

# OFFICIAL REPORT OF PROCEEDINGS

Wednesday, 2nd March 1977

The Council met at half past two o'clock

## PRESENT

HIS EXCELLENCY THE GOVERNOR (*PRESIDENT*)  
SIR CRAWFORD MURRAY MACLEHOSE, GBE, KCMG, KCVO  
THE HONOURABLE THE CHIEF SECRETARY  
SIR DENYS TUDOR EMIL ROBERTS, KBE, QC, JP  
THE HONOURABLE THE FINANCIAL SECRETARY  
MR CHARLES PHILIP HADDON-CAVE, CMG, JP  
THE HONOURABLE THE ATTORNEY GENERAL  
MR JOHN WILLIAM DIXON HOBLEY, CMG, QC, JP  
THE HONOURABLE THE SECRETARY FOR HOME AFFAIRS  
MR DENIS CAMPBELL BRAY, CMG, CVO, JP  
THE HONOURABLE IAN MACDONALD LIGHTBODY, CMG, JP  
SECRETARY FOR HOUSING  
THE HONOURABLE DAVID HAROLD JORDAN, CMG, MBE, JP  
DIRECTOR OF COMMERCE AND INDUSTRY  
THE HONOURABLE LI FOOK-KOW, CMG, JP  
SECRETARY FOR SOCIAL SERVICES  
THE HONOURABLE DAVID AKERS-JONES, JP  
SECRETARY FOR THE NEW TERRITORIES  
THE HONOURABLE LEWIS MERVYN DAVIES, CMG, OBE, JP  
SECRETARY FOR SECURITY  
THE HONOURABLE DAVID WYLIE MCDONALD, JP  
DIRECTOR OF PUBLIC WORKS  
THE HONOURABLE KENNETH WALLIS JOSEPH TOPLEY, CMG, JP  
DIRECTOR OF EDUCATION  
THE HONOURABLE IAN ROBERT PRICE, CBE, TD, JP  
COMMISSIONER FOR LABOUR  
THE HONOURABLE DAVID GREGORY JEAFFRESON, JP  
SECRETARY FOR ECONOMIC SERVICES  
THE HONOURABLE ALAN JAMES SCOTT, JP  
SECRETARY FOR THE CIVIL SERVICE  
THE HONOURABLE GARTH CECIL THORNTON, QC  
SOLICITOR GENERAL  
THE HONOURABLE EDWARD HEWITT NICHOLS, OBE, JP  
DIRECTOR OF AGRICULTURE AND FISHERIES  
THE HONOURABLE THOMAS LEE CHUN-YON, JP  
DIRECTOR OF SOCIAL WELFARE  
THE HONOURABLE DEREK JOHN CLAREMONT JONES, JP  
SECRETARY FOR THE ENVIRONMENT  
DR THE HONOURABLE THONG KAH-LEONG, JP  
DIRECTOR OF MEDICAL AND HEALTH SERVICES  
DR THE HONOURABLE CHUNG SZE-YUEN, CBE, JP  
THE HONOURABLE LEE QUO-WEI, CBE, JP  
THE HONOURABLE OSWALD VICTOR CHEUNG, CBE, QC, JP  
THE HONOURABLE ROGERIO HYNDMAN LOBO, OBE, JP  
THE HONOURABLE PETER GORDON WILLIAMS, OBE, JP

THE HONOURABLE JAMES WU MAN-HON, OBE, JP  
 THE HONOURABLE HILTON CHEONG-LEEN, OBE, JP  
 THE HONOURABLE LI FOOK-WO, OBE, JP  
 THE HONOURABLE JOHN HENRY BREMRIDGE, OBE, JP  
 DR THE HONOURABLE HARRY FANG SIN-YANG, OBE, JP  
 THE HONOURABLE MRS KWAN KO SIU-WAH, OBE, JP  
 THE HONOURABLE LO TAK-SHING, OBE, JP  
 THE HONOURABLE FRANCIS YUAN-HAO TIEN, OBE, JP  
 THE HONOURABLE ALEX WU SHU-CHIH, OBE, JP  
 THE REV THE HONOURABLE JOYCE MARY BENNETT, JP  
 THE HONOURABLE CHEN SHOU-LUM, JP  
 THE HONOURABLE MISS LYDIA DUNN, JP  
 DR THE HONOURABLE HENRY HU HUNG-LICK, OBE, JP  
 THE HONOURABLE LEUNG TAT-SHING, JP  
 THE REV THE HONOURABLE PATRICK TERENCE MCGOVERN, SJ, JP  
 THE HONOURABLE PETER C. WONG, JP  
 THE HONOURABLE WONG LAM, JP

### IN ATTENDANCE

THE CLERK TO THE LEGISLATIVE COUNCIL  
 MRS LOLLY TSE CHIU YUEN-CHU

### Papers

The following papers were laid pursuant to Standing Order 14(2): —

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Hong Kong Industries Estates Corporation Ordinance 1977. Hong Kong Industrial Estates Corporation Ordinance 1977 (Commencement) Notice 1977.....	46
Sessional Papers 1976-77:	
No 42—Draft Estimates of Revenue and Expenditure for the year ended 31st March 1978, including supporting financial statements and statistical appendices (published on 2.3.77).	
No 43—Report of the Establishment Sub-Committee of Finance Committee for the year 1976-77 (published on 2.3.77).	
No 44—Report of the Public Works Sub-Committee of Finance Committee for 1976 (published on 2.3.77).	

**Government business**  
**First reading of bill**

**APPROPRIATION BILL 1977**

*Bill read the first time and ordered to be set down for second reading pursuant to Standing Order 41(3).*

**Second reading of bill**  
**APPROPRIATION BILL 1977**

THE FINANCIAL SECRETARY moved the second reading of: —"A bill to apply a sum not exceeding \$8,245,177,000 to the service of the financial year ending on 31st March 1978."

He said: —

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[THE FINANCIAL SECRETARY] **Appropriation Bill—second reading**

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[THE FINANCIAL SECRETARY] **Appropriation Bill—second reading**

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*MOTION*

Sir, I move that the Appropriation Bill 1977, which was published in an issue of the *Gazette Extraordinary* at 2 o'clock this afternoon, be read the second time.

*ACKNOWLEDGEMENTS*

2. Laid on the table, Sir, are the Draft Estimates of Expenditure for 1977-78 and the Revenue Estimates, together with the usual supporting documents<sup>(1)</sup>. They have been prepared by all concerned in the Finance Branch, the Economic Services Branch and the Census and Statistics Department, and printed by the Government Printer, with the usual care and diligence. Once again, I must gratefully acknowledge the very ready and enthusiastic assistance of heads of departments and their staffs and, of course, of my colleagues in the revenue departments, one of whom has had rather a rough time of it recently. The Economic Background document was prepared, for the third time now, in conjunction with the Economic Review Committee whose comments on the draft were invaluable.

3. Although the Estimates have to be prepared as a matter of administrative obligation under Colonial Regulations, the other documents laid today are in rather a different category. They are designed to provide all concerned with, or simply interested in, the management of our affairs with as much relevant information as possible; and in a reasonably digestible form. The Draft Estimates of Expenditure are in the same form as last year<sup>(2)</sup>. A useful guide to how they have been prepared is contained in the General Memorandum Note<sup>(3)</sup>.

*STRUCTURE OF THE SPEECH*

4. In looking to the future, Sir, I think we may assume that the marked fluctuations of the past four years are safely behind us. Consequently, we may view the next four years<sup>(4)</sup> with some confidence and notwithstanding the many uncertainties that must surround any attempt to predict the course of the world economy. But it is on this view that the Government's revenue forecasts for these four years must be largely, if not wholly, based and it is those forecasts which must largely, if not wholly, determine the level and pattern of expenditure year by year.

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(1) For a list of these documents, see inside cover.

(2) See *Budget Speech (B.S.) 1976*, paragraphs 103 - 105 for the presentational changes introduced in the 1976-77 Estimates.

(3) On pages 27 - 33 of the Estimates.

(4) That is to say, the budget year 1977-78 and the following three forecast years 1978-79 to 1980-81.

[THE FINANCIAL SECRETARY] **Appropriation Bill—second reading**

5. So I shall work towards my presentation of the 1977-78 budget by taking stock of our present economic position (PART I) and then go on to try to develop a view of the immediate, medium term and longer term economic outlook for Hong Kong (PART II). I shall then analyse the present state of the public accounts (PART III). I shall follow this up with a forecast of revenue likely to become available over the next four years on certain assumptions and relate this forecast to a forecast of expenditure based on departmental returns (PART IV). Thus the stage will be set for the details of the budget for the coming year to be revealed (PART V).

## PART I: PRESENT ECONOMIC POSITION

(1) *Course of the Adjustment Process, 1972-76*

6. Whether one considers real gross domestic product or the volume of trade or employment or real wages, the period covering the four years 1973 to 1976 spans a clearly defined cycle of activity<sup>(5)</sup>. Gross domestic product in real terms, that is, at constant (1966) prices, increased by 23% from 1973 to 1976, but the growth rate in individual years varied from 14% in 1973, to between 2% and 3% in 1974 and 1975, to an estimated 16% in 1976.

(5) *Quantum index of domestic exports (1973=100):*

	<i>Q1</i>	<i>Q2</i>	<i>Q3</i>	<i>Q4</i>
1974 .....	93	103	102	88
1975 .....	81	96	111	110
1976 .....	113	128	139	137

*Employment in manufacturing:*

1973 (average) .....	713,688
1974 (December) .....	600,128
1975 (March) .....	591,659
(December) .....	678,857
1976 (March) .....	698,787
(September) .....	778,788
(December) .....	773,746

*Index of real wages in manufacturing (March 1964=100):*

	<i>March</i>	<i>September</i>
1973 .....	163	149
1974 .....	143	136
1975 .....	133	139
1976 .....	152	155 (and rising)



7. I believe that the last four years have marked a period of great importance for Hong Kong. In an overlapping sequence, we have seen a change in the role of sterling, the stock exchange crisis, short lived but unusual rates of inflation, a recession and, finally, an unexpectedly rapid recovery from the recession. The drama of these events impaired our ability to see the period as a whole and as one in which Hong Kong adjusted to a new found maturity and consequent responsibilities.

8. Until the middle of 1972 the Hong Kong dollar was tied to sterling and the Government and the banks stood ready to accept the inflow of foreign exchange that was the outcome of overseas trading and financial transactions. Because the impact of our budgetary policies was small, and tended to be slightly deflationary, it was inevitable that Hong Kong would be in a situation of overall balance of payments surplus, with the Government and the banks acquiring sterling. As a further consequence of being tied to sterling, increases in the money supply in Hong Kong were kept in line with increases in the money supply in the United Kingdom, the country of our reserve currency. In other words, the surpluses that accrued in the public accounts and were used to buy sterling, produced an offsetting increase in the money supply held by the non-bank private sector. So the popular myth that these surpluses were shipped out of Hong Kong is only half the picture. The surpluses accrued because revenue was higher than expenditure: Hong Kong dollars were transferred from the non-bank private sector to the Government; by using these Hong Kong dollars to purchase sterling the money was reinjected into the non-bank private sector.

9. This system ensured that the fixed rate between sterling and the Hong Kong dollar was automatically maintained and this situation continued even after 1967; and so, when sterling was devalued in November of that year, we did not follow completely, preferring to accept some adjustment of our price level through an adjustment of our exchange rate with sterling.

10. Soon after sterling was floated in the middle of 1972, and the Sterling Area was dismantled, the Hong Kong dollar was tied to the US dollar. Because most international currencies were floating against the US dollar, the trade weighted index of the Hong Kong dollar naturally showed some variation which has led some to claim that the Hong Kong dollar floated from mid-1972, rather than November 1974. This, of course, ignores the crucial distinction between a fixed rate and a floating rate regime. When the currency of an open economy floats,

[THE FINANCIAL SECRETARY] **Appropriation Bill—second reading**

the process of adjustment of the domestic rate of inflation to the rates of inflation in the rest of the world is through changes in the exchange rate. In the previous regime of fixed rates, the Government and the banks acted as passive receivers of foreign exchange or passive suppliers. Thus the adjustment process operated through the domestic money supply. So, if the economy's overseas transactions resulted in an overall surplus in the balance of payments, the Government and the banks bought the excess and consequently increased the money supply. Higher imports and an upward pressure on costs then reduced the overall surplus in the balance of payments.

11. Towards the end of 1972 there was a movement out of Hong Kong dollars. On its own, this would have deflated the Hong Kong economy relative to the rest of the world. But, at the same time, there was an increase in domestic lending, partly stimulated by expectations about increases in asset prices, which more than offset the outward movement<sup>(6)</sup>. By the end of 1972 the money supply (M1)<sup>(7)</sup> was 45% higher than a year earlier<sup>(8)</sup>; by the end of the first quarter of 1973 it was 70% higher than a year earlier<sup>(9)</sup>.

12. The effects on asset prices, especially stock and property prices, were immediate and dramatic<sup>(10)</sup>. No economy could sustain such ill-founded expectations for long, but in Hong Kong we also had the judgement of overseas stockbrokers and investors operating through the movement of financial assets. This was, in many ways, a relatively new development. The economy had been used to adjusting through the trading account, that is to say, overseas buyers judged whether or

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(6) *There was a 30% increase in bank loans and advances in Hong Kong between 31st December 1972 and 31st December 1973; but the banks' total foreign currency denominated assets increased by only 6% over the same period and demand and short term claims due from banks abroad actually declined, by 4%.*

(7) *M1: non-bank cash and demand deposits with the licensed banks.*

(8) *31st December 1971: \$7.9 billion;  
31st December 1972: \$11.4 billion.*

(9) *31st March 1972: \$8.3 billion;  
31st March 1973: \$14.1 billion.*

(10) *The Hang Seng Index of selected share prices (31st July 1964=100) rose from 330 at end-January 1972, to 1,775 on 9th March 1973; and then fell away to 434 at end-December 1973 and to 150 on 10th December 1974.*

not our merchandise was good value for money and acted accordingly. But, in early 1973, the economy felt the consequences of judgments passed on the financial sector: after being employed for speculative purposes in the stock market in the latter months of 1972, funds controlled by non-residents were taken elsewhere. As a result, the domestic money supply fell back sharply<sup>(11)</sup> and so did stock prices and other asset prices. But the full impact on the economy took some time to emerge.

13. During 1973 the world economy reached a peak of activity. As a result the volume of Hong Kong's imports and exports grew by 10% and 12% respectively<sup>(12)</sup>. Import prices reflected world inflation. This world inflation had no single cause. But there were at least four contributory factors and they interacted on each other: unusual shortages of certain raw materials and foodstuffs; a coincidence of the peak of the trade cycle in the major industrial countries; unusual increases in world liquidity caused by a large deficit in the American balance of payments; and speculative holdings of raw materials triggered by expectations of continuing inflation and by increased risks from exchange rate fluctuations.

14. Although there were signs of a slow down in world economic activity by the middle of 1973 world trade continued to grow (by 6% in real terms) in 1974. However, with the advantage of hindsight, we can now see that the recession in Hong Kong had probably already started towards the end of 1973 with a slow down in trade<sup>(13)</sup> and with wage rates no longer increasing faster than prices<sup>(14)</sup>. The course of the money supply traces out the effects of the recession very well. At the end of the second quarter of 1973 the money supply stood at

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(11) *At the end of the second quarter 1973, M1 at \$11.9 billion was 15.6% less than at the end of the first quarter 1973.*

(12) Imports    *in 1972 at constant (1966) prices: \$18.0 billion;*  
                  *in 1973:    \$19.8 billion.*  
Exports      *in 1972 at constant (1966) prices: \$14.6 billion;*  
                  *in 1973:    \$16.3 billion.*

(13) *The quarterly index of domestic exports reached a peak during the third quarter of 1973, a level which was not regained until the third quarter of 1975. Furthermore, the moving average of the value of exports started to turn down sharply at the beginning of 1974.*

(14) *Real average daily wage rates (including fringe benefits) in manufacturing declined by 9% between March and September 1973, after increasing by 7.5% per annum over the four years 1969-73.*

[THE FINANCIAL SECRETARY] **Appropriation Bill—second reading**

\$11.9 billion. A year later it was only 2% higher<sup>(15)</sup> and, by the end of 1974, it was 4% below its mid-1973 level<sup>(16)</sup>. Levels of employment, real wages and other prices determined within Hong Kong were having to adjust to two deflationary forces. The first was the monetary consequence of the fall in asset values resulting from the decline of prices on the stock market; and the second reflected a world recession, partly resulting from attempts to modify rates of inflation which were very much higher than any experienced since the Korean War<sup>(17)</sup> and aggravated by the oil exporting countries successfully operating their cartel.

15. By the end of the third quarter of 1974, the automatic adjustment to these two forces through the money supply had largely restored the competitive position of Hong Kong's exports, although employment and real wages had yet to fall even further<sup>(18)</sup>. But the improvement probably produced a net inward flow of foreign exchange during the fourth quarter of 1974. As this was in addition to the inflows resulting from political changes in South East Asia, the Hong Kong dollar came under pressure in the third quarter of 1974. This led to the decision to float on 26th November of that year, that is to say, we opted for the adjustment process to operate through the exchange rate rather than through the domestic money supply. The subsequent appreciation of the Hong Kong dollar and the associated interest rate reductions<sup>(19)</sup> discouraged inward flows and contributed to the 4%

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(15) M1: \$12.1 billion.

(16) M1: \$11.4 billion.

(17) For example, for consumer prices in the OECD countries, average annual rates of increase were:

	%
1953-61 .....	2
1962-72 .....	4
1973 .....	8
1974 .....	13

(18) The index of real average daily wage rates (including fringe benefits) in manufacturing was 136 in September 1974 and 133 in March 1975. Employment in manufacturing in December 1974 was 600,128 and in March 1975 it was 591,659.

(19) There were nine adjustments between 30th October 1974 and 8th March 1975. The best lending rate came down from  $11\frac{1}{2}\%$  to  $6\frac{1}{2}\%$  and the 3-months deposit rate from  $9\frac{3}{4}\%$  to  $3\frac{1}{4}\%$ .

decline in the money supply (M1) between the end of the third quarter and the end of the fourth quarter of 1974<sup>(20)</sup>.

16. The strong appreciation of the Hong Kong dollar between late October 1974 (when the middle inter-bank rate was only  $4\frac{1}{2}$  cents above the central rate of \$5.0850=US\$1) and the end of February 1975, coincided with the first signs that the recession in Hong Kong might be coming to an end<sup>(21)</sup>. Intervention in the foreign exchange market helped to bring the exchange rate down from a high of \$4.6200 =US\$1 towards the end of February to \$4.9550=US\$1 at the end of June. But this process naturally involved quite a large increase in the money supply (M1)<sup>(22)</sup>.

17. the recession in Hong Kong was relatively short lived. This is cold comfort to those affected and, compared with the rest of the world, fluctuations in incomes in Hong Kong will always tend to be larger. The reason for this is that fluctuations in world trade have always shown a greater amplitude than fluctuation in domestic economic activity. It has been estimated that fluctuations in world trade are roughly twice fluctuations in world GDP. Given the dominant influence of external trade, it would be impossible for the Hong Kong economy to avoid such fluctuations. What we must ensure is that our cost/price structure does not get too far out of line with that of our competitors and when it begins to, as it did in 1973 and early 1974, the adjustment process must not be frustrated. The process operated very effectively during the last recession. Competitiveness was restored and this contributed to the 43% increase achieved in the value of exports in 1976, to the reduction of unemployment to its full employment level of around  $4\frac{1}{2}$ %, and to the increase in nominal wage trades<sup>(23)</sup> by 16% in the year ending 30th September 1976.

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(20) 31st September 1974: \$11.8 billion;  
31st December 1974: \$11.4 billion.

(21) In the first quarter of 1975, the quarterly index of exports of clothing (the first category to benefit from the recovery) was 7% higher than a year earlier.

(22) 31st December 1974: \$11.4 billion;  
31st March 1975: \$12.0 billion;  
31st July 1975: \$12.5 billion.

(23) Strictly speaking, nominal average daily wage rates (including fringe benefits) in manufacturing.

[THE FINANCIAL SECRETARY] **Appropriation Bill—second reading**(2) *The State of the Economy*(a) *Gross domestic product*<sup>(24)</sup>

18. So much, Sir, for recent economic history. What is the present state of our economy? A detailed review of the Hong Kong economy in 1976 is available in the *Economic Background* document. But I must review two aggregate indicators, the gross domestic product and the money supply.

19. Since the economy hit the trough of the recession in the first quarter of 1975 we have climbed out of the recession with far greater speed than most thought possible, partly because our rate of inflation has remained below rates in the rest of the world<sup>(25)</sup>. A year ago there

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(24) *A very rough breakdown of the GDP by industrial origin would be as follows:*

	%
<i>Manufacturing</i> .....	28 ( <i>and likely to fall</i> )
<i>Public utilities</i> .....	2
<i>Transport, storage and communications</i> .....	6
<i>Wholesale and retail trade, restaurants and hotels</i> .....	22
<i>Construction</i> .....	4 ( <i>and likely to rise</i> )
<i>Financial services and real estate</i> .....	20 ( <i>and likely to rise</i> )
<i>Community social and personal services</i> .....	16
<i>Agriculture, fishing and mining</i> .....	<u>2</u>
	<u>100</u>

*An approximately corresponding breakdown of employment from the 1976 By-Census would be:*

	%
<i>Manufacturing</i> .....	45
<i>Public utilities</i> .....	1
<i>Transport, storage and communications</i> .....	7
<i>Wholesale and retail trade, restaurants and hotels</i> .....	19
<i>Construction</i> .....	6
<i>Financial services and real estate</i> .....	3
<i>Community social and personal services</i> .....	16
<i>Agriculture, fishing and mining</i> .....	<u>3</u>
	<u>100</u>

(25) *For example, consumer prices in OECD countries increased by 11.2% in 1975 and 8.6% in 1976, compared with 1.2% and 3.4% respectively in Hong Kong.*

was much talk about the weakness of the recovery in world trade and output and of the likelihood that most industrial economies would not reach full capacity during 1976. I assumed that, I am afraid, similar factors would apply in Hong Kong and so, in forecasting a 9% growth in real GDP in my last budget speech<sup>(26)</sup>, I was implying some reduction in unemployment, but not as much as we actually experienced.

20. The preliminary estimate of expenditure on the gross domestic product for 1976 at current market prices is \$47.1 billion, an increase of 26% on the (provisional) estimate for 1975 of \$37.4 billion. This increase, which includes an estimate for stocks accumulated during the year, comprises an increase in real output of 16% and an increase in prices of 8%<sup>(27)</sup>. The preliminary estimate of gross domestic product in real terms is \$23.6 billion. The two measures of price inflation, the GDP deflator of 8% and the consumer price index, which increased by only 3.4%, have moved differently. This is because, with the Hong Kong dollar appreciating on the foreign exchange market, we have been able to increase our export prices and yet not to the extent of depriving ourselves of sufficient orders to return to full employment. This difference cannot continue indefinitely and represents a once-for-all improvement in our terms of trade.

21. Of the individual GDP expenditure components the smallest forecasting errors were in the domestic expenditure categories. I forecast that private consumption expenditure would grow by 8% in real terms and the preliminary estimate shows an increase of 10%. Although the actual growth is higher than my forecast, it is low relative to the growth of the economy as a whole and must indicate continued caution by consumers as well as a normal lag between income increases and increases in consumption.

22. In real terms the Government's consumption expenditure of goods and services increased by 8% in 1976 (calendar year) and is two percentage points lower than the budget speech forecast of 10%.

23. I forecast investment expenditure would grow by 20% in real terms which was high in the context of the other component forecasts. But the growth rate in 1976 was higher than this, the preliminary estimate showing an increase of 29%.

24. My trade forecasts were, of course, much too low and, partly because the forecast balance of exports and imports showed a widening

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(26) *B.S., 1976, paragraphs 31 - 37.*

(27) *Excluding stock building the increase in real output is 15%.*

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of the trade deficit, I did not anticipate so strong an appreciation of the Hong Kong dollar. The budget speech forecast for the volume of exports was for an 8% increase and the preliminary estimate shows an increase of 27%. Imports I forecasted to grow by 10% but, in fact, they grew by 24%.

25. The balance of the export and import of services increased by 60% in real terms which is very much higher. I don't propose to recall the forecast figure.

26. Thus, since 1972, the gross domestic product in real terms has increased by 40%<sup>(28)</sup> with most of the growth occurring in 1973 and 1976. Because of population growth the per capita increase in real terms has naturally been lower: in 1976 GDP per capita was \$10,750 at current prices which was 30% higher in real terms than in 1972<sup>(29)</sup> and 16% higher than the average of the two recession years 1974 and 1975<sup>(30)</sup>.

*(b) Money supply and the Hong Kong dollar*

27. The money supply narrowly defined (M1) that is to say, stood at \$16 billion at the end of 1976, some 18% up on the end of 1975. On the wider definition of M2<sup>(31)</sup>, the money supply was \$48 billion by the end of the year, or some 21% up on the end of 1975. Bank lending within Hong Kong at the end of 1976 was \$29 billion, up by 18% during the year<sup>(32)</sup>. This was a more important contribution to the growth of the money supply in 1976 than in the two previous years. The acquisition of foreign currency assets by the banks and the Exchange Fund was of lesser importance in 1976 than in 1974 and 1975 as an influence on the growth of the money supply in the hands of the non-bank private sector. Although there certainly was a net inflow of foreign exchange, there was a potential excess demand

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(28) 1972: \$16.8 billion at constant (1966) prices and \$24.2 billion at current prices; 1976: \$23.6 billion at constant (1966) prices and \$47.1 billion at current prices.

(29) \$5,923 at current prices and \$4,129 at constant (1966) prices.

(30) \$8,385 at current prices and \$4,640 at constant (1966) prices.

(31) Non-bank cash plus demand deposits, time deposits and savings deposits with the licensed banks.

(32) 31st December 1975: \$25.0 billion;  
31st December 1976: \$29.5 billion.



for Hong Kong dollars and this produced an appreciation of the Hong Kong dollar<sup>(33)</sup>.

28. Another influence on the money supply is transactions through the public accounts. If the public accounts are in surplus, and the surplus is retained in Hong Kong, the effect on the economy is deflationary. The effect is, of course, expansionary if the Government finances a deficit either by running down its Hong Kong dollar balances or borrowing from the banks. Normally, the monetary consequences of budgetary policy in Hong Kong are very small although, in 1976-77, the surplus on the public accounts will have an effect that is small rather than very small. As I shall explain later, the deficit I budgetted for this year is not going to eventuate. Historically, our surpluses have amounted to less than 4% of M1; but this year the percentage will be higher at about 6% and, furthermore, the surplus in the public accounts will be equal to about 30% of the increase in M1 during 1976.

29. I have always eschewed reference to the term monetary policy as such because some might take this to refer, quite wrongly, to the financing of public expenditure with monetary consequences that could be very damaging in the short run and could not be sustained anyway. It remains my intention that budgetary policies shall continue to have a more or less neutral influence on our monetary environment. But this does not mean we should ignore the important monetary consequences of those decisions we do take elsewhere in the economy<sup>(34)</sup>. Our exchange rate policy and the management of the Exchange Fund's assets have monetary consequences of which we are well aware and it is in this sense that we do have an active monetary policy.

30. If the Government, through the Exchange Fund, and the banks operate on the basis of a fixed exchange rate this means that, together, we stand ready to meet any excess demand for foreign currency or accept any excess supply that arises from all overseas transactions.

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(33) *The exchange rate against the U.S. dollar was \$5.0450=US\$1 at the end of 1975 and, by the end of 1976, it had strengthened to HK\$4.6700=US\$1. Apart from June, July and August when the rate steadied the Hong Kong dollar appreciated throughout the year and particularly in December. The nominal index of the Hong Kong dollar at the end of 1975 was 110.8 and by the end of December it was 119.4. The trade weighted index of the Hong Kong dollar at the end of 1975 was 107.4 and by the end of December 1976 it was 114.4. (In both cases, 18th December 1971=100).*

(34) *A measure of their importance is the size of Hong Kong's reserves. Defining them to include the banks' net open foreign currency position and the foreign currency assets of the Exchange Fund, they currently amount to the equivalent of \$15.5 billion.*

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By acting as residual acceptors or suppliers of foreign exchange the Exchange Fund and the banks alter the stock of money in the hands of the rest of the private sector. If the banks buy foreign exchange, they do so by creating deposits. If the Exchange Fund buys foreign exchange, its Hong Kong dollar deposits are transferred from the public to the non-bank private sector. This fixed exchange rate policy is, of course, a monetary policy and I hope it is clear that there can be no question of having a fixed exchange rate and a separate monetary policy.

31. The alternative regime is where the Exchange Fund and the banks do not operate on the exchange rate to keep it at, or move it to, a given level. The exchange rate then adjusts to equate the supply and demand for foreign currency after the Exchange Fund and the banks have adjusted their portfolios of foreign currency and Hong Kong dollar assets. Such a regime obviously involves a higher degree of domestic discretion in the growth of the money supply. The banks are no longer completely constrained by their liquidity ratios for they can acquire foreign currency assets to enable them to increase domestic lending. Similarly, the Exchange Fund can acquire or sell foreign currency assets up to the limits of its Hong Kong dollar or its foreign currency assets respectively. This does not mean of course, that the substantial resources of the Exchange Fund are managed in any arbitrary sense. Decisions to acquire or sell foreign currency assets are taken by the Exchange Fund in the light of the economic and monetary consequences of so doing. I have, for example, stated on previous occasions that it is our policy to intervene against short-term wayward and erratic fluctuations, but not to act against the underlying trend. In terms of monetary policy, this means I would rather see a sudden, but short-lived, increase in the money supply held by the non-bank private sector than a short-lived, but disruptive, movement in the exchange rate which would have a very immediate impact on the economy.

(c) *Future of the financial sector*

32. Before turning to the future, I would like to pause briefly to reflect on what I believe is a new phase in the development and maturity of the Hong Kong economy. Just as our move towards a manufacturing economy with a greatly reduced dependence on our traditional role as an entrepot was marked by a traumatic disruption to trade, so the emergence of the financial sector was marked by a crisis in the stock market. It was a monetary crisis that affected a

wide range of domestic prices, apart from stock prices and, to an extent, the severity of the recent recession was a reflection of the necessity to recover a cost/price structure which was badly out of line with that of our competitors. But we now have a greatly expanded and much more mature financial sector which includes 74 licensed banks<sup>(35)</sup>, 179 registered deposit taking companies, one of the four largest gold markets in the world, one of the leading stock markets in the region and, shortly, a commodity exchange will begin trading. I should note here that, as a great deal of interest has been shown in recent months, both locally and internationally, in Hong Kong dollar denominated bond issues by foreign institutions, I have set up a working party, under the chairmanship of the Secretary for Monetary Affairs, to advise me on the monetary and tax implications of permitting these institutions access to this market. Incidentally, with the establishment last year of a Monetary Affairs Branch within the Secretariat, responsibility for all monetary and related subjects, including most notably the management of our financial assets, has now been centralized partly for administrative reasons and partly by way of recognition of the more diverse and complex circumstances of the post-sterling era.

## *PART II: THE ECONOMIC OUTLOOK*

### *(1) In the Short Term*

#### *(a) GDP forecast by components<sup>(36)</sup>*

33. So much, Sir, for the present state of the economy. What is the outlook for the future? An important reason for some of the hesitation in the growth of world output last year 1976 was the cautious behaviour of consumers. In Hong Kong, private consumption expenditure reflected the world-wide trend. The forecast for 1977 depends on whether one views this as a temporary delay in consumption catching up with the income levels achieved in 1976 or as a more permanent shift in the relationship between income and consumption. Based on

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(35) *In this connection, the change in the composition of the banks assets and liabilities is of interest: from 31st December 1972, when amounts due to banks abroad stood at \$5,428 million, the growth rate has been such that, by 31st December 1976, only four years later, the amount due was \$27,598 million (or over 400% higher). At 31st December 1972, these amounts represented 16% of total liabilities but, four years later, they accounted for 35%. On the assets side, amounts lent abroad were \$1,097 million, or 3% of total assets at 31st December 1972; but, four years later, the amounts so lent were \$13,255 million or 17% of total assets.*

(36) *For a summary, see Annex (1).*

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the relationship between income and consumption expenditure since 1961, the forecast should be for a 14% growth in real consumption expenditure during 1977. I am afraid I am more persuaded by the view that there has been a shift in this relationship and so I have reduced this forecast to 10%.

34. The Government's consumption expenditure on goods and services during 1977 is forecast to grow by 10% in real terms.

35. It is useful to divide the forecast for gross domestic fixed capital formation into investment in building and construction and investment in plant and machinery. The forecast for the former is constrained by the capacity of the construction industry. Despite the high demand for labour elsewhere in the economy, I am assuming the industry's employment level will increase by 3% and that productivity will grow by a further 10%. This implies a growth in the capacity of the industry of 13% next year. This becomes the forecast for real investment in building and construction in 1977<sup>(37)</sup>.

36. Local industrialists were very quick to respond to the recovery of the economy by increasing their investment in plant and machinery by 18% in 1976. Although I believe there will be continued growth, I must allow for some of the uncertainties facing our economy beyond 1977 to affect businessmen's plans and I have, accordingly, decided upon a forecast of a 12% real increase during 1977.

37. The trade forecast depends heavily on developments overseas. Of our three main markets, the prospects seem best in the United States. The wide range of forecasts for the German economy, together with the relatively high proportion of clothing in our exports, makes it a slightly less certain market. The prospects are very limited in the

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(37) *The growth of the industry's capacity is determined by the growth in employment and the growth in the stock of plant and machinery. There were large investment outlays on construction machinery throughout the period 1971 to 1976, as indicated by statistics of retained imports. Thus the stock of capacity equipment in the construction industry grew rapidly during the period and productivity increased at a rate of 10% per annum, compared with an average of 6% per annum between 1961 to 1966 and 0% between 1966 and 1971. Because the tight labour market is likely to continue in 1977, employment in the construction industry cannot be expected to grow at more than 3%, the expected growth in the labour force. If the high rate of productivity increase during 1971 to 1976 were to be sustained in 1977, which is an optimistic assumption, this and the growth in employment would imply a 13% increase in capacity.*

United Kingdom because of the low growth forecast there together with an exchange rate making competitive pricing difficult, at least in the first half of 1977. These considerations, the prospects in our other markets and the outlook for re-exports give a forecast of an 8% growth in the volume of total exports<sup>(38)</sup> in 1977.

38. The growth in imports in 1976 was very high, but the resulting total volume was probably only just back on trend. Reflecting some catching up in consumption expenditure, I am forecasting a 10% growth in the volume of imports in 1977. Foodstuffs are forecast to grow by 6%, raw materials by 10%, fuel by 7%, capital goods by 12% and consumer goods by 10%. Each of these forecasts is consistent with the forecasts for domestic demand and exports.

39. Finally, as regards the balance of the export and import of services: this is an area where the estimates include quite a large token estimate and so one cannot be very confident of any forecast. Although the estimate of the balance has shown some signs of decline over the past six years this was reversed last year and I am assuming the balance remains unchanged compared with last year<sup>(39)</sup>.

40. This all adds up to an 8% increase in real terms in the gross domestic product in 1977 before allowing for stock changes, compared with the gross domestic product in 1976 before allowing for stock changes. Estimates of expenditure on stocks have been produced for the first time this year and cover the years 1973-76 only. I am forecasting a further year of stock accumulation reflecting the growth in the economy and possibly some anticipation of later price increases, but the forecast is for half the accumulation recorded in 1976<sup>(40)</sup>.

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(38) *A survey of manufacturers' intentions carried out by the Census and Statistics Department in January 1977 showed very buoyant prospects for the United States with forecasts of demand showing a 14% increase in 1977 over 1976. Demand in the German market is forecast to remain at its 1976 level. There is an expectation of a 5% decline in demand from the United Kingdom. These views are more extreme than the component forecasts that contribute to my export forecast of an 8% increase in the volume of exports. But the survey throws up an 8% increase in production for overseas markets which is in line with my forecast of growth in exports.*

(39) *The number of incoming tourists is forecast to increase by 6%, with higher rates of increase in the number of tourists coming from the United States and the South East Asian countries. Per capita expenditure will probably remain unchanged in real terms: the falling trend of roughly 5% per annum between 1961 and 1976 is expected to be compensated in the short run by high levels of consumption in 1977 associated with the higher income levels of 1976. Total tourist expenditure in Hong Kong, probably the most important item in our invisible exports is, therefore, forecast to increase by 6% in real terms.*

(40) *1976 on 1975: +\$393 million;  
1977 on 1976: less than +\$200 million.*

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41. The forecast increase for real GDP, including stock changes, for 1977 is, therefore, 7%. We have a rough check on this figure if it is accepted that the economy reached full capacity during 1976. So further growth will be constrained by the growth in the labour force and in productivity. The labour force is unlikely to grow by much more than 3 - 4% and the maximum that can be expected for productivity growth is another 3 - 4%. This suggests, therefore, a ceiling for the growth of the real GDP in 1977 of somewhere between 6% - 8%.

*(b) Prices*

42. The price increases of the various expenditure components of the gross domestic product give a deflator of 7%. The forecast increase in the GDP at current prices is, therefore, 14%. I am assuming an average increase of 8% in the prices of exports and imports and, together with the forecast increases in quantities, this implies a widening of the trade deficit which tends to confirm the assumption, used in the GDP forecast, that the Hong Kong dollar will not strengthen further in 1977.

43. Consumer prices in 1977 will be influenced by the expected acceleration of world prices of foodstuffs and consumer goods and I do not think there will be further protection from a strengthening of the Hong Kong dollar. For locally determined prices (*e.g.* property and consumer services), the more rapid increase in private consumption expenditure compared with the total GDP will also exert some upward pressure. I expect the Consumer Price Index in 1977 will be on average 5% to 6% higher than the average for 1976, with food prices about 4% higher although this will depend very much on the supply situation).

*(c) Construction industry*

44. Last year, Sir, I expressed concern about the very heavy load that was likely to be imposed on the building and construction industry by both the public and private sectors<sup>(41)</sup>. I was concerned that the effect of the excess demand would be to increase prices and that these would equate demand with the capacity of the industry. Output increased in 1976 by about 40% which is in line with our projections of the industry's capacity for 1976. But the expected sharp increases in prices did not materialize. The decline in construction costs which took place in 1975 was reversed at the beginning of 1976 and, at the end of 1976, the labour and material cost index was about 13% higher

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(41) *B.S., 1976, paragraph 38.*

than at the beginning of the year; but the average increase for the year as a whole was only 4%. This was partly due to our strong currency, but another influence must have been the public sector's spending performance in 1976. The public sector's share of the industry's output was 10% below 1975 and 25% to 30% below the share implied in the 1976-77 Estimates<sup>(42)</sup>.

45. All the indications are that the private sector's demands on the industry will continue to grow in 1977 by at least 20%<sup>(43)</sup>. Furthermore, I believe that our estimates of capital expenditure by the public sector in 1977-78 more accurately reflect the public sector's capacity to increase expenditure. I say this because, after two disappointing years (1975-76 and 1976-77), large payments are now coming forward for large projects. So shortfalls as large as those which occurred in those two years<sup>(44)</sup> are less likely.

46. These two forecasts of demand imply an increase in demand which is some 20% to 30% higher than last year's output. I have already mentioned why a 13% increase in the industry's capacity is the highest we can expect. It seems likely, therefore, that there will be an excess demand equal to about 10% of the industry's capacity. Because the estimates for capital expenditure by the public sector are more realistic I believe pressures on costs are more likely than shortfalls because of crowding out by the private sector.

## (2) *Medium Term Uncertainties*

47. The rapid recovery in world trade in 1976<sup>(45)</sup> is expected to slow down gradually during 1977 and 1978<sup>(46)</sup>. This is because the recovery in the major industrialized economies started at a time when

(42) *B.S., 1976, paragraph 212.*

(43) *This forecast is based on planned public sector increases and leading indicators of private demand: for example, floor area of new building plans with consents to commence work in the latter half of 1976 was 36% higher than the corresponding period in 1975. Although the number of private new building plans submitted for approval was only 14% higher, roughly indicating a slowing down in investment intentions, private desired demand on building and construction activity in 1977 is likely to be at least 20% higher than the estimated actual level in 1976.*

(44) *1975-76 (Consolidated Account)*

*Approved estimates: \$2,252 million;*

*Actual expenditure: \$1,641 million*

*1976-77 (Consolidated Account)*

*Approved estimates: \$2,344 million;*

*Revised estimates: \$1,706 million.*

(45) *About 11% up on 1975 when it was 5% down on 1974.*

(46) *To, say, 10% in 1977 and 6% in 1978.*

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inflation rates were high and, from a fear of inflation, these countries were more likely to engage in policies more restrictive in terms of economic expansion than would otherwise be the case. The experience of a severe recession has affected consumer and investment confidence. As a result, the stimulus derived from stock building in the early stage of the recovery was, and probably will be, only partially sustained by a slow growth in private and public consumption demand and in investment demand. Several authoritative sources recently forecast that the major industrial countries in 1978 would grow well below trend at about 3% and this less buoyant outlook for the near term future may in turn depress business expectations. There is, therefore, a danger of a mild recession with slow, but not negative, growth evolving towards 1978. It is difficult to speculate beyond 1978. But if growth were to slow down further towards the end of the decade, a shift into more expansionary policies is much more likely to occur.

48. The slow down in the growth rate forecast for 1978 will inevitably carry with it a slow down in world trade. As a result, the growth of our exports may slow down further in 1978 to show a moderate increase of only say 5% to 7% in real terms, giving a growth rate of no more than 6% in real GDP which is less than the trend rate of growth of 7% - 8% between 1970 and 1976.

49. But, for Hong Kong, future growth will also depend on the trade policies pursued by the governments of countries to which we export. To a large extent our trading environment is shaped by the Multi-Fibre Arrangement, for textiles and clothing continue to represent over half our total domestic exports; and nearly two thirds of our textile and clothing exports are subject to restraints negotiated under the MFA. The Arrangement itself, and most of our bilateral agreements, run through to the end of 1977. During this year, however, the participants in the MFA must decide its future and it is far from certain at this stage what that might be. Most of the participating countries are prepared to extend the Arrangement without amendment, but the EEC wants it changed in such a way to permit greater restriction of exports. Until this disagreement is resolved, there can be no certainty about the framework for trade in textiles and clothing after 31st December 1977, except that restrictions will certainly continue.

50. The members of the GATT undertook in 1973 to engage in a new round of multilateral trade negotiations. A number of different groups have been set up to work on different aspects of the negotiations:



I would expect that the negotiations will, in fact, lead to the reduction of some tariffs and the removal or reduction of some non-tariff barriers. We shall be able to share in any expansion of world trade that results.

51. There is, however, one special area about which we are concerned. Under the GATT, when a member introduces import restrictions, they should be applied to imports from all sources. Some member countries would like to change this rule so that such restrictions could be applied on a selective basis. This is an idea which holds considerable dangers for Hong Kong.

52. The only other fair-sized cloud I see on the horizon arises from the United States Government's remit to its International Trade Commission to review the tariff differential between textile products of cotton and of other fibres and to review the criterion for tariff classification of blended textiles. It is impossible to forecast the outcome of this review nor, indeed, when any decisions may be taken but, as our textile and clothing industry is well aware, any change could have considerable repercussions on our exports.

53. On the whole, I think we may reasonably look for some modest liberalization of world trading rules perhaps counter-balanced by some additional difficulties in particular sectors.

54. It is perhaps fortuitous that 1977 is the Year of the Snake, a treacherous animal which we should treat with caution, if not respect for, whilst I think we can consider our immediate economic prospects with equanimity, the outlook later on is clouded with uncertainties. So we must be on our guard and if ever there was a year in which budgetary policy must be considered in the context of the period to follow—for our purposes the forecast period 1978-79 to 1980-81—it is 1977-78.

### (3) *In the Longer Term*

55. In recent years, I have used a trend projection of the GDP in real terms to give some indication of the size of the economy in the future. The course of the GDP even over the last three years has been such that the trend is still discernible. In 1976, real GDP was 23% higher than in 1973, the previous cyclical peak, and this is equivalent to an average annual growth of 7%. Whether or not we fall below trend in the later years of this decade, I think the time has come to start considering whether we are likely to keep to it beyond 1980-81, the last year of our forecast period.

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56. The growth in our underlying productive capacity is determined by the growth of the labour force and the growth in output per head of the labour force (or productivity). Growth in productivity depends on investment and the discovery of techniques. Although in the short term growth in productivity cannot be represented as a smooth trend, its growth in the medium term can be. The growth of the labour force, on the other hand, depends on the growth and age structure of the population and the participation rates for different groups of the population of working age<sup>(47)</sup>.

57. But the main determinant of the growth of the labour force is the growth of the population of working age. This is fairly well determined for the next 15 years. Between 1961 and 1976 the labour force grew by an average of more than 3% each year. Some of the growth was the result of the age structure of the population—high birth rates during the 1950s—and some the result of net migration. But birth rates and net migration have been much lower recently. These low birth rates, and assuming only small changes from net migration in the future, mean that the growth of the population of working age will decline during the early 1980s. So it will be less than the growth of the population itself; our old projections done before the By-Census suggest an annual rate of only 1% by the mid-1980s.

58. This must, of course, reduce the trend growth of real GDP. I do not propose, at this stage, to say what I think it will be but, if we have previously used a figure in the range of 6 - 8%, perhaps we should be thinking of something about two percentage points lower by the mid-1980s. This, in itself, may well have implications for the growth of public expenditure if not for the relative size of the public sector; more important at this stage, however, are the possible implications for the pattern of public expenditure. These we must consider in the intervening years.

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(47) *Participation rates depend on a number of factors and for female labour are particularly hard to predict. We must await the analysis of the By-Census before new projections of participation rates can be made. Participation rates are at present derived from the Labour Force Surveys of September 1975 and March 1976 and may be, therefore, over-influenced by the recession. We know, for example, that between September 1975 and August 1976 the labour force, which includes the unemployed as well as the employed, declined by 2% suggesting that the recession brought some people into employment at rates that were acceptable only because of the reduced household incomes prevailing at the time.*

## PART III: THE STATE OF THE PUBLIC ACCOUNTS

(1) 1975-76 Accounts<sup>(48)</sup>

59. That concludes, Sir, what I have to say on the state of our economy and our economic prospects. I turn now to a similar exercise on the public finances.

60. Honourable Members will recall that I budgeted for a deficit in 1975-76 of \$431 million which I covered with raised or negotiated loan finance; and quite legitimately so, for a deficit in Hong Kong is a deficit on capital account only, at any rate so long as we limit the rate at which our recurrent commitments grow in relation to recurrent revenue.

61. However, the actual outcome was rather different for the reasons I gave in this Council on 21st July last. The final accounts revealed a surplus of \$224 million or 3.6% of total revenue<sup>(49)</sup>, even better than the \$50 million (only) deficit I predicted in last year's budget speech on the basis of the state of the Treasury's cash book shortly before budget day<sup>(50)</sup>. Revenue at \$6,256 million was very close to my original estimate, a mere 1.2% higher, but expenditure at \$6,032 million was well below the approved estimate by no less than \$583 million, or 8.8%, all but \$168 million being on capital account<sup>(51)</sup>.

62. As a result, recurrent expenditure absorbed only 76% of recurrent revenue compared with the guideline of 80%, and the surplus on recurrent account was sufficient to cover 88% of capital expenditure

(48) All amounts and percentages quoted in this part relate to the General Revenue Account only, that is to say, they are exclusive of all transactions of the Urban Council financed by the Urban Council Rate and the yield from fees and charges levied by the Urban Council and of the Housing Authority's rent income and borrowings from the Development Loan Fund.

(49) \$6,256 million.

(50) B.S., 1976, paragraph 58.

(51) In summary:

	\$ million		\$ million	
	O/A.E.	F.A.	O/A.E.	F.A.
<i>Recurrent Account:</i>				
Revenue .....	5,755	5,843	—	—
Expenditure .....	4,618	4,450	+1,137	+1,393
<i>Capital Account:</i>				
Revenue .....	429	413	—	—
Expenditure .....	<u>1,997</u>	<u>1,582</u>	<u>-1,568</u>	<u>-1,169</u>
Overall deficit/surplus .....	<u>—</u>	<u>—</u>	<u>- 431</u>	<u>+ 224</u>

Notes: O/A.E.=Original/Approved Estimates.

F.A. =Final Accounts.

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compared with the guideline of 60% (but unnecessarily so because capital revenue met 26% of capital expenditure). All this, however, was at the expense of the balance between recurrent expenditure and capital expenditure, the latter being only 26% of total expenditure compared with the guideline of 30%.

(2) *Revised Estimates for 1976-77*(a) *Outturn*

63. This year, after taking into account my revenue proposals<sup>(52)</sup>, the difference between estimated expenditure of \$7,212 million and estimated revenue of \$6,857 million was \$355 million. The deficit on capital account I budgeted for was \$1,435 million, which was only partly covered by the surplus on recurrent account of \$1,080 million. But, even with the prospect of a salaries revision<sup>(53)</sup>, I did not really believe a deficit would be the outcome, though I indicated that, if a deficit did eventuate, it could be covered by our reserves<sup>(54)</sup>. After all, to budget for a deficit, or a surplus, of even a few hundred million dollars when total turnover is \$14,000 million is fine tuning to a degree given the heroic nature of some of the estimates making up the total figure.

64. The revised estimates of revenue and expenditure for 1976-77<sup>(55)</sup> are \$7,400 million and \$6,843 million respectively. Thus, instead of a possible, but somewhat unlikely, deficit the year's operations will result in a surplus of \$557 million<sup>(56)</sup>. But the revised estimates

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(52) *Designed to raise net additional revenue of \$136 million.*

(53) *Now known to have cost \$380 million or rather more than originally estimated because, contrary to normal policy, agencies subvented on a discretionary basis have also received supplementary subventions to enable them to revise salaries this year.*

(54) *B.S., 1976, paragraph 206.*

(55) *As shown in the printed Estimates for 1977-78.*

(56) *In summary:*

	\$ million		\$ million	
	O/A.E.	R.E.	O/A.E.	R.E.
<i>Recurrent Account:</i>				
<i>Revenue</i> .....	6,369	6,711	—	—
<i>Expenditure</i> .....	5,289	5,401	+1,080	+1,310
<i>Capital Account:</i>				
<i>Revenue</i> .....	488	689	—	—
<i>Expenditure</i> .....	<u>1,923</u>	<u>1,442</u>	<u>-1,435</u>	<u>- 753</u>
<i>Overall deficit/surplus</i> .....	<u>—</u>	<u>—</u>	<u>- 355</u>	<u>+ 557</u>

*Notes: O/A.E. = Original Approved Estimates.*

*R.E. = Revised Estimates.*

always tend to understate surpluses and overstate deficits. Why this should be, I do not know but it always happens. (*laughter*). The reason for this is that the revised expenditure estimates, prepared as they are in mid-December, always tend to be on the optimistic side; and, even during the up-swing, some revenue heads tend to still be conservatively estimated, although the deadline for printing the revised revenue estimates is as late as early February. This year I fear is no exception and my own prediction of the outturn, based on the state of the Treasury's cash book at 16th February, last, is for a surplus of \$850 million. So this is the figure I shall use when considering our financial position in the context of budgetary policy in 1977-78 and thereafter. But, in analyzing our revenue collecting and expenditure performance this year 1976-1977 I shall have to use the revised estimates as printed.

(b) *Revenue*

65. At \$7,400 million the revised estimate of revenue for 1976-77 is \$1,144 million, or 18%, up on actual revenue in 1975-76 of \$6,256 million, when it was 12% up on 1974-75, due largely to the tax increases introduced in that difficult recession year<sup>(57)</sup>. The revised estimate exceeds the original estimate of \$6,857 million by \$543 million, or by 8%. I do not regard an error of this order too sadly for the speed of the recovery process in 1976 had a marked effect on certain income-sensitive levies<sup>(58)</sup>.

66. This figure of \$543 million is the algebraic sum of excesses under some heads of \$631 million and shortfalls under other heads of \$88 million. The main shortfall (\$73 million) is in respect of interest earnings, due to the transfer of relatively high interest bearing overseas investments to the Exchange Fund in exchange for debt certificates denominated in Hong Kong dollars<sup>(59)</sup>, lower than anticipated interest

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(57) *For an outline of budgetary strategy in 1975-76, see B.S., 1975, paragraphs 60-67.*

(58)	<i>Actual revenue compared with original estimate</i>	<i>Actual revenue increase over previous year</i>
	%	%
1972-73 .....	+33	+39
1973-74 .....	+ 7	+ 6
1974-75 .....	+ 0.5	+12
1975-76 .....	+ 1.2	+12

(59) *B.S., 1976, paragraphs 78 and 81 - 84.*

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rates on Hong Kong dollar deposits and a run down of the Mass Transit Fund as the Government was called upon to purchase equity capital<sup>(60)</sup>.

67. The main excess is in respect of earnings and profits taxes which are up by \$222 million or 9% on the original estimate. Two other recurrent levies for which yields were better than expected were, not surprisingly, bets and sweeps: up by \$70 million or 39% on the original estimate, thanks to the racing community's enthusiastic reaction to better times (laughter) and the success which has attended the Jockey Club's efforts to push illegal bookmakers out of business; and First Registration Tax on motor vehicles was up by \$51 million or I am afraid 104% on the original estimate, a reflection undoubtedly of quickening economic activity<sup>(61)</sup> (laughter).

68. Capital revenue is up by \$201 million or 41% on the original estimate, as land sales yielded \$180 million more than expected and estate duty \$22 million.

*(c) Expenditure*

69. At \$6,843 million the revised estimated of expenditure for 1976-77 is \$811 million, or 13.5%, up on actual expenditure in 1975-76 when it was \$6,032 million, or only 1% up on 1974-75. However, for the second year running actual expenditure this year will be less than the approved estimate. This year it will be at least \$369 million lower than the approved estimate of \$7,212 million, despite net supplementary provision of \$200 million<sup>(62)</sup>.

70. A shortfall of \$369 million is only 5% of estimated total expenditure, but this figure conceals the fact that recurrent expenditure is likely to exceed the approved estimate by \$112 million and capital expenditure is likely to fall short of the approved estimate by \$481

(60) *the balance in the Mass Transit Fund is now only \$100 million. This sum has been called up in exchange for equity, but is still being held on deposit pending a settlement of land charges for work sites.*

(61) *Registration of new vehicles, 1st April 1975 to 31st December 1975 compared with 1st April 1976 to 31st December 1976:*

*Private cars 5,781 and 9,768 (+69%)*

*Goods vehicles 2,241 and 5,775 (+158%)*

(62) *That is, supplementary provision of \$350 million approved up to 16th February 1977, minus frozen provision of \$330 million (of which \$80 million has been found from Head 52 Miscellaneous Services Subhead 100 Additional commitments) plus an estimated requirement for personal emoluments subheads of \$180 million.*

million, of which \$428 million is accounted for by the two Public Works Programme components of the capital account<sup>(63)</sup>.

71. As a result, expenditure this year on the two Public Works Programme components of the capital account is likely to be only \$1,174 million, which is 27% down on the approved estimate, compared with \$1,272 million last year when there was a shortfall of \$354 million, which was 22% down on the approved estimate. In both years, the approved estimates for the two Public Works Programme components were within and not without guideline figures.

72. There are three reasons for this underspending: first, contract prices for most of the year continued to be 20 - 30% below assumed prices and provision made for payments to contractors for fluctuation clauses remained virtually unspent. Now of course this is a good reason for the underspending and it is rather surprising, given the demands on the construction industry by both the public and private sectors in 1976. However, secondly, it must be admitted that we have tended to overlook the difficulty of spending money in the early stages of complicated engineering projects, particularly as we decided in 1974<sup>(64)</sup> to proceed with the New Towns on a "package" basis in order to achieve balanced development over time. Furthermore, as it happens, our high priority projects tend to be more complicated than projects with a lower priority and this has slowed down expenditure in these earlier years (with consequences for 1978-79, and later, which we must watch out for carefully). Thirdly, there have been delays in the letting of contracts caused by difficulties in land clearances 'and

(63)	<i>Component</i>	<i>Approved Estimates 1976-77 (\$ million)</i>	<i>Revised Estimates 1976-77 (\$ million)</i>
(1)	<i>Public Works Programme (other than New Towns and Housing).....</i>	1,008	765
(2)	<i>Public Works Programme (New Towns and Housing, including transfers from General Revenue to the Development Loan Fund for on-lending to the Housing Authority).....</i>	594	409
(3)	<i>Subventions.....</i>	53	51
(4)	<i>UPGC.....</i>	47	41
(5)	<i>Departmental Special Expenditure.....</i>	120	89
(6)	<i>Defence Costs Agreement: Capital Works.....</i>	26	17
(7)	<i>Miscellaneous.....</i>	<u>75</u>	<u>70</u>
		<u>1,923</u>	<u>1,442</u>

(64) See B.S., 1975 paragraph 53 and Report of the Public Works Sub-Committee of Finance Committee for 1974, page 209.

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acquisitions and last minute changes in the scope of projects requested by client departments, some of whom seem to have, from time to time, great difficulty in making up their minds and in this respect the PWD certainly has my sympathy and finally the August rainstorms affected progress on some site formation works.

73. The only other shortfall to which I should draw honourable Members' attention is in respect of departmental special expenditure: although the shortfall is as much as \$31 million on provision of \$120 million, \$10 million of this is accounted for by a delay in the delivery of a replacement for the Cape St. Mary.

74. This underspending on capital account means that the balance between recurrent expenditure and capital expenditure has again been thrown out, the latter being only 21% of total expenditure compared with the guideline of 30%; and no less than 98% of total expenditure has been covered by recurrent revenue compared with the guideline of at least 88%.

(3) *Financial Position*

(a) *As at 1st April 1976*

75. Last year I estimated that we would begin 1976-77 with fiscal reserves<sup>(65)</sup> amounting to \$2,626 million<sup>(66)</sup>. In the event, our reserves were \$184 million higher at \$2,810 million because, instead of a predicted deficit of \$50 million, the actual outturn was a surplus of \$224 million and exchange losses and appreciation of the book values of fixed interest bearing investments amounted together to a net loss of \$200 million rather than \$110 million.

(b) *As at 1st April 1977*

76. I estimate that we shall begin 1977-78 with fiscal reserves of \$3,660 million<sup>(67)</sup>, an increase of \$850 million on the position at the beginning of this year of \$1,138 million at the beginning of 1975-76,

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(65) *That is, the balances available for appropriation, if need be, over and above the general revenues of the Colony as represented by the General Revenue Balance which is the excess of the Government's financial assets over its short term liabilities.*

(66) *B.S., 1976, paragraph 74.*

(67) *Only minor adjustments have to be made for differences in exchange values and no adjustments for depreciation/appreciation of fixed interest bearing investments in view of the new arrangements whereby all our foreign currency assets are now held by the Exchange Fund: see B.S., 1976, paragraphs 75 - 84.*



when they stood at \$2,522 million. They had fallen to this level from \$2,809 million at the beginning, of 1974-75 largely as a result of the deficit incurred in that year. At the beginning of 1973-74, our reserves stood at \$3,089 million, the decline in that year being due to substantial exchange losses in Hong Kong dollar terms and a depreciation of the book value of fixed interest bearing investments. I shall not evaluate the present level of our reserves until I come to deal with the view we should take of them in the context of budgetary policy.

(c) *Development Loan Fund*

77. The available assets in the Development Loan Fund are not included in our fiscal reserves for they are committed to approved loan allocations. At 1st April 1977 the available assets will amount to about \$237 million against outstanding allocations of \$314 million, of which \$122 million is for housing<sup>(68)</sup>, \$14 million for non-profit making schools, \$32 million for loans to students, \$10 million for industrial training authorities and \$136 million for the Industrial Estates Corporation. As the Housing Authority may wish to draw as much as \$175 million in 1977-78, a sum of \$123 million has been entered in the commitment column under Head 50 Miscellaneous Services Subhead 357 Payment to Development Loan Fund. Whether or not it will be necessary to augment the available assets in the Fund by as much as this will depend on other calls made on the Fund during the year.

(d) *Lotteries Fund*

78. The available assets in the Lotteries Fund at 1st April 1977 will be \$24 million to which must be added receipts during the year of about \$8 million. Payments next year against approved and new allocations are presently estimated at \$10 million which would leave the balance in the Fund at 31st March 1978 at about \$22 million, but the Social Welfare Advisory Committee could come forward with further constructive ideas for social welfare capital projects.

*PART IV: THE OUTLOOK FOR THE PUBLIC FINANCES*

(1) *General*

79. Against the background of our performance over the four years 1973-74 to 1976-77, I shall now consider our present forecast of

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(68) *Housing Authority (\$52 million); Housing Society (Urban Improvement Scheme) (\$63 million); Hong Kong Building and Loan Agency (\$7 million, for guaranteed notes).*

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revenue and expenditure over the coming four years 1977-78 to 1980-81 and the essential elements of budgetary policy<sup>(69)</sup>.

80. Except where I state otherwise, all expenditure figures (amounts and percentages) will relate to the General Revenue Account only, that is to say, they will be exclusive of all transactions of the Urban Council financed by the Urban Council Rate and the yield from fees and charges levied by the Council<sup>(70)</sup> and exclusive also of the Housing Authority's rent income and borrowings from the Development Loan Fund<sup>(71)</sup>.

(2) *Assessment of Performance, 1973-74 to 1976-77*<sup>(72)</sup>

(a) *Total expenditure*

81. After increasing sharply from \$4,644 million in 1973-74 to \$5,973 million in 1974-75, or by 29%, involving the largest overall deficit in post-war years of \$380 million, total expenditure in 1975-76 increased by a mere 1% to \$6,032 million. Thus the budget correctly for that year reflected the slowing down of the growth rate of the economy, although it was possible to maintain considerable momentum in our social programmes<sup>(73)</sup>.

82. As the difficulties of the previous two years were clearly beginning to recede, the 1976-77 budget provided for total expenditure of \$7,212 million, the objective being a resumption of growth after the pause in 1975-76. In 1976-77 I provided for recurrent expenditure of \$5,289 million, an increase of 15%, and for capital expenditure of

(69) *When I come to present next year's budget I shall also be suggesting how the pattern of expenditure should be assessed year by year, but not necessarily controlled: see paragraphs 123 - 128 and 130 - 134 below.*

(70) *Under the authority of the Public Health and Urban Services Ordinance, the Places of Public Entertainment Ordinance and the Dutiable Commodities Ordinance (in respect of liquor licensing).*

(71) *But transfers from the General Revenue Account to the Development Loan Fund are included. The Consolidated Account includes General Revenue Account transactions, all transactions of the Urban Council and the Housing Authority, all other transactions of the Development Loan Fund and the Transactions of the Lotteries Fund and the Home Ownership Fund: see Appendices VI and VII to the printed Estimates.*

(72) *See Annex (2).*

(73) *I actually budgeted for a deficit of \$431 million but, although actual revenue at \$6,256 million only exceeded the original estimate by \$72 million, actual expenditure was less than the approved estimate by \$583 million, of which no less than \$415 million was on capital account.*

\$1,923 million, an increase of 18%<sup>(74)</sup>. In the event, whereas recurrent expenditure in 1976-77 at \$5,401 million is likely to be some 21% up on actual expenditure in 1975-76<sup>(75)</sup>, capital expenditure at \$1,442 million is likely to be 9% down<sup>(76)</sup>.

(b) *Recurrent and capital accounts*

83. If the capital account is to be financed without recourse to substantial borrowings, then recurrent expenditure must not absorb more than a certain proportion of recurrent revenue and recurrent expenditure must bear a certain relationship to capital expenditure. My present guidelines are that recurrent expenditure should not absorb more than 80% of recurrent revenue and that recurrent expenditure should not represent more than 70% of total expenditure.

84. Thus, in 1973-74 and in 1975-76 the proportion of recurrent revenue absorbed by recurrent expenditure was below the guideline at 71% and 76% respectively and, in these two years, we ran surpluses of \$373 million and \$224 million, the latter surplus being due to the underspending on capital account which, however, upset the balance between recurrent and capital expenditure<sup>(77)</sup>. In 1974-75, although the balance between recurrent and capital expenditure was consistent with the guideline, as 81% of recurrent revenue was absorbed by recurrent expenditure a deficit was the inevitable result<sup>(78)</sup>. Put another way capital expenditure at 27% increased almost as fast as recurrent expenditure at 29% and there was no wind-fall of capital revenue. By contrast, in 1976-77, whereas recurrent expenditure will again absorb nearly 81% of recurrent revenue (revised estimate), as recurrent expenditure represents as much as 79% of total expenditure, the result will be an even larger surplus than the higher recurrent revenue, yields would have otherwise thrown up. At the same time, again in contrast to 1974-75<sup>(79)</sup>, capital revenue at \$689 million will exceed the estimate by as much as \$202 million.

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(74) *Approved estimates for 1976-77 on revised estimates for 1975-76. In fact, actual expenditure in 1975-76 was below the revised estimates and so the Approved Estimates for 1976-77 provided for increases of 19% on recurrent account and 22% on capital account.*

(75) *\$4,450 million.*

(76) *\$1,582 million.*

(77) *1973-74, 70 : 30; but 1975-76, 74 : 26.*

(78) *Put another way, capital expenditure at 27% increased almost as fast as recurrent expenditure at 29% and there was no windfall of capital revenue.*

(79) *C.f. original estimate in 1974-75 of \$509 million with actual collections of \$437 million.*

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(c) *Revenue trends*

85. Recurrent revenue increased from \$4,550 million in 1973-74 to \$6,711 million in 1976-77 (revised estimate) or by 47.5%. Discounting the net effect of the revenue proposals in each of these four years, the increase was only 32%, being 10% in 1974-75 falling to 5% in 1975-76 and recovering to 15% in 1976-77 (revised estimate). Capital revenue averaged \$439 million in the first three years of the period I am considering, rising sharply to \$689 million in 1976-77 (revised estimate) as the recovery affected land prices.

(3) *Forecast of Revenue and Expenditure, 1977-78 to 1980-81*

(a) *Introduction*

86. It is against this background that I now wish to consider the forecast of revenue and expenditure for the coming four years prepared by the Finance Branch in the autumn of 1976 on the basis of returns submitted by departments at the end of June<sup>(80)</sup>.

(b) *Method of compilation*

87. The forecast of recurrent revenue was based on existing tax rates and charges and assumed growth rates and was expressed in terms of 1976 values. Capital revenue accrues mainly from land sales but, as it has not yet proved possible to devise a long term land production programme, arbitrary assumptions had to be made for sales proceeds based on such information as was available to us.

88. For the purpose of forecasting expenditure (at 1976 prices), departments were required to submit returns which distinguished between, on the one hand, unavoidable commitments in respect of maintaining present services, expanding them to meet demand at existing standards and extending them within approved policies where timing had been specifically agreed<sup>(81)</sup>; and, on the other hand, new services<sup>(82)</sup> but, in the nature of things, there are bound to be other new services fed into the system during the forecast period.

89. The figures for recurrent expenditure were then adjusted upwards by the Finance Branch for the 1976 salaries revision and corrected for errors and omissions. The figures for the two Public Works

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(80) *See Annex (3).*

(81) *Appendices I — IV referred to in the circular at Annex (3).*

(82) *Appendices V — VI, ibid.*

Programme components of the capital account were reconciled with present guidelines<sup>(83)</sup>. Further adjustments were made to both the recurrent and capital expenditure figures to take account of commitments arising from policy intentions which subsequently become known to the Finance Branch<sup>(84)</sup>.

(c) *Results*

90. This is not the time or place to describe the results of this exercise in detail<sup>(85)</sup>, vital though the exercise is to the sound management of the public finances and, in particular, to the construction of the budget for the immediately ensuing year. Suffice it to say that the exercise threw up an overall deficit of \$380 million in 1977-78 and further deficits of \$650 million and \$200 million in the first two years

(83)	Component	Guideline figure (*) (\$ million)	Acceptable level of expenditure for 1977-78 (**) (\$ million)	Adjusted to April 1976 prices (\$ million)
(1)	Public Works Programme (other than New Towns and Housing).....	1,100	1,100	1,000
(2)	Public Works Programme (New Towns and Housing, including transfers to the Development Loan Fund for on-lending to the Housing Authority).....	<u>1,100</u>	<u>1,000</u>	<u>910</u>
		<u>2,200</u>	<u>2,100</u>	<u>1,910</u>

(\*) B.S., 1975, f.n. (73).

(\*\*) B.S., 1975, paragraph 184.

(84) For example, the Home Ownership Scheme, Phase I (only).

(85)	1977-78 (\$ million)	1978-79 (\$ million)	1979-80 (\$ million)	1980-81 (\$ million)
<i>Recurrent Account:</i>				
Revenue .....	7,600	8,400	9,200	10,200
Expenditure .....	<u>6,400</u>	<u>6,900</u>	<u>7,300</u>	<u>7,700</u>
Surplus .....	1,200	1,500	1,900	2,500
<i>Capital Account:</i>				
Revenue .....	1,170	900	690	650
Expenditure .....	<u>2,750</u>	<u>3,050</u>	<u>2,790</u>	<u>2,870</u>
Deficit .....	-1,580	-2,150	-2,100	-2,220
Overall position .....	- 380	- 650	- 200	+ 280
<i>Guideline:</i>				
<u>Recurrent expenditure</u>	84%	82%	79%	75%
<u>Recurrent revenue</u>				

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of the forecast period namely 1978-79 and 1979-80. By the last two forecast period 1980-81 there is a surplus of \$280 million, reflecting a tailing off in departmental expectations and, consequently, the proportion of recurrent revenue absorbed by recurrent expenditure in that year is, according to the forecast figures, only 75%. Thus, in the absence of serious economic setbacks, there should be some room for feeding essentially new services and works (*i.e.* services and works not yet defined or approved) into the Draft Estimates of the last year or two of the forecast period.

(4) *Essential Elements of Budgetary Policy*

(a) *Present guidelines*

91. Sir, I believe the objectives of budgetary policy in Hong Kong to be:

First, progressively, and to the maximum extent that the economy will permit, to implement approved Government policies and programmes in such a way as to secure the public interest;

Secondly, to ensure that revenue is raised as equitably as possible as between different classes and groups of taxpayers or potential taxpayers;

Thirdly, to minimize any adverse effects of public expenditure and of the fiscal system on the internal cost/price structure of the economy and on private investment decisions so that the growth rate of the gross domestic product is not constrained or business confidence damaged.

92. To help in achieving these three objectives it is necessary to lay down certain guidelines. But, as I said last year, none of these guidelines is absolute and they are no substitute for common-sense, acceptance of economic reality, recognition of social needs, imaginative decision-making<sup>(86)</sup> and a continuing emphasis on cost-effectiveness and cost-efficiency. So my guidelines are simply intended to impose a degree of discipline and to remind us of the consequences of particular courses of action. Although they are grounded in historical experience, there is nothing sacrosanct about them and they have frequently been breached under the pressure of events.

93. To begin with, the relationship between the recurrent and capital accounts must be defined in such a way as to limit the rate at

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(86) *Particularly as regards the establishment of priorities.*

which our recurrent commitments grow in relation to recurrent revenue. Thus I have taken the view that recurrent expenditure should absorb or more than 80% of recurrent revenue and that at least 60% of capital expenditure should be financed by the surplus on recurrent account<sup>(87)</sup>. This sets an upper limit to recurrent expenditure, but not to capital expenditure because, if less than 80% of recurrent revenue is absorbed by recurrent expenditure, the surplus on recurrent expenditure could finance a larger quantum of capital expenditure. Thus separate absolute guideline figures were set in 1974 for the various components of the capital account over the then three year forecast period 1975-76 to 1977-78<sup>(88)</sup>.

94. Secondly, it is necessary to define the way in which the residual deficit on capital account should be financed, viz: at least half in my view should be financed by capital revenue and no more than half with debt.

95. Thirdly, a guideline is required to define a limit for debt in case there is a continuous recourse to loan finance to balance the capital account. Thus I have suggested that annual debt service charges<sup>(89)</sup> should not, at any time, exceed income earned on our fiscal reserves.

96. Fourthly, the balance of the fiscal system needs to be defined in terms of two ratios: the ratio of direct to indirect taxation; and the ratio of direct and indirect taxation taken together to all other recurrent revenue. In 1975-76 these ratios were 55 : 45 and 70 : 30 respectively and in 1976-77 (revised estimates) they are likely to be 55 : 45 and 72 : 28. Whereas I would prefer to see these ratios nearer to 45 : 55 and 65 : 35, I do not take these divergences too tragically. The fact is the ratios do serve to remind us of the significance of indirect taxes and fees and charges in our circumstances. The yields from our system of earnings and profits taxes are income sensitive and must remain so, if the economy's internal flexibility is not to be damaged, whereas yields from indirect taxes and fees and charges are, rightly, and by their very nature, much less so. It is true that, in Hong Kong, there are specific policy reasons why some public services should not be charged for at cost. Education and medical services are obvious

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(87) *From these two guidelines it follows that at least 88% of total expenditure should be met from recurrent revenue.*

(88) *B.S., 1974, paragraph 101; B.S., 1975, f.n. (73) on page 35; and B.S., 1976, f.n.s. (97), (100) and (252) on pages 49, 51 and 113. See also f.n. (126) below.*

(89) *Interest and sinking fund payments (actual or notional).*

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examples. But we must remember that, in a low tax environment, all other things being equal, public services must be charged for<sup>(90)</sup>, at least on a cost-related basis, provided of course adequate remission arrangements are available where required.

97. Finally, in an open economy such as ours, it is necessary to keep a weather eye on the balance between the public sector and the economy as a whole. For this purpose it is necessary to settle upon a definition of the public sector and use it consistently over time. The choice of definition depends upon which consequences of an improper balance are of most concern<sup>(91)</sup> and, of course, on practical considerations. My definition of the public sector is related to the source of funds, that is to say, I include within the public sector all activities financed from public funds<sup>(92)</sup> no matter by whom the expenditure is incurred<sup>(93)</sup>. Thus expenditure by institutions in the private or quasi-private sector is included to the extent of their subventions. The activities which are partly financed by charges raised on a commercial basis are also included, for example the KCR the Airport and the Waterworks. But excluded on the basis of this definition are those organizations, including statutory organizations in which the Government only has an equity position, such as the Mass Transit Railway Corporation, the Hong Kong Air Cargo Terminals Limited, and the Cross-harbour Tunnel Company.

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(90) *B.S., 1975, paragraph 121.*

(91) *For example, a public sector which was too large might result in an excessively large bureaucracy; a distorting effect on the allocation of resources of budgetary and fiscal policies; a destabilizing monetary effect caused by fiscal policies which were either deflationary or inflationary; an erosion of the disciplines of the market mechanism over economic activity. A public sector which was too small would certainly mean that the economic and social infrastructure was inadequate for the purpose of enabling the community to achieve its growth potential and might mean that the private sector was not controlled to an appropriate degree.*

(92) *That is to say, those activities whose transactions are recorded in the Consolidated Account (net of certain transfers).*

(93) *Thus, expenditure by institutions in the private or quasi-private sector is included to the extent of their subventions, and activities which are partly financed by charges raised on a commercial basis are also included (e.g. KCR, Airport, Waterworks). But excluded are those organizations, including even statutory organizations, in which the Government only has an equity position such as the Mass Transit Railway Corporation, Hong Kong Air Cargo Terminals Ltd and the Cross Harbour Tunnel Company.*



98. In the four years 1973-74 to 1976-77 the public sector, so defined, represented 17.2% of the GDP at current prices compared with 14.4% in the four years 1969-70 to 1972-73; and so the relative size of the public sector has been lifted by a fifth in the last four years compared with the four previous years. A public sector of this relative size is clearly within the economy's capability and, if necessary, could be lifted to little further without detriment; and, incidentally, the acceptable relative size of the public sector is larger on the downswing phase of the trade cycle than on the upswing<sup>(94)</sup>.

(b) *Revised and extended guidelines*

99. None of these five guidelines needs revision but, as the absolute guideline figures for the various components of the capital account were fixed in 1974, and we are now approaching the last year of the then forecast period, these figures do need to be updated for the next forecast period 1978-79 to 1980-81. The forecast of capital expenditure for each of these three years is \$3,050 million, \$2,790 million and \$2,870 million respectively<sup>(95)</sup>. Expenditure envisaged on the two Public Works Programme components of the capital account amounts to \$2,300 million, \$2,340 million and \$2,320 million<sup>(96)</sup> with a growing emphasis on New Towns and Housing as urban area developments are completed.

100. For the purpose of this exercise, I accept these figures and so the only remaining question is what else can be fitted in. To begin with, there are certain commitments which are contractual, namely, capital works under the Defence Costs Agreement and the reprovisioning of Victoria Barracks and RAF Kai Tak and public debt repayments.

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(94) *When the economy is enjoying strong growth the ratio of the public sector to the GDP should fall, partly because the growth rate of public expenditure will always tend to lag behind the growth rate of the economy on the upswing and partly because we want to leave room for the public sector to expand relatively to the economy as a whole on the downswing.*

(95) *See f.n. (85) above.*

(96)	Year	Public Works Programme	
		Other than New Towns and Housing (\$ million)	New Towns and Housing (including transfers to DLF) (\$ million)
	1978-79 .....	1,100	1,200
	1979-80 .....	1,010	1,330
	1980-81 .....	1,000	1,320

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These amount to \$90 million, \$60 million and \$310 million in each of the three forecast years<sup>(97)</sup>.

101. Together with the two Public Works Programme components of the capital account, these commitments bring the total of capital expenditure to \$2,390 million in the first year, \$2,400 million in the second year and \$2,630 million in the last year of the forecast period. Capital subventions, UPGC grants, departmental special expenditure and the Home Ownership Scheme (Phase I) will require, according to the forecast, \$660 million in 1979-80 and \$240 million in 1980-81<sup>(98)</sup>. Clearly there can be no certainty that expenditure of this order can be financed and the position will have to be considered year by year. However, I am prepared to assume that the guideline that at least 60% of capital expenditure is financed by the surplus on recurrent account can be observed and that debt can be raised on satisfactory terms to assist capital revenue to cover the residual deficit on capital account.

102. But in constructing the budget there are two other guidelines to be borne in mind if we are to ensure that we maintain, at any rate in the absence of adverse shifts in the world trading environment, a steady rate of progress.

(97)	Year	DCA (\$ million)	Reprovisioning projects for Armed Services (\$ million)	Public debt repayments (\$ million)
	1978-79 .....	20	60	10
	1979-80 .....	20	30	10
	1980-81 .....	20	30	260(*)

(\*) Including repayment of the 1975 Hong Kong dollar bond issue for which there is no sinking fund.

(98)		1978-79 (\$ million)	1979-80 (\$ million)	1980-81 (\$ million)
	Subventions .....	80	60	40
	UPGC .....	60	80	60
	Departmental Special Expenditure .....	220	150	90
	Home Ownership Scheme Phase I(*)	<u>300</u>	<u>100</u>	<u>50</u>
		<u>660</u>	<u>390</u>	<u>240</u>

(\*) The figures relate to the residential side of the scheme financed from the Home Ownership Fund. The Housing Authority may draw on the Development Loan Fund to finance the cost of the commercial facilities in estates built for the Home Ownership Scheme. These drawings have been allowed for in the forecast of expenditure under Public Works Programme (New Towns and Housing): see f.n. (96) above.

103. First, we need to have some idea of the rate at which total expenditure by the public sector can grow annually in real or constant price terms and, based on historical experience in the 70s, this can be taken to be about 10%. Quite apart from the fact that there is a variety of constraints on expenditure (*e.g.* the decision making process, recruitment of staff, land resumptions, planning disputes, the capacity of the construction industry, and so on), there is a very real danger of money being wasted if we try to spend too much, too quickly.

104. But steady progression is not just a matter of fixing upon a growth rate which is practicable. It also depends on the extent to which we are able to insulate the management of the public finances from short term deviations from the trend growth lines of revenue and expenditure. I say this because such deviations should not, ideally, affect the implementation of the Government's policies and programmes or necessarily involve adjustments to tax rates and charges. A sudden change of pace—which is not the same thing as top/go—is inevitable in a situation in which the world trading environment shifts adversely or when, perhaps through failure to exercise proper control over expenditure, a tendency to persistent deficits emerges. But a short-lived tendency for expenditure to exceed revenue or for revenue yields to fall below expectations is best dealt with by having available fiscal reserves.

105. A second additional guideline, therefore, is required to define the relationship which our fiscal reserves should bear to General Revenue Account expenditure, which relationship should be maintained by adding to them over time. The question is: what should that relationship be?

106. At 1st April 1977 our fiscal reserves will be of the order of \$3,660 million, or more than 44% of estimated expenditure in 1977-78. This represents a significant improvement on the position at 1st April 1975 and 1st April 1976<sup>(99)</sup>, when the ratio was 38 - 39%, but not all of our reserves may be considered as being available to finance annual deficits. At least \$2,500 million must be held as assets to secure our

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(99)	<i>Fiscal reserves at 1st April (\$ million)</i>	<i>Estimated expenditure (\$ million)</i>	<i>(1) as a percentage of (2) (\$ million)</i>
	(1)	(2)	(3)
1973/1973-74 .....	3,089	4,183	74
1974/1974-75 .....	2,809	5,465	51
1975/1975-76 .....	2,522	6,615	38
1976/1976-77 .....	2,810	7,212	39

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contingent liabilities which will stand at around \$4,000 million at 31st March 1978 rising to between \$7,500 million and \$8,000 million by 31st March 1981. So to earmark \$2,500 million within our fiscal reserves implies a gearing of three. A higher gearing than this would not be prudent, even though the nature of many of our contingent liabilities is such that we are most unlikely ever to be called upon to meet them.

107. That leaves \$1,160 million out of our fiscal reserves at 1st April 1977 for short term difficulties and to finance our seasonal deficits<sup>(100)</sup>. This is the equivalent of nearly 15% of estimated expenditure next year and this is the sort of relationship which I believe we should maintain. It follows that, to the extent that expenditure increases year by year, our reserves should be augmented.

108. At the same time, I must bear in mind the monetary consequences of the way in which our fiscal reserves are run down or added to because, as I explained earlier, the disposition of our reserves between foreign currency and Hong Kong dollar assets has consequences for the money supply when the exchange rate is not fixed<sup>(101)</sup>.

*PART V: THE BUDGET FOR 1977-78**(1) Introduction*

109. It was these various guidelines which I bore in mind when constructing the budget for 1977-78. It remains to be seen how closely I was able to observe them or, for that matter, felt it necessary to do so. At the outset, of course, I had to take a view of the two permissive guidelines designed to ensure steady progress. I decided that, in the coming year, while remembering always the value for money criterion, we should strive for a real growth rate, not of 10%, but of the order of 15% so as to make up for the fact that we were below this guideline in 1976-77 (+8%) and 1975-76 (+1% only). I decided also that in 1977-78 there was no need to augment our fiscal reserves by deliberately budgetting for a surplus.

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(100) *So that we do not have to realize investments or resort to short term borrowings, part of our reserves are held in liquid or near liquid form specifically to finance our seasonal deficits which reach a peak, normally, in October. As the provisional tax system has somewhat altered the shape of our cash flow, in that we now tend to be in surplus in the first month or two of the financial year, our seasonal deficits are unlikely to exceed  $7\frac{1}{2}$ —100% of estimated expenditure in the future.*

(101) *See paragraph 31 above.*

(2) *Revenue Estimates*

(a) *General*

110. I have earlier described, in general terms, the results of the forecast of revenue and expenditure for the years 1977-78 to 1980-81 as compiled by the Finance Branch in the autumn of 1976<sup>(102)</sup>. The forecast of total revenue was \$8,770 million for 1977-78, \$9,300 million for 1978-79, \$9,890 million for 1979-80 rising to \$10,850 million for 1980-81<sup>(103)</sup>.

111. Subsequently, I had to up-date the figure for 1977-78 in the budget year and to make certain adjustments. In particular, the forecast of recurrent revenue had to be converted into a proper estimate to take into account the intention announced in this Council on 5th January last to reduce the General Rate in the urban areas from 12% to  $7\frac{1}{2}\%$ <sup>(104)</sup>. So the total estimate of revenue for 1977-78 became \$8,412 million.

(b) *Recurrent*

112. The Recurrent Estimates as printed anticipate collections of recurrent revenue of \$7,474 million, an increase of \$763 million, or 11.4% over the revised estimate for 1976-77 of \$6,711 million.

113. Earnings and profits-taxes account for \$3,000 million, or 40% of recurrent revenue. This represents an increase of \$350 million or 13.2% over the revised estimated for 1976-77 (which was \$416 million, or 18.6% up on actual collections in 1975-76). It assumes an increase of \$212 million, or 12%, in the yield from profits tax and of \$138 million, or 15%, in the yield from other taxes. Although I believe these assumptions to be justified, the yield from earnings and profits taxes has always been difficult to estimate with any degree of accuracy<sup>(105)</sup>.

114. The yield from the General Rates is estimated at \$767 million, an increase of \$149 million, or 24%, over the revised estimate for

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(102) See paragraph 90 above.

(103) See paragraph 87 and the table in f.n. (85) above.

(104) See Annex (4).

(105) B.S., 1976, paragraph 62. For 1977-78 account has to be taken of the effects of the introduction of the provisional tax system in 1975-76; and the new basis of assessing property tax introduced in 1976-77 (B.S., 1975, paragraph 192). The revised estimate for 1976-77 is 9% up on the original estimate; actual collections compared with the original estimates were 35% up in 1973-74, 25% up in 1974-75 and nearly 1% down in 1975-76.

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1976-77. This increase takes into account the extension of rating in the New Territories and the yield from new developments in the urban areas which will become liable to rates for the first time in 1977-78. It is based on the percentage rates applicable in 1977-78 applied to the new rateable values established by the 1976 revaluation.

115. Full details of the other changes are included in the Memorandum Notes on the Revenue Estimates: many of the estimated increases are based on assumptions about consumer spending as the upswing of the economy continues<sup>(106)</sup>.

*(c) Capital*

116. My estimates of capital revenue is \$938 million, which is an increase of \$249 million, or 36% over the revised estimate for 1976-77 of \$689 million.

117. Revenue from land sales is expected to yield \$736 million, up by \$133 million or 22%. The estimate does not include payments for land for the Home Ownership Scheme<sup>(107)</sup> or the Mass Transit Railway Corporation works sites<sup>(108)</sup>, which may yield a further \$250 million to \$300 million during the year. The land sales programme for 1977-78 envisages that 45 acres will be disposed of in the urban areas and 77 acres in the New Territories, compared with 22 acres and 114 acres respectively this year<sup>(109)</sup>. The Revenue Estimates also include \$110 million for the estimated yield from some 1,200 taxi licences which are expected to be issued during 1977-78.

(106) *Thus, for example, the yield from dutiable commodities is estimated to be up by 7.5% on the revised estimate for 1976-77 which, in turn, is up by 5% on the original estimate; and First Registration Tax on motor vehicles is up by another 20% after a jump of 104% this year.*

(107) *\$150 million for residential development and \$20 million for commercial development from the Home Ownership Fund and the Development Loan Fund respectively (see f.n. (116) below).*

(108) *\$100 million from the Mass Transit Fund.*

(109)	1977-78	1976-77
Residential	(acres)	(acres)
Residential/commercial } .....	88	37
Commercial		
Industrial .....	34	99
	122	136

(3) *Draft Expenditure Estimates*

(a) *General*

118. The total of the forecast submissions for recurrent expenditure in 1977-78 came to \$6,160 million. This figure of \$6,160 million was adjusted upwards for the 1976 salaries revision (for the returns were prepared before the revision was announced) and downwards as a result of Finance Branch examination<sup>(110)</sup>. So a figure of \$6,400 million emerged<sup>(111)</sup>. Unavoidable commitments in respect of maintaining present services, expanding these to meet increased demand at existing standards and extending them, within approved policies where timing had been specifically agreed, came to \$6,110 million. Thus the submissions contained proposals for recurrent expenditure on new services in 1977-78 costing \$290 million, that is to say the difference between the returns of \$6,400 million and the figure which was derived on the basis of unavoidable commitments of \$6,110 million.

119. Heads of Departments were then advised to prepare their Draft Estimates submissions for unavoidable commitments on existing services within the figure of \$6,110 million which, as it happens, was approximately 80% of the estimate then before me of recurrent revenue. The limits within which departments were advised to prepare their submissions were provisional only: they were still subject to Finance Branch scrutiny and there was still a possibility of Heads of Departments being invited to submit subsidiary estimates in respect of new proposals<sup>(112)</sup>.

120. Having regard to the outturn for 1976-77, on the one hand, and the likely size of the capital account in 1977-78, on the other hand, I took the view that some \$200 million could be afforded for new proposals in 1977-78<sup>(113)</sup>. Following advice from the Chief Secretary's Committee as to the priority to be accorded to new proposals, certain departments were invited to submit subsidiary estimates for the high priority proposals for new services caught within the figure of \$200

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(110) *Reductions and corrections were made for unrealistic assumptions about recruitments, inadequate allowance for previous spending performance, arithmetic errors, wrongful inclusion of new proposals, etc.*

(111) *See the table in f.n. (85) above.*

(112) *Appendices V—VI referred to in the circular at Annex (3).*

(113) *C.f. 1976-77 when the figure was \$80 million.*

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million. The total of both departments' main estimates based on the provisional acceptable levels of expenditure previously given to them and their subsidiary estimates came to \$6,344 million. After Finance Branch processing, the final figure which emerged was \$6,236 million.

121. The Finance Branch took as their starting point for the preparation of the estimates of capital expenditure the guideline figure of \$2,190 million<sup>(114)</sup> which I suggested last year would be acceptable<sup>(115)</sup> and assumed that no adjustment was necessary to update this figure to April 1977 prices<sup>(116)</sup>. This guideline figure envisaged expenditure of \$1,910 million on the two Public Works Programme components of the capital account and \$280 million on all other components of the capital account. Having regard to the spending capability of the Public Works Department and the Housing Authority in relation to projects on hand, the Finance Branch took the view that no more than \$1,500 million would be required for the two Public Works Programme components leaving \$690 million, if required, for all other capital expenditure<sup>(117)</sup>. Eventually, \$1,464 million was inserted in the Draft Estimates for the two Public Works Programme components and \$545 million for all other capital expenditure, a total of \$2,009 million.

122. So the Draft Estimates for 1977-78 provide for total expenditure of \$8,245 million. This represents an increase of \$1,402 million, or 20.5% over the revised estimate for 1976-77 of \$6,843 million. It may be compared with the increase of 13.4% in 1976-77 (revised estimate) and 1% in 1975-76 (and is no less than a 77.5% increase on expenditure in 1973-74). In real or constant price terms the increase budgeted for in 1977-78 is roughly 15%, compared with 8% in 1976-77 (revised estimate) and about 1% in 1975-76 (and is no less than a 38% increase on expenditure in 1973-74).

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(114) *C.f. the figure of \$2,750 million in the table in f.n. (85) above which includes' \$280 million for the Home Ownership Scheme (construction costs and land) and \$560 million for capital expenditure other than the two Public Works Programme components of the capital account.*

(115) *See f.n. (88) above.*

(116) *For the reason implied in paragraph 72 above.*

(117) *This view was endorsed by the departments concerned and the Public Works Priorities Committee and noted by the Public Works Sub-Committee of Finance Committee at the Second Review when approving new items and upgradings within the Public Works Programme.*



*(b) Recurrent (main components)<sup>(118)</sup>*

123. The provision for expenditure on recurrent services is \$6,236 million, including \$100 million for additional commitments of an unavoidable nature arising during the year<sup>(119)</sup>. This represents an increase of \$835 million, or 16%, over the revised estimate for recurrent expenditure over 1976-77 of \$5,401 million.

124. Personal emoluments and allowances (but not on-costs) at \$2,421 million account for 39% of recurrent expenditure, compared with \$2,160 million or 40% in 1976-77 (revised estimates), and an average of 41% over the previous three years. I think we should take 40% as a guideline for personal emoluments, but whether improved productivity will enable us to control increases in the approved establishment of the public service as successfully in the future as in the recent past remains to be seen<sup>(120)</sup>.

125. Departmental other charges<sup>(121)</sup> at \$991 million have been kept to 15.9% of recurrent expenditure, compared with \$851 million or 15.8% in 1976-77 (revised estimates), and an average of 16.9% over the previous three years. I consider that departmental other charges ought to be kept at or below 16% of total recurrent expenditure and if it can be it will reflect a continued concern of departments with cost efficiency.

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*(118) That is to say:*

*Personal emoluments*  
*Departmental other charges*  
*Public Works Recurrent*  
*Recurrent subventions (including UPGC)*  
*Pensions*  
*Defence*  
*Public debt*  
*Miscellaneous*

*See Annex (5).*

*(119) Head 50 Miscellaneous Services Subhead 100 Additional commitments.*

*(120) Over the three years ending 31st March 1975 the approved establishment of the civil service increased from 104,896 to 114,306, or by 9%, but in the last two years through to 31st March 1977 it has grow only by a further 3,189 posts or by 2.8%. This reflects, in part, the virtual standstill on the creation of new posts during 1975-76. In 1977-78, whilst the provision in the personal emoluments subheads allows for new posts probably required, the posts themselves are not shown in the Draft Estimates for they have yet to be approved by Finance Committee. The number involved is likely to be 3,500.*

*(121) That is, all recurrent expenditure other than personal emoluments, Public Works Recurrent, recurrent subventions, defence, pensions, interest and service charges on the public debt and miscellaneous services.*

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126. Public Works Recurrent expenditure<sup>(122)</sup> at \$360 million accounts for 5.8% of recurrent expenditure, compared with \$319 million or 5.9% in 1976-77 (revised estimates), and an average of 6.5% over the previous three years. I doubt whether anything less than 6% of recurrent expenditure is adequate to maintain our various assets intact and operate the various services covered by this component of recurrent expenditure adequately.

127. Recurrent subventions (including UPGC) at \$1,589 million will absorb 25.5% of total recurrent expenditure, compared with \$1,407 million or 26% in 1976-77 (revised estimates), and an average of 26.6% over the previous three years. Overall, taking recurrent and capital subventions together, more than a fifth of total Government expenditure is disbursed by subvented organizations and it is for this reason that a new branch in the Audit Department was set up this year specifically to cover subvented organizations, and the Director of Audit will be taking a very close look at all the larger organizations within the next couple of years<sup>(123)</sup>.

128. Our contribution to the cost of the Armed Forces stationed here will be \$281 million or 3.4% of total expenditure in 1977-78<sup>(124)</sup>, compared with 3.2% in 1976-77 (revised estimates) and 1.6% in the last year of the previous agreement (1975-76).

(c) *Capital* (main components)<sup>(125)</sup>

129. The provision for capital expenditure is \$2,009 million made up of \$833 million for the Public Works Programme, other than New Towns and Housing, \$631 million for New Towns and Housing and

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(122) *That is, all expenditure connected with the maintenance of Government assets and the operation of various services such as water supply, sewage works, quarries, street lighting, etc.*

(123) *The possibility of establishing a Public Accounts Committee is also being considered: see Annex (6).*

(124) *The Defence Costs Agreement provides for the Hong Kong Government's share of the total cost (recurrent and capital) of the agreed garrison of  $4\frac{1}{3}$  major units, as recalculated from time to time by reference to measures of inflation, to be 50% in 1976-77,  $62\frac{1}{2}$ % in 1977-78 and 75% thereafter.*

(125) *See Annex (5).*

\$545 million for all other components<sup>(126)</sup>. This latter figure includes \$88 million for capital subventions for education and medical services (up by no less than \$37 million on the revised estimate for 1976-77 of \$51 million, and well in excess of the guideline figure of \$45 million); and \$158 million for departmental special expenditure (up by \$69 million on the revised estimate for 1976-77 and, again, well in advance of the guideline figure of \$85 million. The reason for this is that, with expenditure on the two Public Works Programme components down on the guideline figures, we are taking the opportunity of updating our stock of equipment).

(126)	<i>Component</i>	<i>Guideline figure (*) (\$ million)</i>	<i>Draft Estimates 1977-78 (\$ million)</i>	<i>c.f. Revised Estimates 1976-77 (\$ million)</i>
(1)	<i>Public Works Programme (other than New Towns and Housing)</i> .....	1,000	833(**)	765
(2)	<i>Public Works Programme (New Towns and Housing including transfers to the Development Loan Fund for on-lending to the Housing Authority)</i> .....	910	631(***)	409
(3)	<i>Subventions</i> .....	45	88	51
(4)	<i>UPGC</i> .....	60	57	41
(5)	<i>Departmental Special Expenditure</i> .....	85	158	89
(6)	<i>Defence Costs Agreement:</i>			
	<i>capital works</i> .....	30	28	17
(7)	<i>Home Ownership Fund</i> .....	—	103	—
(8)	<i>Miscellaneous</i> .....	<u>60</u>	<u>111(***)</u>	<u>70</u>
		<u>2,190</u>	<u>2,009</u>	<u>1,442</u>

(\*) *At April 1976 prices, but not adjusted.*

(\*\*) *Under present accounting arrangements that part of expenditure on two projects met from loans from the Asian Development Bank amounting to \$26 million in 1977-78 is not included here (see Memorandum Note on Head 59 Public Debt, paragraphs 2 - 3 on page 416 of the Estimates).*

(\*\*\*) *Not including \$123 million being the commitment entered in Head 50 Miscellaneous Services Subhead 357 Payment to Development Loan Fund for on-lending to the Housing Authority which may or may not be required depending on the available assets in the Fund (see paragraph 77 above).*

(\*\*\*\*) *Public debt repayments and reprovisioning of Victoria Barracks and RAF Kai Tak.*

[THE FINANCIAL SECRETARY] **Appropriation Bill—second reading***(d) Pattern of expenditure (broad trends)*<sup>(127)</sup>

130. In recent years, through the Green Pages in the printed Estimates, the Finance Branch has prepared an analysis of General Revenue Account (and Consolidated Account) expenditure on a functional basis. I think the time has come when I should draw attention to certain developing trends, now that expenditure has grown from \$2,300 million in 1970-71, to \$4,700 million in 1973-74 and to \$8,300 million in 1977-78 and we have every confidence that, apart from a change of pace from time to time, our developing policies and programmes can be implemented. I do not see such an analysis as a control weapon<sup>(128)</sup>, but simply as a means of assessing the balance of expenditure between the main groups of services.

131. The pattern of expenditure provided for in the Draft Estimates for 1977-78 is as follows: general services (including law and order)<sup>(129)</sup> will absorb 20.2% of total expenditure: economic services<sup>(130)</sup> 8.2%; community services<sup>(131)</sup> 20.3%; social services<sup>(132)</sup> 39.3% (and remember that, additionally, housing is financed outside the General Revenue Account from the Housing Authority's own resources); and finally all other services<sup>(133)</sup> will absorb 12% of total expenditure in 1977-78.

132. Over the three years 1973-74 to 1975-76 the pattern was rather different<sup>(134)</sup> with general services absorbing only 16% of total expendi-

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(127) See Annex (7).

(128) C.f. for example, the guideline for the proportion of recurrent revenue absorbed by recurrent expenditure in order to safeguard the financing of the capital account.

(129) Administration, law and order, defence, public relations, revenue collection, financial control.

(130) Primary products, airport and harbour, commerce and industry, communications, statistics, land and survey, Royal Observatory, miscellaneous subventions.

(131) Transport, roads and civil engineering, water, fire services, amenities and related services.

(132) Education, medical and health, housing, social welfare, labour.

(133) Launches and dockyard, printing, supplies, common supporting services such as E & M Office and BOO, quarters, passages, telephones, telegrams, public debt, pensions and gratuities.

(134)		%
	General services .....	16
	Economic services .....	9
	Community services .....	26
	Social services .....	39
	Other .....	<u>10</u>
		<u>100</u>

ture, but community services absorbing as much as 26%, largely because expenditure on water development projects peaked in those years.

133. In 1976-77, the pattern shifted again, with increased expenditure on law and order pushing the share of total expenditure absorbed by general services up from 16% to nearly 20%; and the share absorbed by community services declined to 21%<sup>(135)</sup>.

134. Given the increases in expenditure provided for in the Draft Estimates for 1977-78, the pattern of expenditure by groups of services is not in my view, at all, unsatisfactory, but we must not be complacent about the cost of general services and the various services in the residual group, for we must maximise our efforts in respect of economic, community and social services<sup>(136)</sup>.

(e) *Expenditure by selected services*<sup>(137)</sup>

135. That is the broad picture. I shall now spell out the Government's intentions in certain areas in the coming year and how they are provided for in the Draft Estimates. And here, Sir, if I may, I would just like to interpolate that the Estimates really do have two functions: on the one hand, they comprise, should they be approved by this Council, a series of authorities for expenditure; and, on the other hand, they reflect the Government's intentions and so any underspending against the various authorities, except for good reason, reflects failure to put those intentions into effect.

(i) *Law and order*

136. The Draft Estimates provide for expenditure of \$952 million on law and order services in 1977-78, compared with the revised estimate

(135)				%	
	<i>General services</i>	.....		19.8	
	<i>Economic services</i>	.....		8.5	
	<i>Community services</i>	.....		21.0	
	<i>Social services</i>	.....		39.6	
	<i>Other</i>	.....		<u>11.1</u>	
				<u>100.0</u>	
(136)					
			%	\$ million	% increase on Revised Estimates 1976-77
	<i>General services</i>	.....	20.2	1,670	24
	<i>Economic services</i>	.....	8.2	680	17
	<i>Community services</i>	.....	20.3	1,670	16
	<i>Social services</i>	.....	39.3	3,243	20
	<i>Other</i>	.....	<u>12.0</u>	<u>982</u>	<u>30</u>
			<u>100.0</u>	<u>8,245</u>	<u>20.5</u>

(137) *Recurrent and capital expenditure.*

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for 1976-77 of \$791 million. This represents 11.5% of total expenditure in 1977-78, compared with 11.6% in 1976-77 (revised estimate), and an average of 10.1% over the three years 1973-74 to 1975-76.

137. Last year I referred to the concentration of effort on law and order, and to the Government's intention of reducing crime<sup>(138)</sup>. It is encouraging to note that the number of violent crimes appears to be falling for the second consecutive year<sup>(139)</sup>, and the growth rate of serious crimes generally also seems to have been contained<sup>(140)</sup> with the help of increased manpower<sup>(141)</sup>. A sustained effort is essential in 1977-78 if we are to reduce crime further and the Government intends to employ additional resources to this end.

138. The Police Force will cost us \$658 million in 1977-78 \$658 million are the total expenditure on law and order services of \$952 million. This figure of \$658 million represents an increase of \$110 million, or 20%, over the revised estimate for 1976-77 of \$548 million, and is accounted for mainly by our intention to create some 1,400 additional posts and to maintain the Force at or near full strength<sup>(142)</sup>. If these posts are approved, the establishment of the Force will exceed 21,800, men and women an increase of more than 2,500 posts over the establishment approved in the 1976-77 Estimates.

(138) *B.S., 1976, paragraph 113.*

(139) 1974-75: 19,820  
1975-76: 17,663  
1975-76 (first 10 months): 14,847  
1976-77 (first 10 months): 13,383

(140) *Reported crimes (excluding minor offences):*

	%
1971-72: 32,713 .....	—
1972-73: 34,975 .....	+7
1973-74: 43,595 .....	+25
1974-75: 57,015 .....	+31
1975-76: 58,318 .....	+ 2.3
1975-76 (first 10 months): 48,318	
1976-77 (first 10 months): 51,205	

(141) 1975-76 establishment in disciplined ranks ..... 16,215  
Strength in disciplined ranks at 1st January 1976 ..... 15,131  
1976-77 establishment in disciplined ranks (including posts authorized during the year) ..... 17,111  
Strength in disciplined ranks at 1st January 1977 ..... 16,244

(142) *The majority of the new posts are to provide the Commissioner of Police with additional manpower for new police stations, reinforcement of CID and new specialized operational squads.*

(ii) *Housing*

139. In the three years 1973-74 to 1975-76 the Public Works Department, the Housing Authority and the Housing Society completed accommodation for 229,000 persons. Additionally, by the end of 1976-77 accommodation for a further 72,000 persons will have been provided. Over the next four years, 1977-78 to 1980-81, accommodation for a further 770,500 persons is expected to be completed, representing two and a half times the addition to the housing stock in the four years 1973-74 to 1976-77. Work on further estates will be in progress at the end of 1980-81 for completion in subsequent years<sup>(143)</sup>. So we can expect that, by 1984, adequate housing will be available to meet a very large proportion of the community's needs. The figures I have just given include an estimate of 10,500 flats, providing accommodation for about 52,000 persons, to be built by the Housing Authority under the Home Ownership Scheme (Phases I and II).

140. During 1977-78, the Housing Department estimates that it will spend about \$302 million on the Housing Authority's existing building programme for rented accommodation, of which about \$175 million, or nearly 60%, will be met from borrowings from the Development Loan Fund, and the balance from the Authority's own funds. The Public Works Department will continue construction work on those estates on which planning had already started when the new Housing Authority was formed<sup>(144)</sup> as from 1st April 1973 and the Public Works Department expects to spend \$131 million on these estates during 1977-78. But the Draft Estimates envisage, over and above this sum,

(143)

<i>Year</i>	<i>Accommodation completed for the rented programme (persons)</i>	<i>Accommodation to be provided under the Home Ownership Scheme (persons)</i>
<i>1973-74 (actual)</i> .....	<i>50,000</i>	—
<i>1974-75 (actual)</i> .....	<i>68,600</i>	—
<i>1975-76 (actual)</i> .....	<i>110,300</i>	—
<i>1976-77 (estimated)</i> .....	<i>72,100</i>	—
<i>1977-78 (estimated)</i> .....	<i>108,700</i>	—
<i>1978-79 (estimated)</i> .....	<i>154,200</i>	—
<i>1979-80 (estimated)</i> .....	<i>236,100</i>	<i>35,950</i> (Phase I)
<i>1980-81 (estimated)</i> .....	<i>219,100</i>	<i>16,450</i> (Phase II)
<i>1981-82 (estimated)</i> .....	<i>235,900</i>	<i>33,000</i> } (Sub-
<i>1982-83 (estimated)</i> .....	<i>240,900</i>	<i>31,250</i> } sequent
<i>1983-84 (estimated)</i> .....	<i>216,300</i>	<i>32,000</i> } phases)
<i>1984-85 (estimated)</i> .....	<i>193,200</i>	<i>32,000</i> }

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the expenditure of \$96 million on community facilities to ensure balanced development<sup>(145)</sup>.

141. Last year I announced the Government's intention of augmenting the public housing programme by building an additional 30,000 flats for sale to provide accommodation for 180,000 persons<sup>(146)</sup>. The intention was to sell these flats only to persons already living in housing estates, so as to make room for others more in need of low-rent accommodation to move into. Subsequently, the emphasis shifted to the promotion of home ownership as a desirable social objection in its own right and, at the end of July, a working party was set up with three tasks. The first was to co-ordinate the efforts of the various departments involved in planning the production of flats for sale; the second was to work out a practical scheme (or schemes) of mortgage facilities; and the third was to decide how, and by whom, such a scheme (or schemes) should be managed.

142. The first task has been completed. Sites with a potential capacity on development of 35,000 flats or so have been identified and the Government is now proceeding with the first phase of an initial building programme of 7,200 flats on five of these sites. The Housing Authority has agreed to be the Government's agent for designing, building and selling the flats. To finance the construction of these flats, the Home Ownership Fund was established by Resolution of this Council on 5th January last. Construction of the 7,200 flats will begin within the next few months, and so the Draft Estimates for 1977-78 provide for the transfer, from General Revenue into the Home Ownership Fund, of an initial sum of \$102.5 million<sup>(147)</sup>.

143. As regards the second and third tasks: when moving the Resolution to establish the Home Ownership Fund, I said that suitable

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(145)

<i>Estates</i>	<i>Housing Authority (\$ million)</i>	<i>Public Works Department (\$ million)</i>
<i>Urban areas</i> .....	178.9	73.2
<i>New Towns</i> .....	110.7	58.1
<i>Community facilities</i> .....	<u>11.8</u>	<u>95.7</u>
	<u>301.4</u> (*)	<u>227.0</u> (**)

(\*) *Of which \$175 million will be met from borrowings from the Development Loan Fund.*

(\*\*) *Financed wholly from General Revenue.*

(146) *B.S., 1976, paragraph 132.*

(147) *The Fund will have to be topped up during the year to enable the Authority to pay land premia on at least some of the five sites.*



mortgage arrangements for assisting would-be purchasers to acquire flats were still being worked out. A Home Ownership Scheme has now been devised to assist house-holds whose monthly income does not exceed \$3,500 and who, additionally, satisfy certain other criteria of eligibility, to become home owners. These households will be able to buy flats at cost, under certain conditions of sale, instead of at open market value and the Government is arranging a package of suitable mortgage facilities to enable them to meet the debt repayments.

144. Before we reach the stage of inviting applications from members of the public to participate in the Scheme, I mention towards the end of this year it will be necessary for the Housing Authority to price the flats, to work out the procedures and conditions for selling them and to make adequate conveyancing arrangements. The Working Party will need to enter into formal negotiations with banks and other financial institutions to determine under what conditions and to what extent they would be prepared to provide suitable mortgage finance<sup>(148)</sup>. When we reach the stage where these arrangements are being finalised, the Government will need to appoint a central agency of some kind to vet applications for mortgage loans.

145. I should add that the Working Party proposes to launch an experimental joint venture scheme to establish the extent to which real estate developers are willing and able to be associated with the Government's efforts to promote home ownership by building suitable flats at acceptable prices on sites provided by the Government.

146. Last year I spoke at some length about the problem which the Housing Authority has to face in reconciling, on the one hand, the need for rents to cover all costs, somehow defined and, on the other hand, the means of its tenants<sup>(149)</sup>. This problem has been examined over the past few months and, as a result, the Government has in mind putting to the Authority a package of revised financial arrangements which would have three main objectives: first, to relieve the Authority of its inordinately large debt liability to the Government which it is quite unable to discharge, and to give it a rational capital base; secondly, to ensure that the Authority can discharge its statutory obligation to meet recurrent expenditure on its estates from rent income and premia for commercial tenancies; and, thirdly, to permit the Authority to be more flexible in determining rents, having regard to

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(148) *The Working Party will also have to prepare draft legislation for the establishment of a Government mortgage institution to tap other sources of funds in the event that lending institutions are unable to meet the total requirement for mortgage finance.*

(149) *B.S., 1976, paragraphs 139 - 143.*

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tenants' ability to pay, to rents in the private sector and to such factors as location and the quality of the accommodation.

147. But, having removed the discipline implied in the obligation on the Authority to determine rents on an historical cost basis, it would be reasonable to expect the Authority to devise a management system to monitor its financial performance over time.

(iii) *Education*

148. The Draft Estimates provide for expenditure of \$1,658 million on education in 1977-78<sup>(150)</sup> made up of \$1,507 million for recurrent expenditure by the Education Department, on subventions and by the University and Polytechnic Grants Committee and \$151 million for capital expenditure<sup>(151)</sup>. The revised estimate for 1976-77 is \$1,453 million. The figure of \$1,658 million represents 21.8% of total expenditure in 1977-78, compared with 21.2% in 1976-77 (revised estimate) and an average of 20.5% over the three years 1973-74 to 1975-76.

149. The Government's policy on primary education is to provide a Government or aided place for every child of primary school age (6 - 11). This objective is already more than provided for. On the

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(150) *Of the total expenditure of \$1,658 million, \$704 million will be spent on primary education, \$466 million on secondary education, \$32 million on technical education, \$352 million on the universities and the Polytechnic and \$104 million on administration, educational television, examinations, further education, the inspectorate, recreation and sports and student fare subsidies.*

(151)	<i>Recurrent</i>	<i>\$ million</i>
	<i>Education Department</i> .....	249.9
	<i>Subventions: Education</i> .....	935.2
	<i>UPGC</i> .....	294.6
	<i>Student fare subsidies</i> .....	<u>27.3</u>
		<u>1,507.0</u>

	<i>Capital</i>	<i>\$ million</i>
	<i>Government-built schools including technical institutes (PWNR)</i> .....	28.7
	<i>Subventions: Education</i> .....	60.5
	<i>UPGC</i> .....	57.0
	<i>Departmental Special Expenditure</i> .....	<u>4.3</u>
		<u>150.5</u>

Note: *additionally, some \$32 million is expected to be drawn in 1977-78 as loans from the Development Loan Fund to assist in the financing of new school buildings in the aided and private sector, and for loans to students at the universities, the Polytechnic and the Baptist College.*

basis of the 1971 Census, the number of children of primary school age will be 500,000 by the end of the current financial year. Taking no account of vacant classrooms the number of places available in Government and aided primary schools at 621,000 is well in excess of the number in the age group. Estimated total enrolment at 537,000 in Government and aided schools and 85,000 in private schools also exceeds the number in the age group for a variety of reasons<sup>(152)</sup>.

150. This is not to say that new primary schools will not be opened, for the Government's aim is to ensure that no child will have to travel an unreasonable distance to attend primary school. With the shift of population to the New Towns and other developing areas, it will be necessary to provide a substantial number of new places in these areas and the Draft Estimates envisage that some 12,240 new places will be so provided. In the meantime, the general strategy of balancing the opening of new schools, or additional classes in existing schools, in areas of shortage with closures elsewhere will continue to be applied, so that there will be in fact an overall net reduction of some 96 classes during 1977-78. The Education Department will, of course, continue to look after the interests of serving teachers in the aided sector through the placement service which has been operating over the past two years.

151. The Draft Estimates seek to provide a further 3,700 places in special schools and special classes during 1977-78 to bring the total up to 15,870 by September 1977. Although this is still some way from the approved target of 18,400 places, special education is a difficult field. Accordingly, the Draft Estimates make provision for reductions in some class sizes, for improving teacher: class ratios to recognize the problems of teaching handicapped children, for providing promotion prospects for teachers similar to those in ordinary schools and for introducing allowances for teachers in recognition of their qualifications in special education.

152. Turning now to the continuing expansion of secondary education: last year the Government decided that all Primary 6 leavers in 1978, and thereafter, wanting secondary education would be able to obtain a Form I place in the public sector. Thus the SSEE is being held for the last time this year. The measures employed to achieve this rely heavily on buying places already existing in private schools and exhausting the possibilities of voluntary flotation in existing Government and aided schools. Accordingly, the Draft Estimates make provision

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(152) *It is permissible to repeat one year and enrolment can be at any age between 6 and 8 years of age. The Director of Education has set up a working party within the Education Department to look at the problems of over-age children and repeaters.*

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for increasing the number of Form I places in 1977-78 in the public sector from 63,300 at the present time to 74,500 in 1977.

153. Last year, Sir, I said that these measures must be recognized as temporary and that, consistent with the quality objectives of the 1974 White Paper on Secondary Education, new schools must be built and equipped<sup>(153)</sup>. To this end, 31 school projects (including the conversion of primary schools) were started during 1976-77 and approval has been given further to augment the Secondary Schools Building Programme by starting 15 projects during 1977-78 and another 26 thereafter. Under this programme it is expected that 32 schools will be completed during 1977-78, with a further 46 completed by September 1981<sup>(154)</sup>. So, by 1983, all the Forms I—III places in these schools will be fully operational<sup>(155)</sup>.

(153) As a further means of improving quality, ETV has been introduced for Form I classes in 1976-77. The Draft Estimates provide for a total of 318 programmes to be produced in 1977-78, including remakes for primary schools and the extension of ETV into Form II, at a cost of about \$7 million in recurrent expenditure. The production of programmes will be phased as follows:

	1976-77	1977-78	1978-79
Primary: re-makes .....	120	120	120
Secondary: new programmes .....	64	166	150
	(Form I)	(Form II)	(Form III)
Secondary: Re-makes .....	—	32	64
		(Form I)	(Form I-II)
	<u>184</u>	<u>318</u>	<u>334</u>

(154)

Year	Building Starts		Building Completions					
	No. of projects		1976-77	1977-78	1978-79	1979-80	1980-81	1981-82
Before 1976-77 .....	11	2(*)	6	—	—	—	—	—
During 1976-77 .....	31	—	23	6	2	—	—	—
To start in 1977-78 .....	15	—	3	6	6	—	—	—
To start after 1977-78 .....	26	—	—	—	9	13	4	—

(\*) Three projects were completed in 1975-76.

(155)

Type of School	Present Programme (Forms I-III places)	White Paper (Forms I-III places)
Government and aided schools, with flotation/extended day and including prevocational/secondary modern schools	139,160	118,040
Bought places .....	<u>86,385</u> (*)	<u>117,560</u> (*)
Total .....	<u>225,545</u>	<u>235,600</u>

(\*) The White Paper estimate of 235,600 places is based on the 12-14 age group in 1983. The estimate of 225,545 under the present programme is based on the number of Primary 6 leavers and is subject to adjustment, as necessary, in the light of changes in demand.

154. As regards the number of places in Forms IV and V, the White Paper proposed that there should be places for 40% of the 15 - 16 age group<sup>(156)</sup>. A working party of officials on senior secondary and tertiary education is now looking at the whole question of education beyond Form III and will be reporting later in the year. Meanwhile, for children wishing to proceed beyond Form III, the Draft Estimates provide for an additional 1,500 places in Forms IV and V, increasing the total number of such places to 39,500 by September 1977. There will also be an increase of about 1,300 places in Form VI to bring the total number of such places in the public sector to 11,200.

155. In September 1977 total enrolment in technical institutes is expected to be the equivalent of about 4,520 full-time students, an increase of 2,200 over September 1976. This includes a fourth technical institute, at Cheung Sha Wan, which is expected to open in September 1977 with an initial intake of 720 full-time students. Work on a fifth institute at Kowloon Tong will begin during 1977-78.

156. At the tertiary level the Government aims to achieve targets of 8,850 students at the universities and 9,850 full-time equivalent students (including evening students) at the Polytechnic by 1977-78<sup>(157)</sup>. With the current quadrennial and biennial arrangements for the universities and Polytechnic respectively coming to an end in mid-1978, the University and Polytechnic Grants Committee has been asked to make proposals for triennial grants to achieve targets of 10,330 students at the universities and 11,400 full-time equivalent students at the Polytechnic by 1980-81. Thus bringing the planning period for the Universities and the Polytechnic in line with an own planning periods. The Committee hopes to make proposals to the Government in the second half of 1977.

(iv) *Medical and health*

157. The Draft Estimates provide for expenditure of \$781 million on medical services in 1977-78, compared with the revised estimate

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(156) *The White Paper estimated a requirement of 69,800 places in Forms IV — V, representing 40% of the 15-16 age group in 1983. The present programme provides for 58,480 places, equivalent to 34% of the 15-16 age group in 1983.*

(157) *Within the grants included in the draft Estimates, the universities will actually be able to enrol 8,950 students in September 1977, thus exceeding the target by 100. At the Polytechnic, the number of full-time equivalent students (including evening students) enrolled in September 1977 is expected to be 9,850, compared with 7,760 in September 1976. In terms of the actual numbers of day and evening students, these figures become 8,812 and 18,819, compared with 6,813 and 12,720 in September 1976.*

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for 1976-77 of \$662 million. This represents 9.5% of total expenditure in 1977-78, compared with 9.7% in 1976-77 (revised estimate) and an average of 9.5% over the three years 1973-74 to 1975-76.

158. Provision has been included for implementing the first stage of the regionalization scheme for the administration of medical and health services. The scheme will facilitate the transfer of patients between hospitals and thus improve the utilization of beds and other hospital facilities. To enable such transfers to be made, it will be necessary to introduce the new standard charge of \$5 a day for third-class maintenance in all Government and subvented hospitals included in the scheme. To this end provision has been made to bring the Pok Oi and Buddhist Hospitals on to a full deficiency grant basis so that their charges may be brought into line.

159. Funds will be available in 1977-78 to support a pilot scheme for community nursing. This important service has been pioneered by certain voluntary agencies with some success and it is appropriate that support should now be given from public funds. The pilot scheme will be assessed by the Medical Development Advisory Committee during the next three years with a view to formulating plans for the development of this service.

160. Planning will continue in 1977-78 on the Sha Tin Hospital and, with the help of the University and Polytechnic Grants Committee, on the new Medical and Dental Schools. Consideration will also be given to the building of a new blood collection and transfusion centre, and the Medical Development Advisory Committee will be giving further thought to the need for a third nurses training school<sup>(158)</sup>.

(v) *Social welfare*

161. The Draft Estimates provide for expenditure of \$433 million on social welfare<sup>(159)</sup> in 1977-78, compared with the revised estimate for 1976-77 of \$368 million. This represents 5.2% of total expenditure in 1977-78, compared with 5.4% in 1976-77 (revised estimate) and an average of 4.4% over the three years 1973-74 to 1975-76.

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(158) *Building work will continue on the MacLehose Dental Centre, to provide facilities for a dental nurses training school and a dental clinic for school children; on the psychiatric wing of the Princess Margaret Hospital; and on the extension to the Caritas Medical Centre, to mention but three major projects.*

(159) *Defined to include the Social Welfare Department, social welfare subventions, certain miscellaneous subventions and the Legal Aid Department.*

162. The provision in 1977-78 for recurrent expenditure is \$425 million. Estimated recurrent expenditure on social security, at \$280 million, accounts for nearly two-thirds of this provision, and represents an increase of \$39 million over the revised estimate for 1976-77<sup>(160)</sup>. In the 12 months ending 30th November 1976 public assistance cases declined by a net 10%, from 55,500 to 50,100<sup>(161)</sup>. I would have expected a further net decline in public assistance cases during 1977-78, but for the extension of public assistance eligibility to young persons aged 15 to 17 who are unemployed family members, and to able-bodied unemployed adults between 18 and 55 who, having resided in Hong Kong for over two years, have been out of work for a month. This extension will come into effect on 1st April 1977.

163. Disability and infirmity cases, on the other hand, increased during the year ending 30th November 1976 by over 10%, from 63,700 to 70,700; and a further increase is expected in 1977-78, largely because of the increasing number of applicants for infirmity allowances for which all persons aged 75 and over are eligible. Provision has been made for an average monthly caseload during 1977-78 of 74,700.

164. The provision for recurrent expenditure in 1977-78 on social welfare also includes \$68 million for subventions, an increase of 22% on 1976-77 (revised estimate)<sup>(162)</sup>.

(160)	<i>Type of Relief</i>	<i>Revised Estimates 1976-77 (\$ million)</i>	<i>Draft Estimates 1977-78 (\$ million)</i>
	<i>Compensation for victims of crimes</i>		
	<i>of violence</i> .....	1.8	1.8
	<i>Emergency</i> .....	0.6	0.5
	<i>Disability and infirmity allowances</i> .....	90.0	97.7
	<i>Public assistance</i> .....	<u>148.2</u>	<u>180.0</u>
	<i>Total</i> .....	<u>240.6</u>	<u>280.0</u>

(161) *There was a decline of 4,300 cases (33.7%) giving, as their reasons for application, unemployment and low earnings and the number of such cases is expected to decline further. The main increase over the same period has been in the category giving "old age" as the reason for application and, even here, the increase has been only 697 cases (or 2.4%).*

(162) *Social welfare subventions are, of course, allocated by the Director of Social Welfare on the advice of the Social Welfare Advisory Committee, but I envisage that in 1977-78 the provision will make possible the subvention of an additional 1,000 places in day nurseries; an improvement in the standards in subvented day nurseries and in day and residential creches to meet the requirements of the Child Care Centres Ordinance; and the bringing on to subvention of 14 additional training centres, sheltered workshops and homes for the blind, the deaf, the physically handicapped and the mentally retarded.*

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165. Last year I suggested that a review should be carried out to establish where the need for continuing to expand social services, apart from cash payments, truly lies<sup>(163)</sup>. Such a review is now being conducted in respect of proposals for the elderly and for preventive social work among young people. It has already been done in respect of rehabilitation services for the disabled. A review of our social security programmes is also to be carried out and will cover not only administrative questions, but also the extent to which vulnerable groups in the community should be further assisted with cash payments. In this connection, I personally would like to suggest that some priority should be given to lowering the age limit of eligibility for infirmity allowances.

(vi) *Communications*

166. In the field of transport and communications there are two studies which have major implications for public investment over the next few years.

167. The first is the Comprehensive Transport Study which was completed in November 1976 after three years' work and at a cost of \$10 million. The purpose of the study was to forecast the future demand for, and supply of, transport facilities for both passengers and freight over the next 15 years. A White Paper on transport policy is now being drafted in the light of the consultants' findings. The implications for capital expenditure could be of the order of \$12,000 million<sup>(164)</sup>.

168. The second study, which is about to start, concerns the long term future of the Kowloon-Canton Railway. Meanwhile, the facilities on the existing Railway are being improved. To facilitate double tracking the entire track will be reballasted<sup>(165)</sup> in stages, and construc-

(163) *B.S., 1976, paragraph 159.*

(164) *Approximately \$5,800 million of this is for the Modified Initial System of the Mass Transit Railway (of which \$1,100 million has already been spent), and a further \$3,000 million could be committed to an extension of the system to Tsuen Wan; a sum of around \$2,000 million is likely to be required on major road projects; and capital investment of some \$1,500 million is contemplated for the modernization and expansion of the Kowloon-Canton Railway.*

(165) *Head 69 PWRN: Engineering Subhead 678. Approved project estimate: \$11.2 million; anticipated expenditure to 31st March 1977: \$0.4 million; Draft Estimates for 1977-78: \$1.6 million.*



tion of a new tunnel through Beacon Hill will begin in 1977-78<sup>(166)</sup>. Work on the KCR/MTR interchange station at Kowloon Tong is in an advanced stage of planning<sup>(167)</sup>. Construction work is progressing satisfactorily on a new marshalling yard at Lo Wu to facilitate the receipt and despatch of goods wagons to and from China<sup>(168)</sup>.

169. At Kai Tak, the terminal building and landing facilities are being improved. The extension of the terminal building will be substantially completed in 1977-78<sup>(169)</sup>, and work on modernizing the existing terminal building has begun<sup>(170)</sup>, while supporting facilities, including freight handling, are being augmented.

170. The highways construction programme will regain momentum in 1977-78, I hope with contracts on a number of major projects having been let in 1976-77. Expenditure is estimated to be \$255 million in 1977-78, compared with the revised estimate for 1976-77 of \$215 million, and expenditure on highway are expected to grow to some \$460 million by 1980-81. Within the provision of \$255 million for 1977-78, \$88 million will be spent specifically on roads associated with the development of the three New Towns.

(vii) *New Towns*

171. We are all well aware of the large sums of money being spent on the public housing estates in the New Towns; but it is easy to lose sight of the large sums being spent on the infrastructure that goes with them. This infrastructure comprises the formation of land for both public and private development, the provision of roads, services and water supplies and the building of community facilities. During 1976-77 \$297 million will have been spent on such works in the New Towns and the Director of New Territories Development expects to

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(166) *Head 69 PWRN: Engineering Subhead 680.*

*Approved project estimate: \$52 million; anticipated expenditure to 31st March 1977: nil; Draft Estimates for 1977-78: \$8.1 million.*

(167) *Kowloon-Canton Railway—Mass Transit Railway interchange station at Kowloon Tong is a Category B item in the Public Works Programme. Order of cost: \$28 million.*

(168) *Head 69 PWRN: Engineering Subhead 673.*

*Approved project estimate: \$10.7 million; anticipated expenditure to 31st March 1977: \$3.6 million; Draft Estimates for 1977-78: \$1.5 million.*

(169) *Head 68 PWRN: Buildings Subheads 450 - 451.*

*Approved project estimate: \$178 million; anticipated expenditure to 31st March 1977: \$98 million; Draft Estimates for 1977-78: \$18 million.*

(170) *Head 68 PWRN: Buildings Subheads 456 and 458.*

*Approved project estimate: \$53 million; anticipated expenditure to 31st March 1977: nil; Draft Estimates for 1977-78: \$2 million.*

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spend about \$457 million in 1977-78. Comparable figures for the market towns and rural townships are \$7 million in 1976-77 and \$43 million in 1977-78.

172. The amount of land formed in the New Territories in 1976-77 will total 119 acres, of which 22 acres will be for industry. In 1977-78, 264 acres will be formed, including 47 acres for industrial use. In the market towns and rural townships only 8 acres will have been formed in 1976-77 but, in 1977-78, 114 acres will be formed of which 5 acres will be industrial land. (This does not include incidentally the Tai Po Industrial Estate where a total of 79 acres of industrial land will have been formed by March 1978). At the same time, the package concept will ensure a balanced build-up of all necessary facilities at each stage in the development of these communities<sup>(171)</sup>.

173. The emphasis on development in Tsuen Wan New Town will still be on the provision of more land in Tsing Yi and on the development of community facilities in the old town. The development of Sha Tin New Town is less advanced, and the emphasis there will still be on the provision of land and basic engineering services to permit further development. A unique feature of the development of Sha Tin New Town is the substantial involvement of private developers who are forming large areas of land for the Government. In return, the developers will retain some of the land they have formed. Engineering development works will continue to be given prominence in Tuen Mun New Town, where development on Stage IB<sup>(172)</sup> will be well under way this year, with investigations continuing into the subsequent development of Stage II<sup>(173)</sup>.

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(171) *Anticipated population of the New Towns and Market Towns by 1980-81:*

	<i>31st March 1977</i>	<i>31st March 1981</i>
<i>Tsuen Wan</i> .....	<i>593,000</i>	<i>727,000</i>
<i>Sha Tin</i> .....	<i>60,000</i>	<i>231,000</i>
<i>Tuen Mun</i> .....	<i>51,000</i>	<i>166,000</i>
<i>Market Towns</i> .....	<u><i>135,000</i></u>	<u><i>170,000</i></u>
	<u><i>839,000</i></u>	<u><i>1,294,000</i></u>

(172) *Head 70 PWRN: New Towns and Public Housing Subheads 853 - 859. Approved project estimate: \$181 million; anticipated expenditure to 31st March 1977: \$43 million; Draft Estimates 1977-78: \$40 million.*

(173) *Head 70 PWRN: New Towns and Public Housing Subhead 860. Approved project estimate: \$13.7 million; anticipated expenditure to 31st March 1977: \$6.6 million; Draft Estimates 1977-78: \$3.9 million*

(4) *Revenue Proposals*(a) *Introduction*

174. The difference between my estimate of revenue of \$8,412 million shown in the Revenue Estimates as printed and the Draft Estimates of Expenditure amounting to \$8,245 million is \$167 million<sup>(174)</sup>. Effectively, this means that in 1977-78 I am budgeting for a balance between revenue and expenditure, a year earlier than I thought possible when presenting this year's budget<sup>(175)</sup>. Last year I anticipated being back in balance in 1978-79, possibly with the help of additional revenue which might arise from the implementation of some of the recommendations of the Third Inland Revenue Ordinance Review Committee<sup>(176)</sup>.

175. I do not propose today to discuss the Committee's valuable report for we are, at this very time, studying it with care and in depth. As I explained in this Council on 16th February last<sup>(177)</sup> the Government's views on the Committee's recommendations will take a little time to be formulated.

(b) *Charges*

176. But as there will always be a tendency for recurrent expenditure to absorb too large a proportion of recurrent revenue—in 1977-78 on the basis of the Estimates just presented, the proportion will be 83.4% as they were always be these tendency. I would like to dwell briefly on the importance of fees and charges in our fiscal system. In

(174) *Despite the fact that 83.4% of recurrent revenue has to be ear-marked for recurrent expenditure (c.f. guideline of 80%) there is an overall surplus because capital revenue covers 47% of capital expenditure, viz:*

	\$ million	\$ million
<i>Revenue:</i>		
<i>Recurrent</i> .....	7,474	—
<i>Capital</i> .....	<u>938</u>	<u>8,412</u>
<i>Expenditure:</i>		
<i>Recurrent</i> .....	6,236	—
<i>Capital</i> .....	<u>2,009</u>	<u>8,245</u>
<i>Overall surplus</i> .....		167
<i>Surplus on recurrent account</i> .....		1,238
<i>Deficit on capital account</i> .....		1,071

(175) *B.S., 1976, paragraph 217.*

(176) *For a summary of the Committee's recommendations, see Annex (8).*

(177) *See Annex (9).*

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1977-78 they will contribute only 21.4% of total recurrent revenue compared with 22.2% in 1976-77 (revised estimate) and 22.8% in 1975-76. So we must not relax our efforts to update fees and charges whether they are just cost-related, or contain a loading to earn a return on capital employed, or include a surcharge to reflect a royalty payment for a monopoly privilege<sup>(178)</sup>.

177. When introducing a differential pricing system for domestic consumers of water in 1975-76<sup>(179)</sup> I said that a revision of the present flat rate charge of \$4 a thousand gallons for non-domestic consumers could not be long delayed<sup>(180)</sup>. Technical difficulties prevented the introduction of a differential pricing system for non-domestic consumers in 1976-77, but these have now been overcome<sup>(181)</sup>. So I am now in a position to propose such a system and also amend the present differential pricing system for domestic consumers by subdividing the top bracket who pay \$6 a thousand gallons in excess of 14,000 gallons in a four-month billing period.

178. However, I do not intend to do so yet for the notional commercial accounts of the Waterworks Authority will show an accumulated surplus of \$49 million at 31st March 1977. It is true this is largely brought forward from 1974-75 and 1975-76 when the Authority earned surpluses of \$22 million and \$40 million, compared with a mere \$100,000 surplus in 1976-77. It is also true that, on present charges, there might well be a deficit as high as \$85 million converting the accumulated surplus of \$49 million at 31st March 1977 into an accumulated deficit at 31st March 1978 of \$36 million. This accumulated deficit of \$36 million, which is very possible at the end of the coming financial year, I expect to rise to \$300 million by 31st March 1981. There can be no question, therefore, of a revision of water charges being delayed indefinitely for, taking one year with another, the Authority must pay its way.

(a) *Tax concessions*

179. I said, Sir, a few moments ago that I was effectively budgetting for a balance, but I think I would be doing so even if I proposed certain tax concession and I would feel justified in doing so if the case for each

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(178) B.S., 1975, paragraph 121.

(179) B.S., 1975, paragraphs 141 - 151.

(180) B.S., 1975, paragraphs 152 - 153.

(181) B.S., 1976, paragraph 199.

of them was made out on grounds of equity or simplicity of administration or having regard to certain social considerations. Accordingly, I have four set of proposals for honourable Members' consideration.

(i) *General Rates*

180. The first concerns rates, a subject which, in recent months, has received considerable public attention and criticism. This criticism has largely stemmed from a misunderstanding about the different roles played, on the one hand, by the rates charges, expressed as percentages of rateable values and, on the other hand, by the rateable values themselves; and a good deal of misleading and at times quite malicious comment has led to further confusion.

181. Rateable values represent the value to the occupier of the premises occupied. While they are derived from open market rentals, they do not, in practice, necessarily correspond to actual rentals, for actual rentals are a measure of the benefit derived from the property by the landlord, rather than the occupier. For example, the actual rental may be artificially restrained, or it may be excessive, or there may be no rental at all, as in the case of owner-occupiers. It is only by assessing rateable values on the same basis for all premises that we can apportion fairly the rates burden.

182. Thus a reassessment of rateable values has two objectives: first, to ensure that rateable values are kept up-to-date having regard to open market rentals, so that they remain an effective tax base; and secondly, to ensure that relative changes in values between different premises are taken fully into account, so that the incidence of the tax remains fairly distributed. To achieve these objectives, it is clearly necessary for rateable values to be reassessed at regular intervals. Such reassessments, or revaluations, are the responsibility of the Commissioner of Rating and Valuation, who is charged by the Rating Ordinance to assess rateable values in accordance with its provisions. The law provides for appeals against assessed rateable values to be dealt with by the Lands Tribunal, a special appellate tribunal set up to adjudicate in valuation matters. It is no part of a revaluation exercise as such to increase or decrease rate revenue; that is a matter for this Council when determining the rates percentages.

183. In line with the policy of achieving a steady growth in General Rate revenue, it was possible to reduce the rate percentage for 1973-74 since a fairly substantial increase in rateable values resulted from the 1972 revaluation. A further revaluation was planned for 1974 but, for a variety of reasons, it was necessary to postpone this exercise. So in order to maintain a steady growth in revenue in the absence of a

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reevaluation, the General Rate percentage for 1975-76 was increased by 2 percentage points to 11%<sup>(182)</sup>. For 1976-77 it was increased by a further 1 percentage point to 12%, though I made it clear on that occasion that, fully to restore the benefit to the revenue, would have necessitated an increase of  $4\frac{1}{2}$  percentage points<sup>(183)</sup>. The revaluation having been carried out, at last, in 1976, it became necessary to consider the General Rate percentage to determine at what level it should be fixed for 1977-78. Having regard to what I had said previously in this connection<sup>(184)</sup>, I believed that ratepayers would appreciate that, in view of the greatly increased values established by the revaluation, the General Rate percentage would be reduced.

184. Although the point was again clearly made prior to the despatch of notices of the new rateable values in December 1976, there was widespread public concern at the magnitude of the increases in rateable values<sup>(185)</sup>. In order to allay that concern, and despite the fact that the budget for 1977-78 was barely beginning to take shape, I felt obliged to make a prior statement on 5th January last<sup>(186)</sup>. I said that, subject to this Council making the necessary Resolution under section 18 of the Rating Ordinance, the General Rate percentage in the urban areas of Hong Kong, Kowloon and New Kowloon would be set at  $7\frac{1}{2}$ % for 1977-78 as opposed to the present 12%<sup>(187)</sup>. I added that the General Rate percentage for the New Territories would be adjusted in a way comparable to that proposed for ratepayers in the urban areas.

185. To do this would result in a percentage for 1977-78 of  $11\frac{1}{4}$ % for the New Territories<sup>(188)</sup>. I now propose that the General Rate percentage for Area D that is to say (Tsuen Wan/Kwai Chung) for 1977-78 should be set at 11% and, therefore, the corresponding General Rate percentage for the seven additional areas<sup>(189)</sup> brought into assessment from 1st April 1976 will be 7%<sup>(190)</sup>.

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(182) *B.S., 1975, paragraph 106.*

(183) *B.S., 1976, paragraph 186.*

(184) *B.S., 1974, paragraph 182.*

(185) *See Annex (10).*

(186) *See Annex (4).*

(187) *See Annex (11).*

(188) *General Rate percentage for urban areas: 12% to  $7\frac{1}{2}$ %, for the New Territories: 18% to  $11\frac{1}{4}$ %.*

(189) *Yuen Long, Tai Po, Sha Tin, Tuen Mun, Clear Water Bay Road, Luen Wo Market/On Lok Tsuen and Shek Wu Hui.*

(190) *60% of the full General Rate, rounded up to the nearest 0.5%: see B.S., 1976, paragraph 187.*

186. I estimate that the total yield from the General Rate for 1977-78, applying these percentages to the new rateable values, will be \$767 million. This is the figure shown in the Revenue Estimates as printed and represents an increase of 24% over the revised estimate for 1976-77<sup>(191)</sup>.

187. Since 1st April 1973 the urban areas have been charged the Urban Council Rate in addition to the General Rate. This was done by splitting the then General Rate percentage into two, the Urban Council Rate of six percentage points and the General Rate of nine percentage points, the latter being subsequently increased to the present 12%. The Urban Council Rate at 6% was calculated to yield sufficient revenue to meet the Council's budgetted net expenditure in 1973-74 (that is to say the Council's gross expenditure less income from fees and charges). This percentage rate, together with interim valuations, has yielded sufficient revenue for the Council's net expenditure since then. Given the new rateable values resulting from the 1976 revaluation, the Council has recommended, and the Government is accordingly proposed, that the Urban Council Rate be set at 4%, as opposed to the present 6%.

188. The total rates payable in the urban areas in 1977-78 will then be  $11\frac{1}{2}\%$  of rateable values (that is to say  $7\frac{1}{2}\%$  General Rate, plus 4% Urban Council Rate), compared with the present 18% (that is to say 12% General Rate, plus 6% Urban Council Rate). In other words, the General Rate percentage of 12% will be reduced by 37.5%, and the Urban Council Rate 6% will be reduced by 33.3%. With these reduced percentage rates some 75,000 ratepayers, that is, about 1 in 6, will pay less in 1977-78 than in 1976-77. Reductions will be enjoyed by a proportion of ratepayers in most classes, but particularly by those in small flats, shops and miscellaneous commercial premises, and factory and storage premises. There will be reductions for ratepayers in some 1,000 or so pre-war premises.

189. A motion asking this Council to make a Resolution under Section 18 of the Rating Ordinance giving effect to these proposals will be put to this Council on 31st March 1977. This means that demand notes for the second quarter will have to issue a few days later than usual.

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(191) *The estimate for 1977-78 includes the effect of bringing in Phase IV of the extension of rating in the New Territories from 1st April 1977. This phase comprises a number of small extensions to the Phase III areas, plus one new area at Sai Kung. The extension areas will come into assessment at 7%, but Sai Kung, being a new area, will come in at 50% of the full General Rate percentage, that is 5.5%. Estimated revenue in 1977-78 from these Phase IV areas is \$1.5 million.*

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190. When I announced the proposed reduction in the General Rate percentage on 5th January last, I referred to the possible need for a scheme of relief for pre-war rent-controlled premises, and certain other classes of ratepayers, who may be particularly affected by the revaluation of their premises.

191. As the revaluation has resulted in a substantial increase in rateable values for some premises in a number of classes, I am satisfied that it would be equitable to provide relief in all cases where the increased rates payable in 1977-78 are substantially above those payable in 1976-77. I wish to propose, therefore, a scheme of relief to cushion the impact of these increased rates. Such a scheme in on way invalidates the revaluation itself, but simply has regard to the social effects of a sharp and unexpected change.

192. My proposal is that, irrespective of increases in rateable values, the rates payable by a ratepayer in 1977-78 should not increase by more than  $33\frac{1}{3}\%$  of the rates paid by him in 1976-77, and the rates payable by a ratepayer in 1978-79 should not increase by more than  $33\frac{1}{3}\%$  of the rates paid by him in 1977-78<sup>(192)</sup>. This should deal with the generality of cases and, indeed, after 1977-78, there are likely to be only a few thousand cases left which would be in need of further relief.

193. There has, in fact, been a change in the basis of assessment of pre-war rent-controlled premises. Previously, rateable values of pre-war rent-controlled premises were based on the controlled rents paid. In the 1976 revaluation they were correctly assessed without regard to the fact that rents are controlled. For pre-war rent-controlled premises, therefore, I propose that the relief scheme should continue after 1978-79 for so long as it takes to bring total rates up to the full charge which, in a few extreme cases, may be about seven or eight years. Thus, in each successive year, the amount actually payable will not exceed by more than  $33\frac{1}{3}\%$  the amount payable in the immediately preceding year<sup>(193)</sup>.

194. In addition, methods of valuation are constantly being examined and updated and, on this occasion, this has resulted in fairly substantial increases in rateable values for certain types of premises. So I have asked the Commissioner of Rating and Valuation to consider

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(192) See Annex (12).

(193) See Annex (13).



the implications of the reassessed rateable values for such premises. Without entering into any commitment whatever at this time, as I am not in fact very sympathetically with these cases, if a proper case exists, I would be prepared to consider whether or not further relief might be desirable for such premises after 1978-79.

195. The scheme of relief will apply to premises assessed for rates in 1976-77 and then only so far as such premises about it to think which is a very important point exist physically at the end of the year<sup>(194)</sup>. Amendments to the Rating Ordinance to give effect to the scheme will be introduced into this Council in due course but, meanwhile, a Revenue Protection Order will be necessary to give effect to the scheme for the second quarter of 1977. I must make it clear, Sir, that the scheme will operate by reference to total rates payable, but the revenue foregone will be at the expense of the General Rate, not the Urban Council Rate. The Council will receive the full amount of the 4% Urban Council Rate proposed for 1977-78. In 1977-78 over 100,000 ratepayers will enjoy some relief under the scheme proposed and about 12,000 in 1978-79, leaving only some 8,000 per-war rent-controlled premises in 1979-80.

196. As I said earlier, with the General Rate percentage fixed at  $7\frac{1}{2}\%$  for the urban areas and 11% for the New Territories, I expected the General Rate yield to increase by about 24%. The proposed scheme of relief will cost some \$46 million in the first year. Revenue from General Rates in 1977-78 is, therefore, now put at \$721 million, that is, an increase of 16.8% only over the revised estimate for 1976-77, compared with an average annual increase of 18.7% over the four years 1973-74 to 1976-77.

197. All this means for the generality of ratepayers, the average increase in rates payable for 1977-78 will be about 15%. On average, the revised rates in 1977-78 will mean only a very small increase in the total cost of accommodation: the increase will be between 1.17% and 2.31% of market rentals, inclusive of rates, for the bulk of post-war domestic units.

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(194) *The Commissioner of Rating and Valuation will adjust the charge where alterations, amalgamations and so on take place, to give effect to this scheme. In the case of pre-war rent-controlled premises and certain other premises he will, where necessary, also apportion or consolidate 1976-77 assessments to provide a corresponding reference point for determining the measure of relief.*

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(ii) *Personal taxation*

198. Last year, Sir, I explained why it had been necessary to retain the 10% surcharge on the standard rate of profits tax paid by corporations and why a further one-half percentage point was being added to bring the rate to 17%<sup>(195)</sup>. The situation has not changed and so this difference of two percentage points between the rate of corporation profits tax and the standard rate of profits tax is to be retained.

199. Last year I also considered whether there was anything which could be done to reduce the tax liability of those at the lower end of the schedular system of salaries tax (and personal assessment) and to reduce the number of small taxpayers coming into the direct tax net<sup>(196)</sup>. But I came to the conclusion that to do anything would be too expensive in terms of revenue. Since then the number of persons coming into the tax net at the lower end of the scale has continued unabated. For instance, the number of active salaries tax files will be approaching 290,000 by the end of this financial year and the number of persons actually liable to salaries tax for the year of assessment 1975-76 is likely to be in excess of 230,000. Of those already processed, 62% had assessable incomes of less than \$30,000 per annum, but contributed only 9.5% of total tax collectible. Many of these assessments will be for exceedingly small amounts, so small indeed that it is an open question whether they are worth assessing and collecting<sup>(197)</sup>. I believe myself the staff involved could be employed more productively on other duties.

200. Accordingly, the Commissioner of Inland Revenue and I have, after further consideration, manage to formulate a proposal which will have the effect of removing 45,000 small taxpayers from the tax net, keeping out a further 10,000 who would otherwise become liable for provisional tax for the year of assessment 1977-78<sup>(198)</sup> and bringing some relief to salaries (and personal assessment) taxpayers in the lower and middle income ranges. This proposal will not be as expensive in terms of foregone revenue as some of the ideas I considered last year.

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(195) *B.S., 1976, paragraphs 174 - 177.*

(196) *B.S., 1976, paragraphs 181 - 182.*

(197) *For example, of those processed so far for the year of assessment 1975-76 (final tax), no fewer than 23,000 taxpayers paid (or will pay) an average of \$53 in salaries tax and a further 54,000 an average of \$212.*

(198) *And, therefore, for final tax 1977-78.*

201. My proposal is to retain the basic personal allowance of \$10,000 for a single person and \$20,000 for a married person, but to supplement each with an allowance of \$2,500 and \$5,000 respectively, which will be reduced by 20% of the amount by which the taxpayer's income exceeds the supplemented basic allowance until the point is reached where the entire supplement disappears. (*laughter*). It is a very generous scheme! In other words, for every dollar of income in excess of \$12,500 in the case of a single person and \$25,000 in the case of a married person, 20 cents of the supplementary allowance will be recovered, or clawed back, until the allowance is eliminated and the taxpayer simply enjoys the basic personal allowance of \$10,000 or \$20,000 as the case may be<sup>(199)</sup>.

202. This proposal avoids the objection to across-the-board or non-reducing increases in the basic personal allowances, namely, that they would be extremely expensive. If such increases were, say, \$2,500 and \$5,000 respectively, the effect would be felt by the band of taxpayers paying tax at marginal rates as high as 30%. Thus there would be a reduction in the effective rate of tax being paid at the upper end of the schedular system where the effective rate is clearly not excessive.

203. Honourable Members will note that the 2:1 relativity between the allowances for married persons and single persons has been maintained. Honourable Members will also be glad to hear that at Annexes (14) and (15) to the printed version of this speech I have set out examples of how the supplementary basic allowances will operate and their effect on specimen incomes. In absolute terms, taxpayers with incomes of about \$3,000 per month will receive the greatest benefit.

204. Concurrently with this proposal for supplementary basic allowances, I propose to introduce some relief to persons with families. As this will not be so expensive in terms of revenue, there will be no need to provide for a claw-back. I propose, therefore, that the allowance for the first child should be increased from \$3,000 to \$4,000; for the second child from \$2,500 to \$3,000; and for the third child from \$1,500 to \$2,000. The ratio between the allowances for the first four children would become, therefore, 4:3:2:1. The allowances

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(199) For example, a single person earning up to \$12,500 will no longer pay salaries tax. A single person earning, say, \$16,000 will receive a basic personal allowance of \$10,000 plus a reduced supplementary allowance of \$1,800. This latter figure represents the supplementary allowance of \$2,500 reduced by 20% of \$3,500, i.e. \$700. The figures of \$3,500 is arrived at by subtracting the supplemented basic allowance of \$12,500 from the taxpayer's income. Thus the supplementary allowance will be eliminated when the single person's salary reaches \$25,000 and when the married person's salary reaches \$50,000.

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for the fourth to sixth child will remain at \$1,000 each and for the seventh to the ninth child at \$500 each. Examples of the tax effect on specimen incomes of the increased child allowances, taken in conjunction with the effect of the supplementary basic allowance are set out very clearly in Annex (14) to the printed version of this speech.

205. The supplemented basic allowances and the increased child allowances will be effective for provisional salaries tax for the year of assessment 1977-78. I considered making them effective for final salaries tax (and for personal assessments also) for the year of assessment 1977-78 only<sup>(200)</sup>. But I concluded this would be inconsistent with the philosophy behind provisional tax<sup>(201)</sup>. So they will be effective for final salaries tax and for year of assessment 1976-77 as well.

206. The cost to the revenue in the financial year 1977-78 of these two proposals will be \$64 million<sup>(202)</sup>; and, for the same group of taxpayers, and assuming their incomes are unchanged, the cost will be \$38 million in 1978-79 when only one set of additional allowances—on provisional tax for 1977-78—will be involved<sup>(203)</sup>. The number of salaries taxpayers and potential salaries taxpayers<sup>(204)</sup> benefiting from

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(200) *Provisional tax does not apply to personal assessment.*

(201) *And would certainly require the Inland Revenue Ordinance to be amended to permit the allowance to be calculated separately, because provisional tax is computed on the assumption that net chargeable income (income less allowances) will be the same as for the preceding year.*

	<i>\$ million</i>
(202) <i>Supplementary basic allowances for final 1976-77 salaries tax .....</i>	22
<i>Improved child allowances for final 1976-77 salaries tax .....</i>	13
<i>Personal assessment for 1976-77 .....</i>	3
<i>Supplementary basic allowances for provisional 1977-78 salaries tax and increased child allowances, less <math>\frac{1}{4}</math> payable in 1978-79 .....</i>	<u>26</u>
	<u>64</u>

*\$ million*

(203) *Supplementary basic allowances for provisional 1978-79 salaries tax and increased child allowances, less  $\frac{1}{4}$  payable in 1979-80.....* 26

*Plus: cost of new allowances in respect of the second instalment of tax payable carried forward from 1977-78, say .....* 9

*Personal assessment for 1977-78 .....* 3

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(204) *Potential salaries taxpayers are salary earners becoming liable for provisional tax for the year of assessment 1977-78 for the first time.*

these increases will be about 192,000 altogether. Of these about 55,000 will be completely removed from the salaries tax net. The number of personal assessment taxpayers affected will be about 18,000 and 5,000 will be removed from the tax net completely<sup>(205)</sup>.

(iii) *Stamp duties*

207. No budget speech would be complete without some reference to that rather quaint piece of legislation, the Stamp Ordinance, and so my third set of revenue proposals involves, first, the elimination of five archaic heads from the Schedule to the Ordinance at a cost of only \$30,000, (*laughter*) but the legal and financial professions will be spared some inconvenience<sup>(206)</sup>.

208. And, secondly, as a further earnest of the Government's intention to promote home ownership, I propose that the concessionary rates of duty on conveyances of low value properties provided for under Head 19(1) of the Schedule, should apply to properties of \$100,000 and \$175,000 respectively, compared with \$75,000 and \$150,000 at present<sup>(207)</sup>. That is to say, on properties up to \$100,000 only the fixed charge of \$20 will be levied and on properties up to \$175,000 the *ad valorem* rate of 1%. The cost to the revenue in 1977-78 will be \$12 million<sup>(208)</sup>.

209. At the same time, these new platforms will have to be extended to Head 53(1), voluntary dispositions *inter vivos*; and, also, I propose to remove the anomalous bias against the gift element in voluntary dispositions *inter vivo*<sup>(209)</sup> at a total cost to the revenue of \$3 million.

210. This lifting of the platforms by  $33\frac{1}{3}\%$  and  $16\frac{2}{3}\%$  respectively means that, at present day prices 80% of all residential properties will be affected, compared with 70% affected by the present platforms. A Revenue Protection Order will make these concessions effective from 1st April.

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(205) *C.f. number of persons opting for personal assessment in 1975-76 of about 22,000.*

(206) *Head 7, Agreement of Service with a Corporate Body  
Head 17, Compradore Note  
Head 33, Letter of Allotment  
Heads 35 and 51, Assignment of Letters Patent and Trade Marks.*

(207) *B.S., 1973, paragraph 93.*

(208) *Including the cost of marginal relief.*

(209) *At present it is only the consideration for the property sold which qualifies for the concessionary rate of duty, whilst the so-called gift element suffers the full  $2\frac{3}{4}\%$  ad valorem duty.*

[THE FINANCIAL SECRETARY] **Appropriation Bill—second reading**(iv) *Estate duty*

211. Last year, after defending the role of estate duty in our fiscal system, I stretched the Schedule to the Estate Duty Ordinance by three steps and set the top rate at 18% for estates over \$3 million. Estate duty continues to make a most useful contribution to the revenue<sup>(210)</sup>. But I think the exemption limit should be raised from \$300,000 set in 1974 to \$400,000 for the estates of persons dying after the enactment of the necessary legislation. This will also have the effect of making the lower steps in the schedule more logical and will remove from the tax net about 50 estates a year. I also propose that the limit on funeral expenses should be increased from \$5,000 to \$10,000 and the further limitation of  $2\frac{1}{2}\%$  of the value of the estate allowable for funeral expenses should be abolished<sup>(211)</sup>. The cost to the revenue of this, my fourth set of revenue proposals, in a full year will be about \$1.75 million.

(5) *Estimated Outturn for 1977-78*

212. The total cost to the revenue in 1977-78 of these proposals will be about \$127 million, thus reducing estimated revenue to \$8,285 million. As estimated expenditure is \$8,245 million this leaves me with a small surplus of \$40 million. So, effectively, I am still budgetting for a balance.

(6) *Evaluation of Budget in terms of Guidelines*

213. Evaluating now the budget in terms of my guidelines and beginning with the actual structure of the budget<sup>(212)</sup>: although recurrent revenue will finance 89% of total expenditure the relationship between the recurrent account and the capital account does not observe the guidelines. Thus recurrent expenditure absorbs nearly 85% of recurrent, the surplus on recurrent account will finance only 55% of capital expenditure and the ratio of recurrent expenditure to total expenditure is 76%. These are quite serious breaches of the guidelines but, as capital revenue will be so buoyant in 1977-78, financing 47% of capital

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(210) \$84 million in 1976-77 (revised estimate) and an estimated \$90 million next year, the equivalent of 12% and 10% respectively of capital revenue in these years.

(211) As provided for in section 13(1) of the Estate Duty Ordinance.

(212) In terms of the guidelines mentioned in paragraphs 93 - 95.

expenditure, these breaches are acceptable<sup>(213)</sup>. The position must, however, be carefully watched for we simply cannot allow recurrent expenditure to absorb too large a share of recurrent revenue indefinitely.

214. As regards the balance of the fiscal system<sup>(214)</sup>, the Revenue Estimates, as amended by my revenue proposals, show a ratio of direct to indirect taxation of 54.5:45.5 and a ratio of direct and indirect taxation taken together to all other recurrent revenue of 73.3:26.7.

215. Finally, as regards the guideline relating to the size of the public sector<sup>(215)</sup>: the ratio of public expenditure to the GDP this year, 1976-77, will be 16.4%<sup>(216)</sup>. The ratio will rise to 17.6% next year<sup>(217)</sup>. As I said earlier, we must keep a weather eye on this ratio, but this 7.3% increase in the relative size of the public sector in 1977-78 is consistent with the slower growth rate forecast for the economy in 1977 compared with 1976<sup>(218)</sup> and our policy of lifting public expenditure to a rather higher plateau<sup>(219)</sup>.

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(213)	<u>Recurrent revenue</u>	=	<u>\$7,349 million</u>	=	89% (c.f. 88%)
	Total expenditure		\$8,245 million		
	<u>Recurrent expenditure</u>	=	<u>\$6,236 million</u>	=	84.9% (c.f. 80%)
	Recurrent revenue		\$7,349 million		
	<u>Surplus on recurrent account</u>	=	<u>\$1,113 million</u>	=	55.4% (c.f. 60%)
	Capital expenditure		\$2,009 million		
	<u>Recurrent expenditure</u>	=	<u>\$6,236 million</u>	=	75.6% (c.f. 70%)
	Total expenditure		\$8,245 million		
	<u>Capital revenue</u>	=	<u>\$ 936 million</u>	=	46.6% (c.f. 20%)
	Capital expenditure		\$2,009 million		

(214) See paragraph 96 above.

(215) Defined, as in paragraph 97 above, to include all expenditure financed from public funds.

(216) Consolidated Account expenditure at \$7,709 million (\*) = 16.4%  
 Preliminary estimate of GDP at \$47,100 million  
 (\*) Revised Estimates.

(217) Consolidated Account expenditure at \$9,455 million (\*) = 17.6%  
 Forecast of GDP at \$53,700 million  
 (\*) Draft Estimates.

(218) See paragraph 42 f.n. (94) above.

(219) In paragraph 98 above the relationship between public sector expenditure and the GDP at current prices was considered in terms of the average ratio prevailing in two 4-year periods, namely, 1969-70 to 1972-73 and 1973-74 to 1976-77. Another way of looking at the development of the public sector in recent years is to compare the estimated increase in public sector expenditure in 1977-78 over 1973-74, the year which I have tended to use as the base year for most of the statistical comparisons in this speech: thus, whereas GDP in real terms is estimated to increase by 31% between these two years, Consolidated Account expenditure, again in real terms, is estimated to increase by 44% (c.f. paragraph 122 above for the increase in General Revenue Account expenditure in real terms over the same period of 38%. The difference is mainly accounted for by Housing Authority expenditure).

[THE FINANCIAL SECRETARY] **Appropriation Bill—second reading**(7) *Economic Implications of the Budget*

216. The macro-economic implications of the budget can be dealt with very briefly: the General Revenue Account will be in surplus in 1977-78 by \$167 million before allowing for my tax concessions and \$40 million after allowing for them. The Consolidated Account shows a deficit of \$44 million before and \$171 million after allowing for my tax concessions<sup>(220)</sup>.

217. This deficit of \$171 million arises from the Housing Authority's deficit and other small deficits outside the General Revenue account. It will be financed from drawings on the Development Loan Fund and other Hong Kong dollars reserves and will involve transferring Hong Kong dollar deposits from the public sector to the non-bank private sector. This will be inflationary, but obviously only to a very small extent and will be tantamount to the public sector having a neutral impact on the economy in monetary terms. I am sure this is right for 1977-78, particularly after this year's unexpected surplus in the accounts of the public sector of between \$800 and \$900 million which will have had a small deflationary effect<sup>(221)</sup>. Taking the two years together, the effect of the public sector's outturn will help to maintain the external price competitiveness of the economy at a time when it has been operating near full capacity, and when it will continue to do so.

*CONCLUSION*

218. That concludes, Sir, my presentation of the budget for the Year of the Snake. I commend the Draft Estimates of Expenditure and my revenue proposals to honourable Members for their due consideration and now move that the debate on this motion be adjourned.

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(220) *Consolidated Account:*

	<i>\$ million</i>
<i>Expenditure</i> .....	9,455
<i>Revenue</i> .....	<u>9,284</u>
	<u>- 171</u>

*This deficit is made up as follows:*

	<i>\$ million</i>
<i>Housing Authority Urban Council</i> .....	- 150
<i>Development Loan Fund</i> .....	- 67
<i>Lotteries Fund</i> .....	+ 6
<i>General Revenue Account</i> .....	<u>+ 40</u>
	<u>- 171</u>

(221) *See also paragraph 28 above.*



Annex (1)

FORECAST INCREASES IN GROSS DOMESTIC  
PRODUCT AND PRICES, 1977 ON 1976

	<i>Real</i>	<i>Price</i>
	<i>increase</i>	<i>increase</i>
	(%)	(%)
Private consumption expenditure:	+ 10	+ 6
Foodstuffs .....	+ 5	+ 4
Consumer goods .....	+ 12	+ 5
Other goods and services .....	+ 11	+ 8
Government consumption expenditure .....	+ 10	+ 6
Gross domestic price capital formation:	+ 12	+ 12
Building and construction .....	+ 13	+ 15
Plant, machinery and equipment .....	+ 12	+ 9
Exports:	+ 8	+ 8
Domestic exports:	+ 8	+ 8
to US .....	+ 11	+ 6
UK .....	+ 1	+ 8
Germany .....	+ 5	+ 7
Other countries .....	+ 8	+ 10
Re-exports .....	+ 8	+ 8
Imports:	+ 10	+ 8
Foodstuffs .....	+ 6	+ 4
Consumer goods .....	+ 10	+ 5
Raw materials .....	+ 10	+ 10
Fuels .....	+ 7	+ 8
Capital goods .....	+ 12	+ 9
Export <i>less</i> import of services .....	+ 0	
GDP excluding stocks .....	<u>+ 8</u>	<u>+ 7</u>
Increase in stocks .....	- 50	
GDP adjusted for stocks .....	<u>+ 7</u>	<u>+ 7</u>
Consumer Price Index .....	+ 6	

Annex (2)

SUMMARY OF REVENUE AND EXPENDITURE  
1973-74 TO 1977-78

With effect from 1st April 1975 expenditure on services provided by the Government on behalf of the Urban Council and the Housing Authority, comprising mainly personal emoluments and public works non-recurrent projects, and the reimbursements from the Urban Council and the Housing Authority were taken below-the-line. For purposes of comparison, the figures given in the summary in respect of 1973-74 and 1974-75 have been adjusted also to exclude these transactions.

	<i>1973-74</i> <i>Adjusted</i> <i>actual</i> (\$ million)	<i>1974-75</i> <i>Adjusted</i> <i>actual</i> (\$ million)	<i>1975-76</i> <i>Actual</i> (\$ million)	<i>1976-77</i> <i>Revised</i> <i>Estimates</i> (\$ million)	<i>1977-78</i> <i>Draft</i> <i>Estimates</i> (\$ million)
Recurrent Revenue	4,550	5,156	5,843	6,711	7,474
<i>Less</i> Recurrent Expenditure	<u>3,231</u>	<u>4,175</u>	<u>4,450</u>	<u>5,401</u>	<u>6,236</u>
Surplus on Recurrent Account	1,319	981	1,393	1,310	1,238
Capital Revenue	467	437	413(*)	689	938
<i>Less</i> Capital Expenditure	<u>1,413</u>	<u>1,798</u>	<u>1,582</u>	<u>1,442</u>	<u>2,009</u>
Surplus/deficit	<u>373</u>	<u>-380</u>	<u>224</u>	<u>557</u>	<u>167</u>
Total Revenue	5,017	5,593	6,256	7,400	8,412
Total Expenditure	4,644	5,973	6,032	6,843	8,245

(\*) Excluding loans and grants totalling \$264 million credited to General Revenue.

*Annex (3)*

## FINANCIAL CIRCULAR NO. 10/76(\*)

FIVE YEAR FORECAST OF REVENUE AND EXPENDITURE  
1976-77 TO 1980-81*Five Year Forecast Returns*

In connexion with the preparation of the Five Year Forecast of Revenue and Expenditure for the period 1976-77 to 1980-81, Heads of Departments are requested to complete the returns in the form of Appendices I—VII. These appendices are designed to distinguish between—

- (a) the financial implications of maintaining existing activities at the present levels (Appendix I);
- (b) the financial implications of increasing, or reducing, the present levels of existing activities, to accord with changes in demand (Appendix II); and
- (c) the additional cost of extending existing activities, or introducing new activities, depending upon whether—
  - (i) this is within approved policy, with agreed timing, but with no capital works involvement (Appendix III);
  - (ii) this is within approved policy, with an approved capital works involvement, which may be taken to imply an agreed timing (Appendix IV);
  - (iii) this is within approved policy, but without specifically agreed timing (Appendix V); and
  - (iv) this is in respect of new activities for which the policy has not yet been approved (Appendix VI).

2. The completed returns, in duplicate, should reach the Finance Branch, *with a copy* to the appropriate policy Secretary, *not later than 30th June 1976*.

3. The form of the returns has been changed from last year, these changes being necessary to enable more information to be obtained from them to assist in determining priorities, and to help in preparing the Development Plan, work on which is being coordinated by the Management Unit. Towards this end, Heads of Departments

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(\*) This is an abridged version of the original Circular and the Appendices to the Circular are not attached.

are asked to forecast their financial requirements in accordance with the programmes which have been identified and listed in Management Circular No 1/76.

4. On receipt of the returns, the Finance Branch will conduct a detailed examination in consultation with departments and policy branches. Following this, Heads of Departments will be given an indication of the provisional acceptable levels of expenditure in respect of existing activities and new activities for their submissions for the draft Estimates 1977-78. These may have to be changed as the situation develops, but it is hoped that any such change would be a matter of fine-tuning. These provisional acceptable levels of expenditure will be notified by 1st October, when the draft Estimates call circular will issue, and draft Estimates submissions will have to reach Finance Branch not later than 1st November.

5. As Heads of Departments will thus have only one month in which to make their submissions for the draft Estimates *they should start compiling their submissions well before receiving the call circular*, working on the assumption that the levels of expenditure they will be permitted in 1977-78 will be little higher than in 1976-77.

6. It is thus essential that the information given in the Five Year Forecast returns is accurate and realistic, as the information derived therefrom will be used to determine the provisional acceptable levels of expenditure for 1977-78 and the priorities in respect of new activities. Heads of Departments are personally responsible for this, and for ensuring that the appropriate policy Secretary is *fully* consulted.

#### *Acceptable Rate of Expenditure*

7. As regards recurrent expenditure, the total provision in the draft Estimates for the current year is \$5,289 million. The Financial Secretary has indicated that his present view of the acceptable levels of recurrent expenditure at constant prices for the years 1977-78 to 1979-80, on the basis of his present assessment of the growth of the economy, the likely level of recurrent revenue, and on the basis of the guideline of recurrent expenditure not exceeding 80% of recurrent revenue, are \$5,760 million in 1977-78, \$6,280 million in 1978-79 and \$6,860 million in 1979-80. The Financial Secretary has stressed that these figures are tentative.

8. As regards capital expenditure, the Financial Secretary has also indicated tentative acceptable levels, at 1976-77 prices, of \$2,190

million for 1977-78 and \$2,280 million for 1978-79 and 1979-80. These levels have three components—

- (a) the Public Works Programme (other than New Towns and Housing)—\$1,000 million in each year;
- (b) the Public Works Programme (New Towns and Housing)— \$910 million in 1977-78 and \$1,000 million in each of 1978-79 and 1979-80; and
- (c) subventions, the UPGC, departmental special expenditure, the Defence Costs Agreement capital works, and other miscellaneous capital expenditure items— \$280 million in each year.

Leaving aside the two public works programme components, the tentative level of \$280 million for other capital expenditure in each year compares with last year's total departmental forecast submissions of \$396 million in 1977-78, \$340 million in 1978-79 and \$269 million in 1979-80.

#### *Public Works Programme*

9. The Five Year Forecast returns called for by this circular *exclude* direct expenditure on projects in the Public Works Programme, or projects not yet in the Programme but which, in accordance with existing procedures, would if approved require the inclusion of an item in the Programme. The forecast of direct expenditure on the Public Works Programme will be dealt with separately. But the returns must *include* all other expenditure arising from a Public Works Programme project—*e.g.* staff costs and recurrent running expenses. To assist Heads of Departments in preparing their returns, the Director of Public Works will be forwarding to departments tentative completion dates for all projects currently under construction or likely to be started in the current year. A further list giving tentative completion dates for other projects not yet under construction and not scheduled to begin in the current year, but which are likely to be completed within the forecast period (*i.e.* before 1st April 1981) will be issued as soon as possible.

#### *Capital Subventions*

10. In respect of building projects financed by capital subventions, the rate of building will be dependent on the ceiling for capital expenditure already laid down and notified the departments concerned.

*Annex (4)*

STATEMENT BY THE FINANCIAL SECRETARY IN  
LEGISLATIVE COUNCIL ON WEDNESDAY,  
5TH JANUARY 1977

Sir,

Honourable Members will recall that on 3rd December 1975 I made a Statement concerning certain changes in motor vehicle taxes and excise duties in advance of the 1976 Budget Speech. I did this because we were obligated to honour certain undertakings to the US Government in connection with our designation as a beneficiary under the US Generalized Scheme of Preferences. But I combined the changes necessary to honour that undertaking with certain budgetary proposals specifically designed to raise additional revenue. I did this in order both to avoid disrupting the trades concerned twice within a short period and to protect the revenue against possible speculative withdrawals from bonds in the weeks preceding Budget Day, 1976.

With your permission, Sir, I wish to make a similar statement in advance of Budget Day, 1977 which is on 2nd March next. This Statement concerns the General Rate or, if you like, the Government Rate as opposed to the Urban Council Rate, to be set under the Rating Ordinance for 1977-78. I have decided to take this step in view of the evident public concern about the implications for ratepayers of the substantially higher rateable values, ranging from an average of 54% for factories to 158% for large houses, established as a result of the recent revaluation of premises. All ratepayers have now been notified of the new rateable values applicable to their premises. The revaluation was carried out by the Commissioner of Rating and Valuation during 1976 and the new values become effective from 1st April 1977.

Subject to this Council making the appropriate Resolution under Section 18 of the Rating Ordinance, the General Rate in the three urban rating areas of Hong Kong Island, Kowloon and new Kowloon will be set at  $7\frac{1}{2}\%$  as opposed to the present 12%. I have not yet decided what the General Rate should be for the New Territories, where there is no Urban Council Rate in addition to the General Rate, for the Council does not operate there. The present General Rate in the New Territories varies as between Rating Areas and newly rated areas are brought into assessment on a phased basis. But, generally speaking, New Territories ratepayers can expect an adjustment comparable to that proposed for ratepayers in the urban rating areas.

I estimate that the yield from this rate, when applied to the new rateable values, will be of the order of \$770 million, or 25% up on the estimated yield from the present General Rate applied to present rateable values.

In addition, between now and Budget Day, I shall be considering the position of certain classes of ratepayers who may be particularly affected by the revaluation of their premises. I am concerned, for example, about the position of occupiers of pre-war rent controlled premises. The rateable values of their premises have been this time, quite correctly, assessed without regard to the fact that rents are controlled. There may be, therefore, a case for temporarily suppressing the full effect on occupiers of the revaluation of these premises.

This Statement, Sir, is solely concerned to describe the proposals the Government has in mind and to do no more than that. A definitive justification in terms of fiscal and budgetary policy and equitable treatment of ratepayers must await the 1977 Budget Speech.

Annex (5)

SUMMARY OF EXPENDITURE BY MAIN COMPONENTS,  
1973-74 TO 1977-78

The figures in this summary are a breakdown by main components of the total expenditure figure given in Annex (2).

	<i>1973-74</i> <i>Adjusted</i> <i>actual</i> (\$ million)	<i>1974-75</i> <i>Adjusted</i> <i>actual</i> (\$ million)	<i>1975-76</i> <i>Actual</i>  (\$ million)	<i>1976-77</i> <i>Revised</i> <i>Estimates</i> (\$ million)	<i>1977-78</i> <i>Draft</i> <i>Estimates</i> (\$ million)
<i>Recurrent Account</i>					
Personal Emoluments .....	1,336	1,674	1,782	2,160	2,421
Departmental Other Charges .....	498	739	781	851	991
Public Works Recurrent .....	224	263	277	319	360
Subventions .....	742	881	950	1,147	1,295
University and Polytechnic Grants					
Committee .....	159	187	217	260	294
Defence .....	56	60	51	202	253
Pensions .....	117	151	166	213	229
Public Debt .....	3	5	9	27	28
Miscellaneous .....	<u>96</u>	<u>215</u>	<u>217</u>	<u>222</u>	<u>365</u>
Total Recurrent .....	3,231	4,175	4,450	5,401	6,236
<i>Capital Account</i>					
PWP (other than New Towns and Housing) .....	1,148	1,518	759	765	833
PWP (New Towns and Housing) .	—	—	388	409	631
Transfer to DLF .....	—	20	125	—	—
Transfer to Home Ownership Scheme .....	—	—	—	—	103
Subventions .....	74	68	44	51	88
University and Polytechnic Grants Committee .....	26	37	93	41	57
Departmental Special Expenditure .....	50	79	69	89	158
Defence Costs Agreement: capital works .....	32	38	44	17	28
Public Debt .....	2	2	9	14	24
Miscellaneous .....	<u>81</u>	<u>36</u>	<u>51</u>	<u>56</u>	<u>87</u>
Total Capital .....	1,413	1,798	1,582	1,442	2,009
Total Expenditure .....	<u>4,644</u>	<u>5,973</u>	<u>6,032</u>	<u>6,843</u>	<u>8,245</u>



*Annex (6)*

## REPLY BY THE FINANCIAL SECRETARY TO A QUESTION

IN LEGISLATIVE COUNCIL ON WEDNESDAY,  
19TH JANUARY 1977

Sir,

No definite plans have yet been formulated, but considerable thought has been given to the possible terms of reference of a Public Accounts Committee and the practice elsewhere has been researched by the Director of Audit.

I envisage that such a Committee would be a Committee of this Council, with the Director of Audit, the Deputy Financial Secretary, and the Director of Accounting Services in attendance. We have not yet worked out just how such a Committee might fit into our existing constitutional arrangements, but the aim would be to complete the process of this Council's control over the use of public funds which begins with the passing of the Appropriation Ordinance. This would be done first, by, examining the accounts of the Government and possibly those of other organizations financed wholly or partly from public funds. And this would be done, secondly, by enquiring into matters raised by the Director of Audit in his reports to the Government on the accounts which reports are laid before this Council. The Committee would report on its endeavours to this Council.

Annex (7)

SUMMARY OF EXPENDITURE BY GROUPS OF SERVICES,  
1973-74 TO 1977-78

The figures in this summary are a breakdown by groups of services of the total expenditure figures given in Annex (2).

	<i>1973-74</i>	<i>1974-75</i>	<i>1975-76</i>	<i>1976-77</i>	<i>1977-78</i>
	<i>Adjusted</i>	<i>Adjusted</i>	<i>Actual</i>	<i>Revised</i>	<i>Draft</i>
	<i>actual</i>	<i>actual</i>		<i>Estimates</i>	<i>Estimates</i>
	<i>(\$ million)</i>	<i>(\$ million)</i>	<i>(\$ million)</i>	<i>(\$ million)</i>	<i>(\$ million)</i>
General services					
Law and order .....	452	601	637	791	952
Others .....	320	349	349	559	718
Economic services .....	441	533	553	581	680
Community services					
Transport, roads and civil engineering .....	595	716	640	728	963
Water .....	485	629	486	517	434
Others .....	189	308	148	201	273
Social services .....					
Education .....	990	1,145	1,268	1,453	1,658
Medical and health .....	457	560	562	662	781
Housing .....	104	219	439	205	344
Social welfare .....	144	262	352	368	433
Labour .....	13	16	16	20	27
Common supporting services ..	238	318	245	353	393
Unallocable expenditure .....	98	165	168	169	327
Other financial obligations .....	<u>118</u>	<u>152</u>	<u>169</u>	<u>236</u>	<u>262</u>
Total .....	<u>4,644</u>	<u>5,973</u>	<u>6,032</u>	<u>6,843</u>	<u>8,245</u>

*Annex (8)*

REPORT OF THE THIRD INLAND REVENUE ORDINANCE  
REVIEW COMMITTEE

The Third Inland Revenue Ordinance Review Committee was appointed in February 1976 and commenced work in June 1976. It submitted its report to the Acting Governor on 15th December 1976.

2. The terms of reference of the Committee were—

*Having regard to the economic circumstances of Hong Kong which dictate—*

- (a) a comparatively low level of direct taxation;
- (b) that the system at given tax rates should be as productive of revenue as possible;  
and
- (c) that the relevant legislation should be simple and inexpensive to administer;

*To consider the present system of taxation of profits and other forms of income contained in the Inland Revenue Ordinance, and in particular—*

- (a) the system of voluntary aggregation under Personal Assessment;
- (b) the taxation of husbands and wives;
- (c) the treatment of dividends and its relation to the taxation of corporate profits;
- (d) the treatment of interest and the relief for interest paid;
- (e) the territorial ambit of the various charges (having regard, *inter alia*, to the effects of changing commercial practices and recent case law);
- (f) the taxation of benefits in kind;
- (g) the notional basis of the property tax charge;
- (h) the taxation of specific classes of taxpayer, including profits from shipping; and
- (i) the adequacy of existing relief for expenses incurred by businesses and employees.

3. The main recommendations and observation of the Committee are as follows:

A. That the existing system of voluntary personal assessment be replaced by a mandatory system of assessment on total income from salaries, business profits, interest and rent.

4. This recommendation would not in any way extend the totality of the existing charges but would mean that, generally speaking, all persons deriving income of the kind mentioned above would be obliged to file a return of total income and would in due course receive an assessment on total income (paragraphs 29 to 47).

5. The Committee felt that this would—

(a) remove the multiplicity of returns and assessments inherent in the existing system of personal assessment and the heavy expenditure on manpower which this entails and that it would permit the diversion of this manpower to the detection and prevention of evasion (paragraphs 37 and 38);

(b) assist the Investigation Section of the Inland Revenue Department in its work (paragraph 38);

(c) remove certain horizontal anomalies in the present system. These anomalies arise where two taxpayers receiving the same amount of income chargeable to tax pay substantially different amounts of tax (examples are given at paragraphs 39 and 40);

(d) remove the administrative complications inherent in a system which depends on an election being made by the taxpayer (paragraph 44); and

(e) be an essential step towards the introduction of a further degree of progressivity in the rates of tax *should* this be thought necessary (paragraph 46).

B. That the existing system of aggregating a wife's income with that of her husband should continue, but a special allowance should be granted.

6. This would, in effect, be a re-introduction of the working wife's allowance which was repealed in 1973-74. The Committee has recommended that the allowance, which was previously only available in respect of salaried wives, should also apply where wives derive profits from a business or profession (paragraphs 48-66).

7. The Committee felt that any close approximation to a complete separation of the income of husband and wife would result in a consi-

derable loss of revenue and would lead to a relatively higher tax burden for those husbands who are the only income earners of their families (paragraph 59).

8. In recommending the re-introduction of the working wife's allowance, the Committee felt that this would encourage trained married women back into the work force and would also recognize the additional expenditure incurred when both husband and wife are employed. It further recommended that to preserve its relativity the allowance should be set at a fixed percentage of the personal allowance (paragraph 62).

C. That the plan to introduce a Dividend Withholding Tax should be abandoned but that the tax rate on corporate profits should continue to be one or two percentage points higher than the standard rate (paragraphs 67-89).

9. The Committee felt that, as it was hard to decide whether the receipt of a dividend could justly be considered to constitute a separate source of income, it was necessary to examine the proposals for imposing a Dividend Withholding Tax and the related Undistributed Profits Tax. Having done so, it came to the conclusion that—

(a) in the legislation as drafted the need for simplicity and the requirement of equity were in conflict; and

(b) the simpler approach of raising the tax rate on the assessable profits of companies would be just as appropriate when a method is sought to regulate the tax burden on shareholders who are individuals (paragraph 89).

D. That the charge to interest tax should be extended to include in its ambit interest paid by a person carrying on a trade or business here on money borrowed by him or employed or expended in or in connection with the production of the assessable profits of that trade or business (paragraphs 97-102).

10. After considering the various factors which determine where income arises for the purpose of the charge to interest tax and profits tax, and after noting that it has been the tendency to treat the place which the credit is provided to the borrower as the dominant factor, the Committee stated that many of these factors were capable of manipulation and that, if Hong Kong were to subject to tax all significant flows of income which are the result of economic activity in Hong Kong, it would be better served if the charging words were to be extended as recommended. It also thought that apart from

countering tax avoidance this would give effect to correct tax principles.

- E. That in broad terms the existing restriction of the various charges in the Ordinance to income having a Hong Kong source should be maintained but that business profits accruing to a trade or business exercised in Hong Kong, which are not substantially caused by the action of a branch outside Hong Kong should also be brought to charge. This extension of the charge would also apply where the business profits take the form of interest derived by banks and allied institution (paragraphs 106-133).

11. The Committee felt that the existing tests to identify the origin of particular profits have, over the years, been put under considerable strain and that an intermediate category of profits, whilst exempt from Hong Kong tax at present, arises from the existence of business and its management in Hong Kong. It pointed out that the failure of the Hong Kong administration to tax these profits is likely to produce the result that they do not suffer tax anywhere. The Committee felt, therefore, that in including these profits, the double taxation problems feared by its predecessors would not arise (paragraph 120).

12. Examples of the so-called intermediate category are given in paragraph 121. The Committee stated that it did not, as did its predecessors, feel that the extension of the profits tax charge in the way recommended would be inconsistent with the Hong Kong tax structure and, whilst it respected its predecessors' doubts as to whether the extension would be effective, it nevertheless considered that an attempt should be made to extend the profits tax charge.

- F. That the existing treatment for salaries tax purposes of benefits in kind should, with certain minor exceptions, be maintained.

13. This would mean that with the exception of the value of quarters, benefits in kind which cannot be converted into money would remain outside the charge. The Committee found that a systematic exploitation of this tax-free area does not occur on any significant scale and that the practical difficulties of quantifying the benefits should be given great weight. The only extensions which it recommended would reassure those persons who felt that the door was being left open to tax avoidance and would yield a large enough

amount, but would be present in so few cases as to be easy to administer, are:

- (a) cases where the employer meets the cost of electricity, gas and water bills at the employee's residence; and
- (b) cases where the employer similarly meets charges of indoor and outdoor servants (paragraph 142).

14. In considering benefits in kind, the Committee gave its attention to the existing valuation of free quarters supplied by employers and felt that, as the existing percentage (10%) was introduced as recently as 1975, it was not incumbent on it to attempt any reappraisal of the social comparisons which were evaluated in fixing that level.

15. The Committee did, however, make a specific recommendation for overcoming one weakness in the system. This occurs when director-controlled companies avoid or minimise salaries tax on the value of quarters provided to directors by keeping their salaries artificially low and by permitting the directors to take a proportionately large amount of profits by way of dividends (paragraph 143).

- G. That property tax, based as it is on estimated rental values supplied by the Commissioner of Rating and Valuation, should be completely abolished and replaced by including the actual net rent in the aggregated return and assessment mentioned in recommendation A above (paragraphs 145-161).

16. The Committee found that the existing property tax system was neither simple nor efficient and noted the following defects—

- (a) three Government departments were involved in its administration (paragraph 157);
- (b) of the property tax charged, a large proportion is eventually either discharged or refunded each year because of the provisions for relief in the Ordinance (paragraph 157);
- (c) the existing system involved a multiplicity of assessments where property owners owned several properties. This multiplicity also affected the follow-up action of the collection of a tax. The Committee noted that in relative terms the arrears of property tax far exceed the arrears of other taxes (paragraph 157);
- (d) a revenue leak of substantial proportions where revaluations did not occur on an annual basis. It noted that there was already a built-in leak in the system (paragraph 159) because

property tax is based on the estimated net rent on the first day of the year of assessment and in effect, therefore, reflected the income of the *previous* year. This meant that there was a privileged band of taxpayers paying less than the standard rate of tax. These taxpayers were in a particularly favourable position vis-a-vis corporations which pay tax on the actual net rent received during the year; and

- (e) the large number of objections that are currently being generated following the introduction of values which are different from rateable values (paragraph 159).

17. After considering various alternative remedies, the Committee recommended that the actual net rental should be included in the return of total income mentioned in recommendation A above. It noted that, if this was done, the notional attribution of rent which occurs in the case of non-rental producing property, for example, club premises, ancestral properties in the New Territories, second homes occupied as residences *etc.*, would automatically fall away (paragraphs 152-159).

- H. That resident ship-owners should be charged tax on all charter hire with the limited exception of charter hire receivable under general charters (trip or voyage charters) without demise.

18. The Committee admitted that the structure of the ship-owning trade (typical patterns are outlined in paragraph 175) is such that, as long as tax havens exist, even the charging of the whole of a resident's ship-owning profits is unlikely to produce increased revenue. The Committee also accepted that, while it would have liked to see ship-owners contribute more to public revenue, any move to reach these large profits would require detailed and complicated legislation and would probably be counter-productive (paragraph 182). The Committee nevertheless went on to make the specific proposal mentioned above. If accepted, it would no longer be possible for a resident ship-owner to avoid Hong Kong tax by attributing charter hire to a permanent establishment abroad. It also noted in passing that, on the information available to it, nowhere else in the world are the charter hire earnings of a non-resident ship-owner taxed in the country visited by a ship. Thus the existing provisions of the Ordinance were in effect giving the resident Hong Kong ship-owner a tax-free bonus. It followed that, to fall into line with international practice, the existing charge on non-resident ship-owners in respect of charter hire should be abolished. A secondary recommendation in relation to non-resident



ship-owners is that they should be assessed on a fixed percentage of freight *etc.* uplifted in Hong Kong and that this should be a final figure and not a provisional one. This would simplify the administration of Section 23C of the Ordinance (paragraph 190).

- I. That the existing rules regarding deductible expenditure and allowances for capital expenditure should not be altered (paragraphs 220-273).

19. The Committee, however, considered that there should be some relief for payments of lease premia on short term leases of business premises and defined "short term" leases as leases of up to three years. It considered that these payments were more akin to rents in advance (paragraph 270).

*Annex (9)*

STATEMENT BY THE FINANCIAL SECRETARY IN  
LEGISLATIVE COUNCIL ON WEDNESDAY,  
16TH FEBRUARY 1977

Sir,

As I have already informed you in accordance with Standing Order 20(1), I wish to make a statement on the Report of the Third Inland Revenue Ordinance Review Committee which was tabled earlier this afternoon.

The Committee was appointed in February 1976 and commenced work on 15th June. It submitted its report to the Acting Governor on 15th December 1976. The report is the product of six months painstaking work, undertaken at considerable personal inconvenience to the members of the Committee. I would like, therefore, to take this opportunity to thank them publicly for their service to the community.

The Commissioner of Inland Revenue is now studying the technical aspects of the recommendations of the Committee and will be submitting his appraisal to me in about two months' time. I shall then chair a small internal working party which will consider the financial, economic, social and political implications of the Committee's recommendations, taking into account such public comments as may be available to us, with a view to formulating policy recommendations for the further consideration of Your Excellency in Council. The working party is likely to spend about four months on its deliberations. Thereafter, the drafting of any necessary amendments to the law and the reorganization of departmental procedures would take some considerable time, although in theory there is no reason why some of the acceptable recommendations could not be implemented sooner than others.

I should perhaps add that additional copies of the Report in both Chinese and English are now being printed and will be on sale to the public very shortly.

*Annex (10)*

TOTAL RATEABLE VALUES BY MAIN  
POST-WAR CATEGORIES

Figures relate only to premises in valuation lists at 1.4.1976 and do not allow for additions and deletions occurring in 1976-77.

<i>Category</i>	<i>No. of assess- ments in valuation lists as at 1.4.1976</i>	<i>Total rateable value as at 1.4.1976</i>	<i>Equivalent total rateable value for 1977-78 based on average increases</i>
<i>Domestic</i>	(to nearest 100)	(\$, 000)	(\$, 000)
Small tenements .....	107,400	347,862	657,459
Large tenements .....	108,800	440,221	880,442
Small flats .....	76,200	481,048	841,834
Medium flats .....	21,700	264,594	492,145
Large flats .....	7,900	201,589	405,194
Houses .....	1,100	41,424	106,874
<i>Non-domestic</i>			
Ground floor shops .....	46,300	619,955	1,041,524
Commercial premises .....	8,500	386,067	648,593
Offices .....	14,000	333,336	586,671
Flatted factories .....	10,900	443,081	686,776

Annex (II)

COMPARISON OF GENERAL RATE PAYABLE IN  
URBAN AREAS FOR THE YEARS 1976-77 AND 1977-78

Category	1976-77		1977-78		Increase in monthly rate payment
	average rateable value	Monthly rate at 12%	average rateable value	Monthly rate at 7½%	
	(\$)	(\$)	(\$)	(\$)	(\$)
<i>Domestic</i>					
Small tenements .....	3,240	32.40	6,120	38.25	5.85
Large tenements .....	4,050	40.50	8,100	50.63	10.13
Small flats .....	6,360	63.60	11,130	69.56	5.96
Medium flats .....	12,360	123.60	22,990	143.69	20.09
Large flats .....	25,740	257.40	51,740	323.38	65.98
Houses .....	38,110	381.10	98,320	614.50	233.40
<i>Non-domestic</i>					
Ground floor shops .....	13,630	136.30	22,900	143.13	6.83
Commercial premises .....	45,190	451.90	75,920	474.50	22.60
Offices .....	24,110	241.10	42,430	265.19	24.09
Flatted factories .....	49,210	492.10	76,280	476.75	-15.35 (decrease)

*Annex (12)*

MAXIMUM INCREASES IN TOTAL RATES PAYABLE  
UNDER THE RELIEF SCHEME

Total rates (General Rate plus Urban Council Rate) payable in the urban rating areas will in no case increase by more than the following amounts in 1977-78 and 1978-79: —

<i>1976-77 rateable value (\$)</i>	<i>Maximum increase in rates over preceding year</i>	
	<i>1977-78 (\$ p.m.)</i>	<i>1978-79 (\$ p.m.)</i>
2,400 .....	12.00	16.00
3,000 .....	15.00	20.00
3,600 .....	18.00	24.00
4,800 .....	24.00	32.00
6,000 .....	30.00	40.00
7,200 .....	36.00	48.00
8,400 .....	42.00	56.00
9,600 .....	48.00	64.00
12,000 .....	60.00	80.00
15,000 .....	75.00	100.00
18,000 .....	90.00	120.00
21,000 .....	105.00	140.00
27,000 .....	135.00	180.00
33,000 .....	165.00	220.00
42,000 .....	210.00	280.00
51,000 .....	255.00	340.00
66,000 .....	330.00	440.00
81,000 .....	405.00	540.00
99,000 .....	495.00	660.00

Annex (13)

TOTAL RATES PAYABLE FOR PRE-WAR DOMESTIC UNITS  
IN THE URBAN AREAS SHOWING EFFECT  
OF RELIEF SCHEME

Figures based on *average* rateable values.

	<i>Where rent payable approximates permitted rent</i>	<i>Where rent payable exceeds permitted rent, premises occupied by owners etc.</i>
	(\$ p.m.)	(\$ p.m.)
Full rates payable:		
1976-77 (@ 18%) .....	14.15	106.52
1977-78 (@ 11½ %) .....	62.41	169.20
As reduced under relief scheme:		
1977-78 .....	18.87	142.03
1978-79 .....	25.16	169.20
1979-80 .....	33.55	(no relief)
1980-81 .....	44.73	(no relief)
1981-82 .....	59.64	(no relief)
1982-83 .....	62.41	(no relief)

## Annex (14)

## EFFECT ON SALARIES TAX OF THE INCREASED ALLOWANCES TAKING SPECIMEN INCOMES

<i>Marital status and children</i>	(a) <i>Income (p.a.)</i>	(b) <i>Present tax</i>	(c) <i>Tax after increased basic allowance</i>	(d) <i>Reduction (b)-(c)</i>	(e) <i>Tax after increased child allowance</i>	(f) <i>Reduction (e)-(c)</i>	(g) <i>Total reduction (d)+(f)</i>
	(\$)	(\$)	(\$)	(\$)	(\$)	(\$)	(\$)
Single .....	12,000	100	—	100	—	—	100
Married .....	12,000*	—	—	—	—	—	—
Married + 1 .....	12,000*	—	—	—	—	—	—
Married + 2 .....	12,000*	—	—	—	—	—	—
Married + 3 .....	12,000*	—	—	—	—	—	—
Single .....	24,000	900	880	20	880	—	20
Married .....	24,000	200	—	200	—	—	200
Married + 1 .....	24,000	50	—	50	—	—	50
Married + 2 .....	24,000*	—	—	—	—	—	—
Married + 3 .....	24,000*	—	—	—	—	—	—
Single .....	36,000	2,400	2,400	—	2,400	—	—
Married .....	36,000	1,100	820	280	820	—	280
Married + 1 .....	36,000	800	520	280	460	60	340
Married + 2 .....	36,000	550	385	165	310	75	240
Married + 3 .....	36,000	450	310	140	210	100	240
Single .....	48,000	4,600	4,600	—	4,600	—	—
Married .....	48,000	2,700	2,640	60	2,640	—	60
Married + 1 .....	48,000	2,250	2,190	60	2,040	150	210
Married + 2 .....	48,000	1,875	1,815	60	1,590	225	285
Married + 3 .....	48,000	1,650	1,590	60	1,360	230	290
Single .....	60,000	7,500	7,500	—	7,500	—	—
Married .....	60,000	5,000	5,000	—	5,000	—	—
Married + 1 .....	60,000	4,400	4,400	—	4,200	200	200
Married + 2 .....	60,000	3,900	3,900	—	3,600	300	300
Married + 3 .....	60,000	3,600	3,600	—	3,200	400	400

\* already exempt.

Annex (15)

EXAMPLES OF THE CALCULATION OF SALARIES  
TAX WITH THE INCREASED ALLOWANCES

*Example 1*    *Single person earning \$22,000 a year*

Salary .....	\$22,000
Less: Single allowance .....	<u>12,500</u>
	\$ 9,500
Add: "Claw back" (20% of \$9,500) .....	<u>1,900</u>
Net chargeable income .....	<u>\$11,400</u>
Tax thereon .....	<u><u>\$ 640</u></u>

*Example 2*    *Single person earning \$26,000 a year*

Salary .....	\$26,000
Less: Single allowance .....	<u>12,500</u>
	\$13,500
Add: "Claw back" (20% of \$13,500 = \$2,700, therefore restrict to \$2,500) .....	<u>2,500</u>
Net chargeable income .....	<u>\$16,000</u>
Tax thereon .....	<u><u>\$ 1,100</u></u>

*Example 3*    *Single person earning \$13,000 a year*

Salary .....	\$13,000
Less: Single allowance .....	<u>12,500</u>
	\$ 500
Add: "Claw back" (20% of \$500) .....	<u>100</u>
Net chargeable income .....	<u>\$ 600</u>
Tax thereon .....	<u><u>\$ 30</u></u>



*Example 4 Married person, with no children, earning \$40,000 a year*

Salary .....	\$40,000
Less: Married allowance .....	<u>25,000</u>
	\$15,000
Add: "Claw back" (20% of \$15,000) .....	<u>3,000</u>
Net chargeable income .....	<u>\$18,000</u>
Tax thereon .....	<u><u>\$ 1,300</u></u>

*Example 5 Married person, with one child, earning \$45,000 a year*

Salary .....	\$45,000
Less: Married allowance .....	<u>25,000</u>
	\$20,000
Add: "Claw back" (20% of \$20,000) .....	<u>4,000</u>
	\$24,000
Less: Child allowance (as increased) .....	<u>4,000</u>
Net chargeable income .....	<u>\$20,000</u>
Tax thereon .....	<u><u>\$ 1,500</u></u>

*Motion made. That the debate on the second reading of the bill be adjourned—*THE FINANCIAL SECRETARY.

*Question put and agreed to.*

### **Adjournment and next sitting**

HIS EXCELLENCY THE PRESIDENT: —In accordance with Standing Orders I now adjourn the Council until 2.30 p.m. on Wednesday, the 16th of March.

*Adjourned accordingly at twenty-five minutes to six o'clock.*

