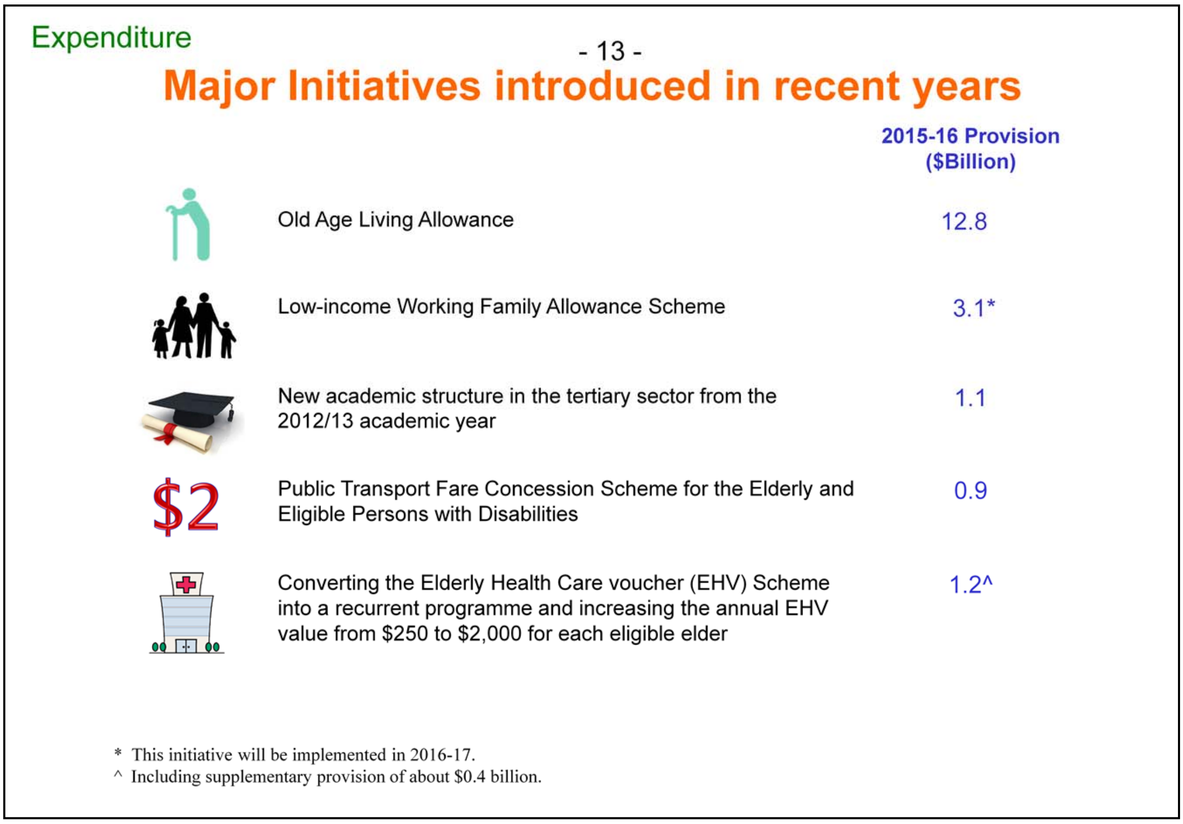
- Our recurrent expenditure on social welfare, health and education has been increasing –

		Compared with 1997-98
➢ Social Welfare		+199%
Comprehensive Social Security Assistance Scheme	+121%	
Social Security Allowance Scheme	+333%	
Other welfare expenditure	+224%	
➢ Health		+110%
➢ Education		+91%



- The cumulative growth and trend growth from 2010-11 to 2015-16 are as follows -

	Cumulative Growth	Trend Growth
Recurrent Government Expenditure	+45%	+7.8%
➢ Social Welfare	+59%	+9.7%
➢ Health	+48%	+8.2%
➢ Education	+40%	+6.9%
➢ Others	+42%	+7.3%
Nominal GDP	+31%	+5.5%
Government Revenue	+27%	+4.9%



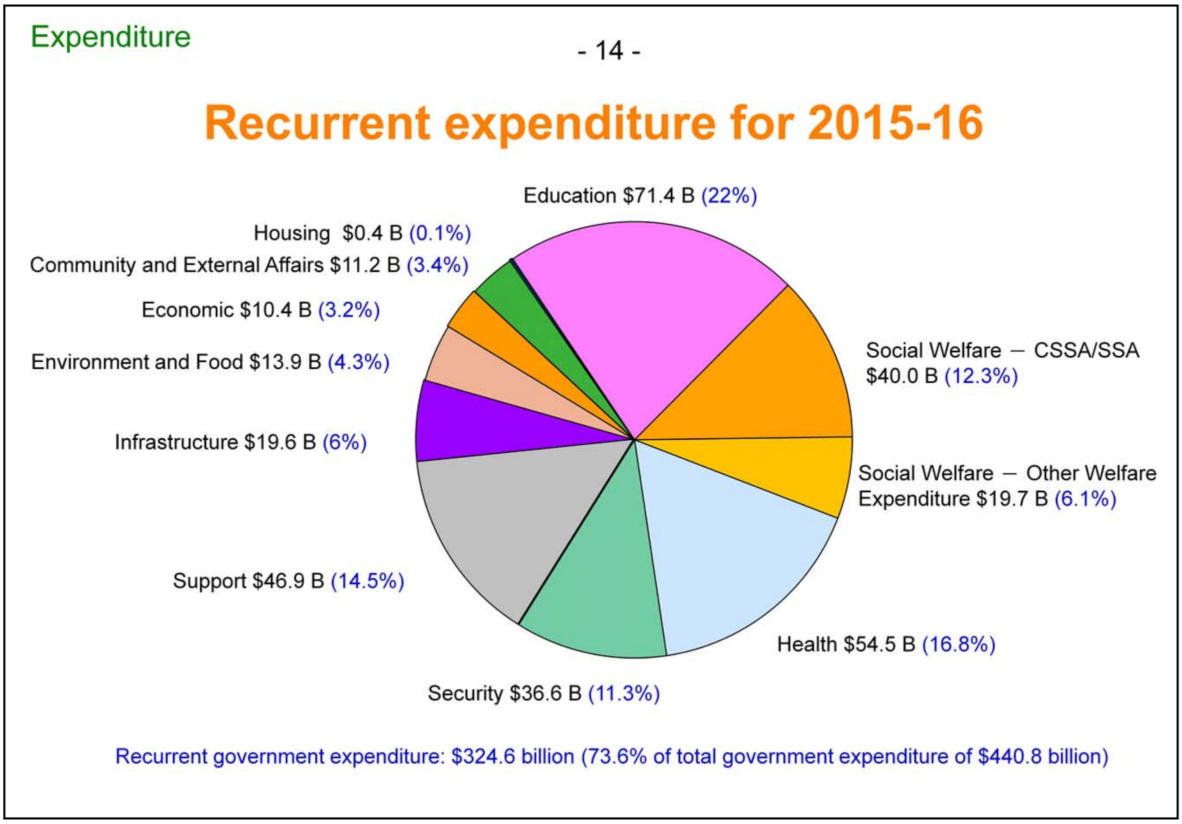
Expenditure

Major Initiatives introduced in recent years

	2015-16 Provision ($Billion)
Old Age Living Allowance	12.8
Low-income Working Family Allowance Scheme	3.1*
New academic structure in the tertiary sector from the 2012/13 academic year	1.1
Public Transport Fare Concession Scheme for the Elderly and Eligible Persons with Disabilities	0.9
Converting the Elderly Health Care voucher (EHV) Scheme into a recurrent programme and increasing the annual EHV value from $250 to $2,000 for each eligible elder	1.2^

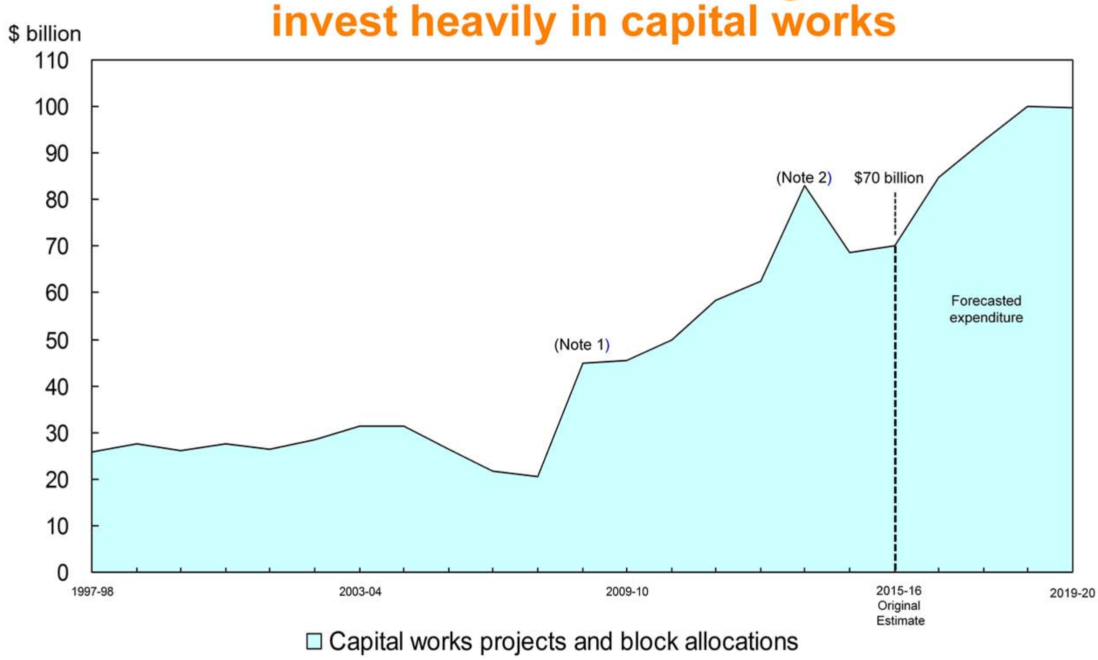
* This initiative will be implemented in 2016-17.
^ Including supplementary provision of about $0.4 billion.

- The increase in government expenditure in recent years is by no means conservative, which is a testimony to the Government's on-going commitment to the community.



- Based on the 2015-16 Estimates of Expenditure, the spending on Education (22%), Social Welfare (18.4%) and Health (16.8%) together accounts for 57.2% of total recurrent government expenditure.

Government continuing to invest heavily in capital works



Note 1 : Including the one-off grant of $21.6 billion provided to the West Kowloon Cultural District Authority.
Note 2 : Including the one-off grant of $13 billion provided to the Hospital Authority.

- The 2015-16 estimated expenditure on capital works under the Capital Works Reserve Fund will reach $70 billion (including $8.9 billion allocation for minor works). The actual expenditure in 2014-15 ($68.8 billion) is comparable to the estimated expenditure in 2015-16.

- Compared with the actual expenditure for 1997-98, the level of expenditure has increased by about 172%.

- With many major projects at their construction peaks, the estimated annual capital works expenditure for the next few years will continue to stay at the level of over $70 billion.

Capital Works Projects

Apart from strategic infrastructure to improve transport links and develop new growth areas, the capital works programme covers cultural, education, environmental protection, hospitals, sports complexes and district projects, etc.

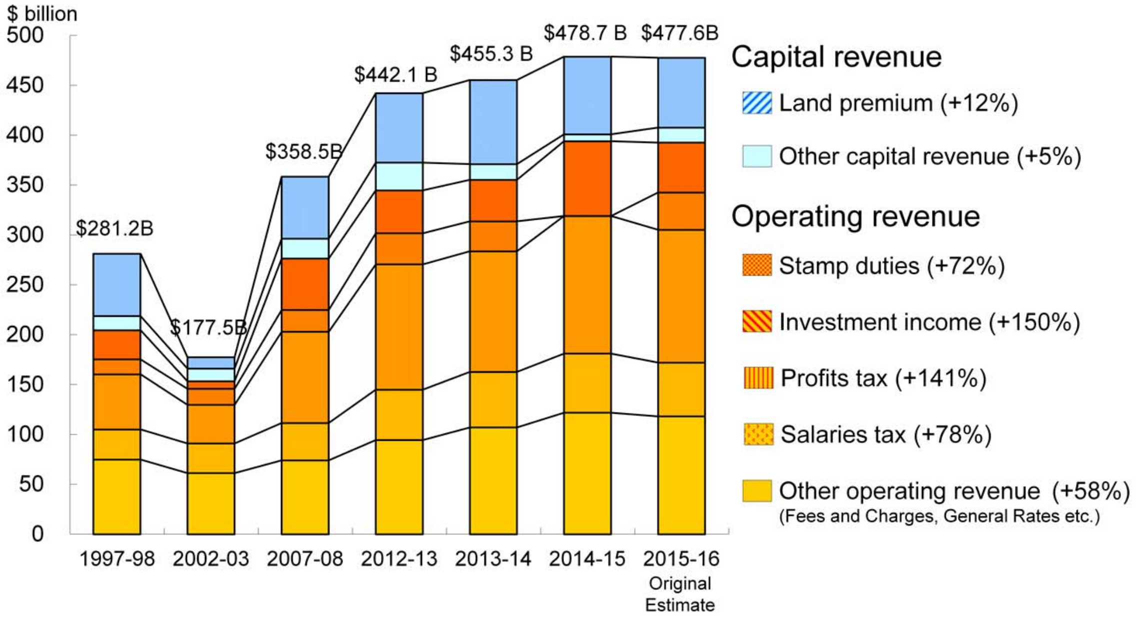



- Strategic infrastructure projects under way –
    1. Hong Kong – Zhuhai-Macao Bridge
    2. Hong Kong Section of Guangzhou-Shenzhen-Hong Kong Express Rail Link
    3. Tuen Mun – Chek Lap Kok Link and Tuen Mun Western Bypass
    4. Shatin to Central Link
    5. South Island Line (East)
    6. West Kowloon Cultural District
    7. Kai Tak Development
    8. Joint Development of the Lok Ma Chau Loop with Shenzhen
- Other projects include –
    9. Health – e.g. Tin Shui Wai Hospital, Hong Kong Children's Hospital, redevelopment of the Yan Chai Hospital and refurbishment of Hong Kong Buddhist Hospital
    10. Environmental protection – e.g. development of the organic waste treatment facilities at Siu Ho Wan and treatment and recycling facilities for waste electrical and electronic equipment at the EcoPark in Tuen Mun
    11. Education –primary and secondary schools, and special school projects
    12. Sports, recreational and cultural – e.g. sports centre in Area 24D in Sha Tin, a Government Complex in Area 14 (Siu Lun) in Tuen Mun and the East Kowloon Cultural Centre

Revenue

Revenue

Total revenue grew by 70% since 1997-98



- Profits tax has been our largest operating revenue. It varied from $37.7 billion (1999-2000) to $137.8 billion (2014-15).

- Salaries tax has been our second or third largest operating revenue. It varied from $24.8 billion (1999-2000) to $59.3 billion (2014-15).

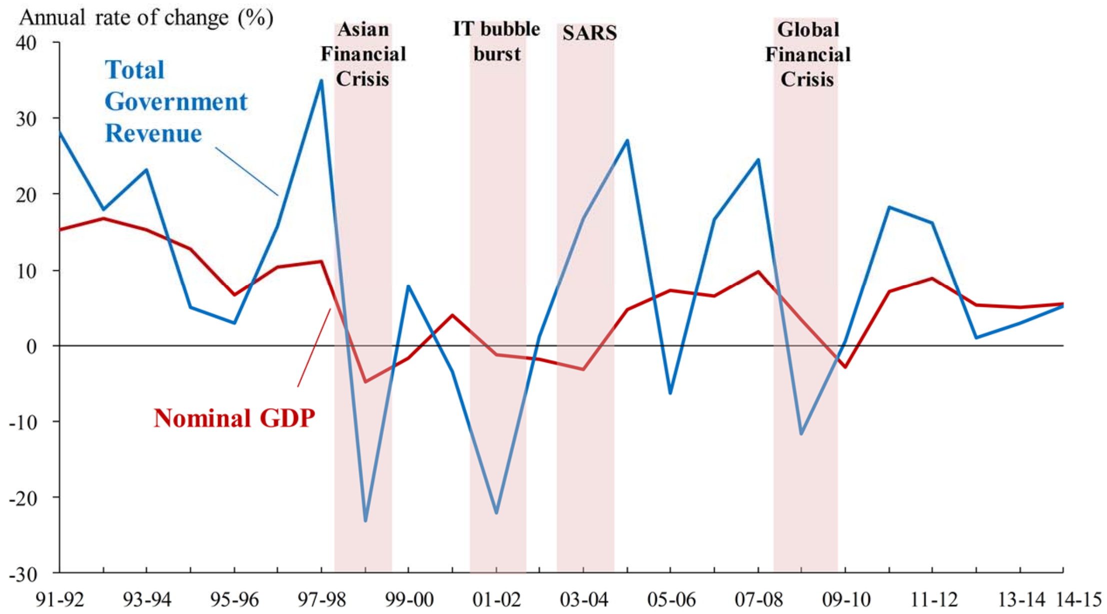
- Stamp duties varied from $7.5 billion (2002-03) to $74.8 billion (2014-15).

- 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 $33 billion for the years from 2007-08 to 2015-16.

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

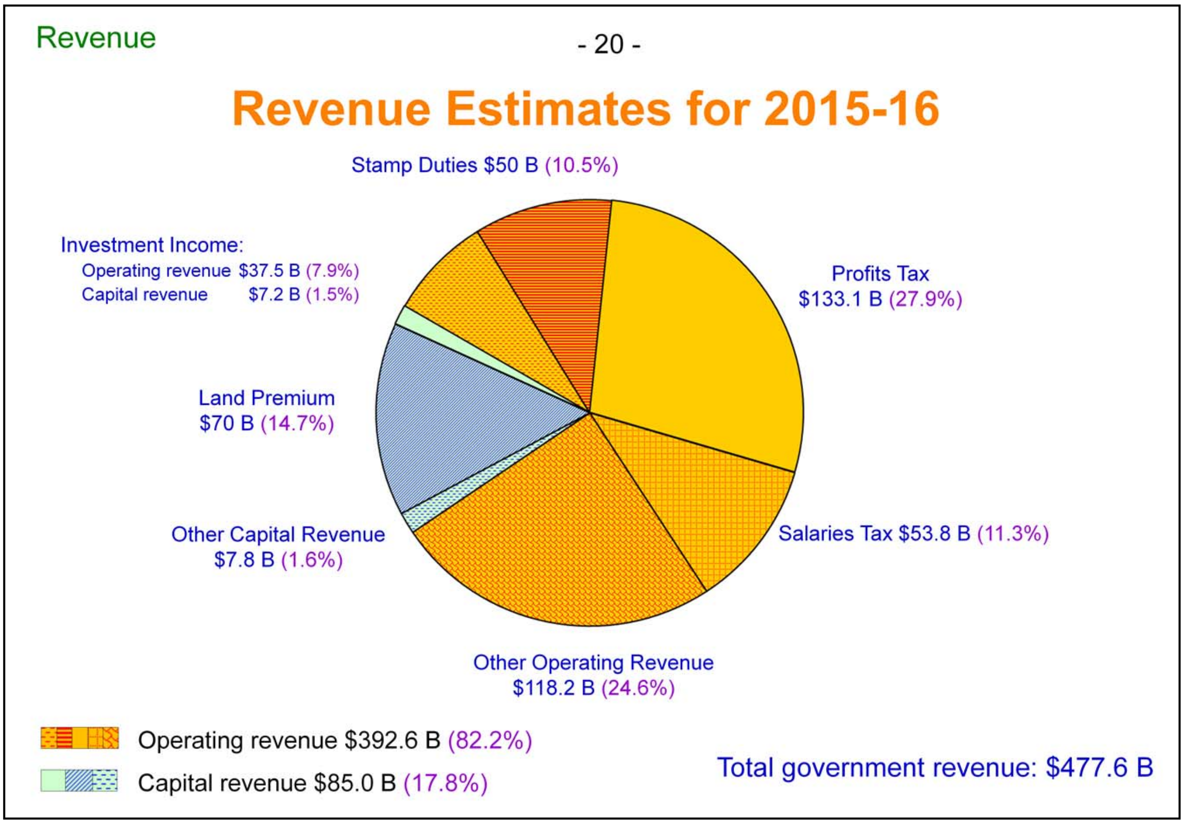
- The volatility of our revenue income poses challenges to the management of public finances.

Volatility of Government Revenue



- 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 duties and land premium account for 73% of the 2014-15 total government revenue.



- The five major revenue items are profits tax (27.9%), salaries tax (11.3%), stamp duties (10.5%), investment income (mainly from placement of the fiscal reserves with the Exchange Fund) (9.4%) and land premium (14.7%). Together they account for 73.8% of total government revenue.

Revenue

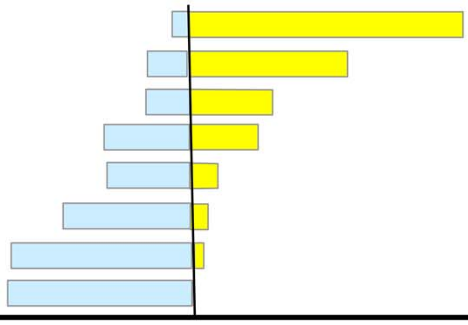
Only 46% of the working population paid salaries tax, with the top 5% taxpayers paying about 60% of the total salaries tax

Salaries tax

2013-14 (Year of assessment)

Taxpaying population : 1 703 000^

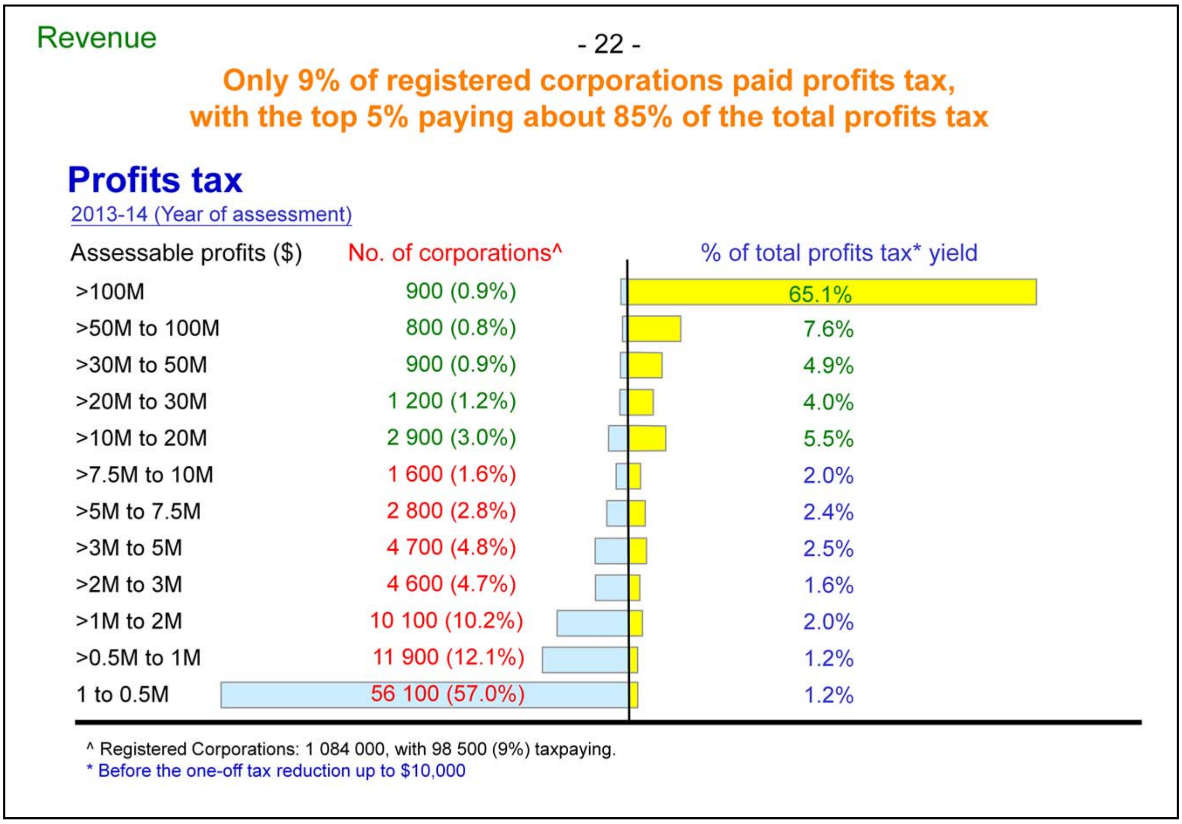
Annual income ($)	No. of taxpayers	% of total salaries tax* yield
>2,000,000	38 000 (2.2%)	43.5%
1,000,001 to 2,000,000	89 000 (5.2%)	24.3%
700,001 to 1,000,000	106 000 (6.2%)	13.0%
500,001 to 700,000	196 000 (11.5%)	10.9%
400,001 to 500,000	186 000 (10.9%)	4.3%
300,001 to 400,000	281 000 (16.5%)	2.8%
200,001 to 300,000	403 000 (23.7%)	1.0%
120,001# to 200,000	404 000 (23.8%)	0.2%



^ Of the 3 730 000 working population, 2 027 000 do not pay any salaries tax
* After the one-off tax reduction up to $10,000
# The basic allowance for individuals in the 2013-14 year of assessment is $120,000

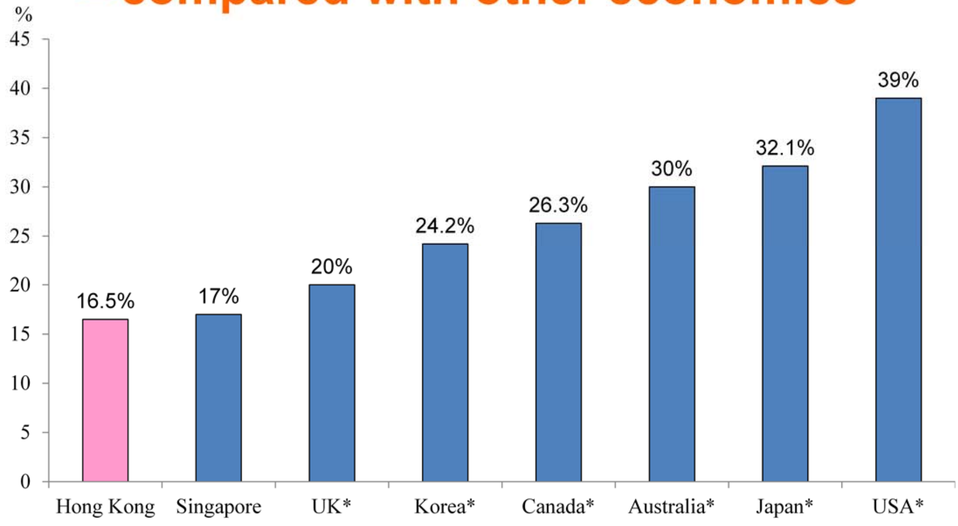
- In the year of assessment 2013-14, of the 3.73 million working population, about 2.03 million or 54% of the working population need not pay any salaries tax.

- Of the 1.7 million who paid salaries tax, the top 5% taxpayers (i.e. about 85 000 taxpayers) contributed 60% of the revenue from salaries tax.



- In the year of assessment 2013-14, about 85% of our profits tax is contributed by the top 5% taxpaying corporations (i.e. about 4 900 corporations). Around 985 500 registered companies (about 91% of the total registered corporations) do not pay any profits tax.

Profits Tax rates
– compared with other economies

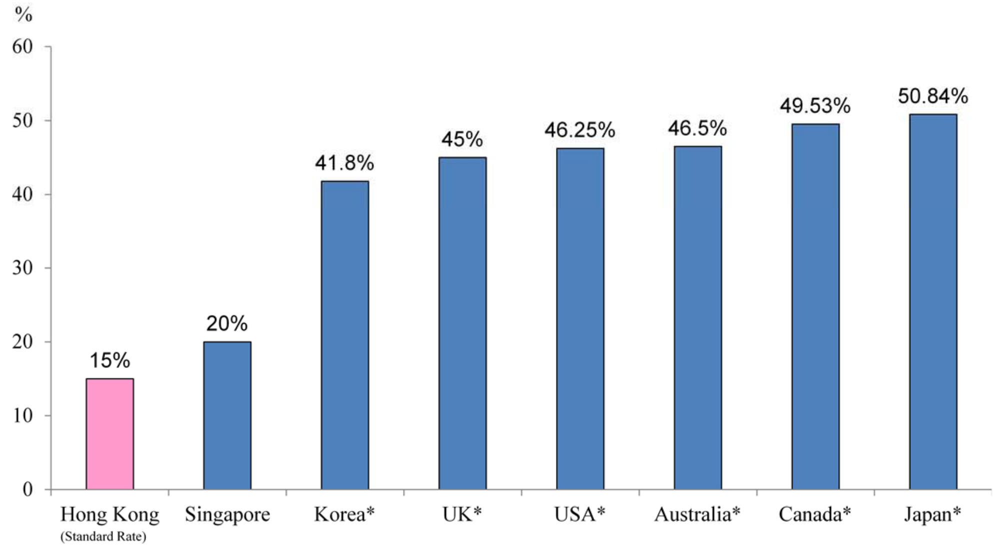


*Source: OECD Statistics

● Hong Kong has a simple tax system anchored by a low tax rate. Our profits tax rate is a flat 16.5% for corporations, and is among the lowest in the world.

Revenue

Salaries Tax rates (“Top statutory personal income tax rates”) – compared with other economies



*Source: OECD Statistics

- The same applies to our salaries tax rate, which is now capped at a standard rate of 15%.

Fiscal Reserves

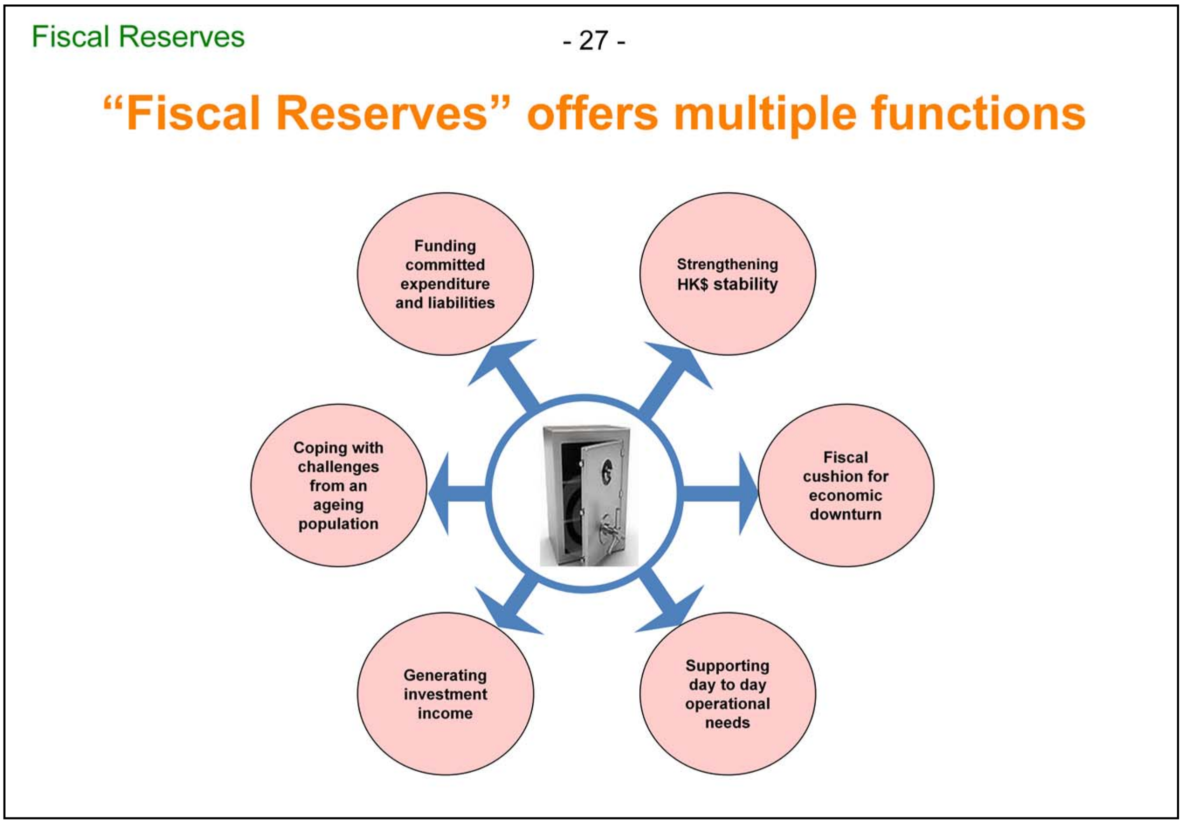
Fiscal Reserves

"Fiscal Reserves" is the aggregate of cash balances, much of which is locked up in funds with designated use

($ million)	2014–15 Actual
General Revenue Account	**478,856**
Funds with designated use	**129,928**
Capital Works Reserve Fund	76,362
Capital Investment Fund	1,443
Civil Service Pension Reserve Fund	27,029
Disaster Relief Fund	15
Innovation and Technology Fund	987
Loan Fund	2,472
Lotteries Fund	21,620
Land Fund	**219,730**
Total	**828,514**

- "Fiscal Reserves" stands for 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 over $300 billion for capital works) and liabilities (such as public officers' pensions, the present value of which as at 31 March 2014 was $747.2 billion).



- The fiscal reserves help strengthen the stability of the Hong Kong dollar. At the end of March 2015, the fiscal reserves constituted a quarter of the Exchange Fund's total assets.

Long-Term Fiscal Challenges Ahead

Challenges Ahead

- Ageing population
- Slowing economic growth
- Government revenue constraints
- Public expenditure needs

- Looking ahead, we must stay alert to the challenges that lie ahead.

Long-Term Fiscal Sustainability

- Government's fiscal position remains healthy in the short to medium term
- Ageing population will put massive pressure on public finance
- A structural deficit could surface within a decade or two should government expenditure growth keep exceeding revenue growth
- Resolute and effective fiscal measures required

● The Working Group on Long-Term Fiscal Planning published its report in early March 2014, providing a scientific and objective basis on Hong Kong's fiscal sustainability.

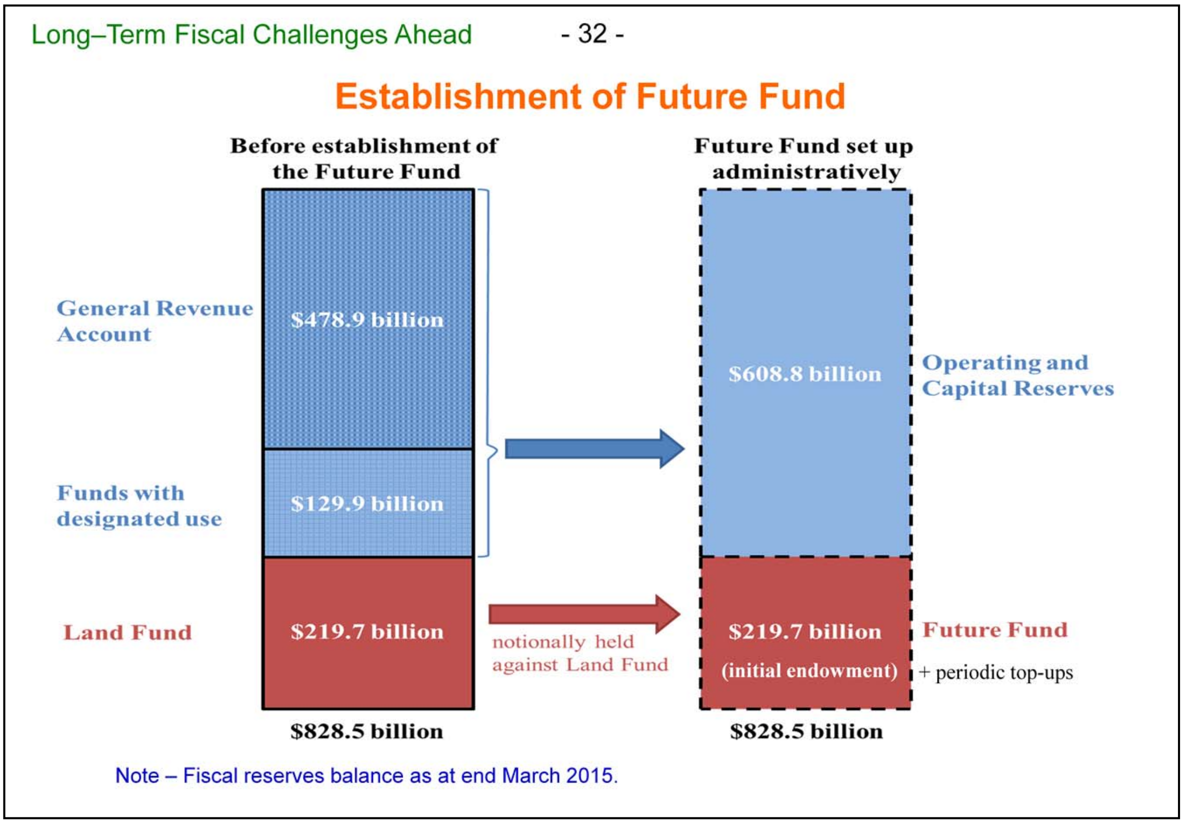
● According to the Working Group, if government expenditure keeps growing and outpacing economic and revenue growth amid an ageing population and slower economic growth, a structural deficit would be inevitable.

Stricter Fiscal Discipline

- Containing expenditure growth
- Preserving, stabilising and broadening the revenue base
- Setting up a Future Fund
- Stepping up the management of government assets

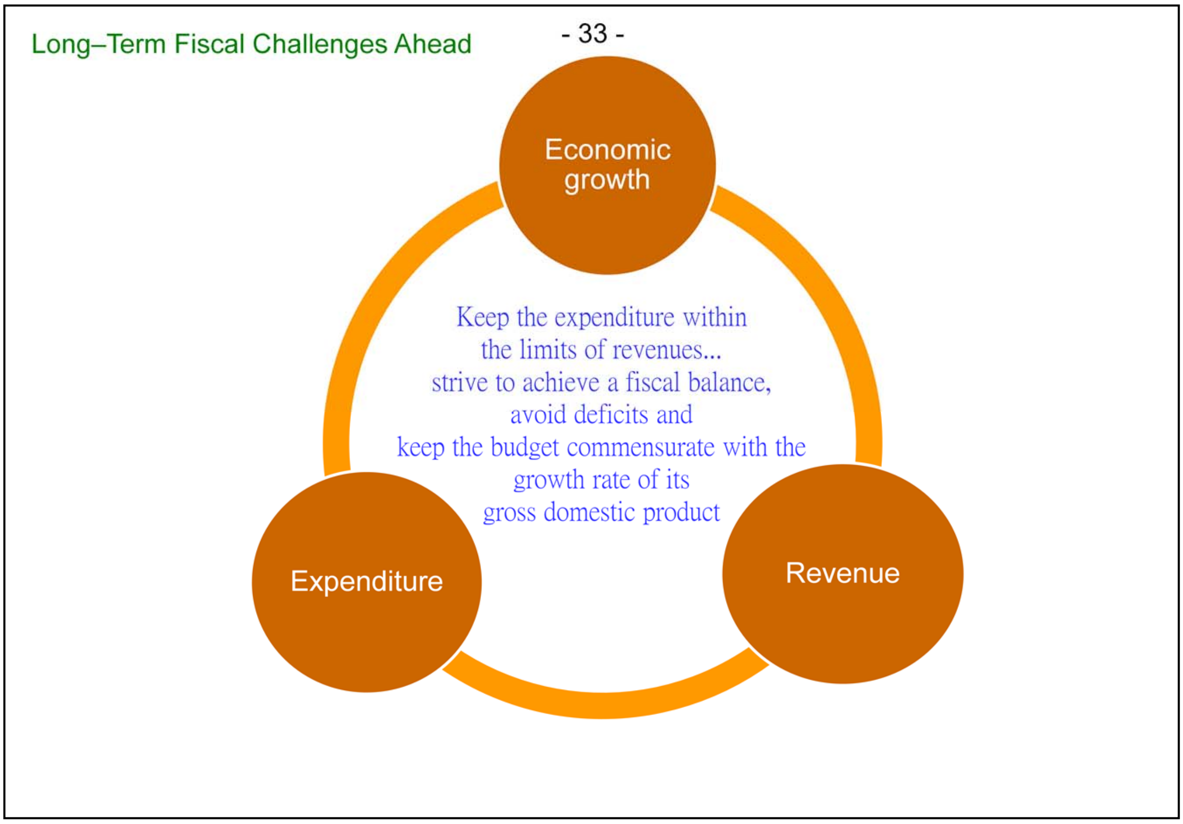
● While it is important for the Government to continue promoting the growth of the economy, the key to resolving the anticipated structural deficit or deferring its onset is to contain the growth of government expenditure, safeguard the revenue base, save for the future and manage government assets more proactively.

● As announced in the 2015-16 Budget, a Future Fund will be established this year to serve as long-term savings and be placed in long-term investments for higher returns.



- The Future Fund will be set up administratively within the fiscal reserves with an "initial endowment" of $219.7 billion notionally held against the Land Fund, plus about 25% to 33% of the annual budget surpluses as periodic top-ups. Government would have flexibility to adjust the top-up percentages having regard to the prevailing fiscal situation and community needs.

- Future Fund will remain an integral part of the fiscal reserves. The part of the fiscal reserves outside Future Fund will be referred to as "Operating and Capital Reserves".



- To address structural deficit problems, the Government and the community would need to acknowledge the problem ahead and adjust.

- The Government would take serious and early action to realign the growth of government expenditure with that of government revenue and of the economy.

Thank you