

1 HONG KONG LEGISLATIVE COUNCIL -- 1 March 1989

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OFFICIAL REPORT OF PROCEEDINGS

Wednesday, 1 March 1989

The Council met at half-past Two o'clock

PRESENT

HIS EXCELLENCY THE GOVERNOR (PRESIDENT)
SIR DAVID CLIVE WILSON, K.C.M.G.

THE HONOURABLE THE CHIEF SECRETARY
SIR DAVID ROBERT FORD, K.B.E., L.V.O., J.P.

THE HONOURABLE THE FINANCIAL SECRETARY
MR. PIERS JACOBS, O.B.E., J.P.

THE HONOURABLE ALLEN LEE PENG-FEI, C.B.E., J.P.

THE HONOURABLE DONALD LIAO POON-HUAI, C.B.E., J.P.
SECRETARY FOR DISTRICT ADMINISTRATION

THE HONOURABLE STEPHEN CHEONG KAM-CHUEN, O.B.E., J.P.

THE HONOURABLE CHEUNG YAN-LUNG, O.B.E., J.P.

THE HONOURABLE MRS. SELINA CHOW LIANG SHUK-YEE, O.B.E., J.P.

THE HONOURABLE MARIA TAM WAI-CHU, C.B.E., J.P.

DR. THE HONOURABLE HENRIETTA IP MAN-HING, O.B.E., J.P.

THE HONOURABLE CHAN YING-LUN, J.P.

THE HONOURABLE MRS. RITA FAN HSU LAI-TAI, O.B.E., J.P.

THE HONOURABLE PETER POON WING-CHEUNG, O.B.E., J.P.

THE HONOURABLE CHENG HON-KWAN, J.P.

THE HONOURABLE CHUNG PUI-LAM, J.P.

THE HONOURABLE HO SAI-CHU, M.B.E., J.P.

THE HONOURABLE HUI YIN-FAT, O.B.E., J.P.

THE HONOURABLE MARTIN LEE CHU-MING, Q.C., J.P.

THE HONOURABLE DAVID LI KWOK-PO, J.P.

THE HONOURABLE NGAI SHIU-KIT, O.B.E., J.P.

THE HONOURABLE PANG CHUN-HOI, M.B.E.

THE HONOURABLE POON CHI-FAI, J.P.

PROF. THE HONOURABLE POON CHUNG-KWONG, J.P.

THE HONOURABLE SZETO WAH

THE HONOURABLE TAI CHIN-WAH, J.P.

THE HONOURABLE MRS. ROSANNA TAM WONG YICK-MING, J.P.

THE HONOURABLE TAM YIU-CHUNG

DR. THE HONOURABLE DANIEL TSE, O.B.E., J.P.

THE HONOURABLE ANDREW WONG WANG-FAT, J.P.

THE HONOURABLE LAU WONG-FAT, M.B.E., J.P.

THE HONOURABLE GRAHAM BARNES, C.B.E., J.P.
SECRETARY FOR LANDS AND WORKS

THE HONOURABLE RONALD GEORGE BLACKER BRIDGE, O.B.E., J.P.
SECRETARY FOR EDUCATION AND MANPOWER

THE HONOURABLE MICHAEL LEUNG MAN-KIN, J.P.
SECRETARY FOR TRANSPORT

THE HONOURABLE EDWARD HO SING-TIN, J.P.

THE HONOURABLE GEOFFREY THOMAS BARNES, J.P.
SECRETARY FOR SECURITY

THE HONOURABLE PETER TSAO KWANG-YUNG, C.P.M., J.P.
SECRETARY FOR ADMINISTRATIVE SERVICES AND INFORMATION

THE HONOURABLE CHAU TAK-HAY, J.P.
SECRETARY FOR HEALTH AND WELFARE

THE HONOURABLE RONALD JOSEPH ARCULLI, J.P.

THE HONOURABLE MARTIN GILBERT BARROW, O.B.E.

THE HONOURABLE PAUL CHENG MING-FUN

THE HONOURABLE MICHAEL CHENG TAK-KIN, J.P.

THE HONOURABLE DAVID CHEUNG CHI-KONG, J.P.

THE HONOURABLE RONALD CHOW MEI-TAK

THE HONOURABLE MRS. NELLIE FONG WONG KUT-MAN, J.P.

THE HONOURABLE MRS. PEGGY LAM, M.B.E., J.P.

THE HONOURABLE DANIEL LAM WAI-KEUNG, J.P.

THE HONOURABLE MRS. MIRIAM LAU KIN-YEE

THE HONOURABLE LAU WAH-SUM, J.P.

DR. THE HONOURABLE LEONG CHE-HUNG

THE HONOURABLE LEUNG WAI-TUNG, J.P.

THE HONOURABLE JAMES DAVID McGREGOR, O.B.E., I.S.O., J.P.

THE HONOURABLE KINGSLEY SIT HO-YIN

THE HONOURABLE MRS. SO CHAU YIM-PING, J.P.

THE HONOURABLE JAMES TIEN PEI-CHUN, J.P.

THE HONOURABLE MRS. ELSIE TU, C.B.E.

THE HONOURABLE PETER WONG HONG-YUEN, J.P.

THE HONOURABLE THE ATTORNEY GENERAL

MR. JAMES KERR FINDLAY, Q.C., J.P.

IN ATTENDANCE

THE CLERK TO THE LEGISLATIVE COUNCIL

MR. LAW KAM-SANG

Papers

The following papers were laid on the table pursuant to Standing Order 14(2):

| Subject | L.N. No. |
|---|-------------------|
| Public Health and Municipal Ordinance Health and Municipal Services (Public Pleasure Grounds) (Amendment of Fourth Schedule) Order 1989..... | Public 52/89 |
| Public Health and Municipal Services Ordinance Public Swimming Pools (Designation) Order 1989..... | 53/89 |
| Revised Edition of the Laws Ordinance 1965 Revised Edition of the Laws (Correction of Errors) Order 1989..... | 54/89 |
| Interpretation and General Clauses Ordinance Declaration of Change of Title (Deputy Chief Secretary) Notice 1989..... | 55/89 |
| Dutiable Commodities Ordinance Commodities (Liquor Licences) (Specification of Fees) (Regional Council Area) Notice 1988..... | Dutiable 56/89 |
| Interpretation and General Clauses Ordinance Specification of Public Office..... | |

Sessional Papers 1988-89

No. 58 -- Draft Estimates for the year ending 31 March 1990
Estimates Summaries -- General Revenue Account and Fund Accounts
including Controlling Officers' Report on Heads of Expenditure

No. 59 -- Draft Estimates for the year ending 31 March 1990
Supporting Details
Section I: General Revenue Account

No. 60 -- Draft Estimates for the year ending 31 March 1990
Supporting Details
Section II: Funds

Government Business

First Reading of Bill

APPROPRIATION BILL 1989

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 1989

THE FINANCIAL SECRETARY moved the Second Reading of: "A Bill to apply a sum not exceeding \$70,005,834,000 to the service of the financial year ending on 31 March 1990".

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He said: I move the Appropriation Bill 1989 be read the Second time. My task in preparing this year's Budget has been to try to meet the aspirations of the community

without exacerbating the current inflationary situation or placing in jeopardy our prosperity in the longer term.

2. There are three key factors which I have had to take into account: first, inflation; secondly, the accumulation of substantial budget surpluses; and thirdly, the need to embark upon a major programme of infrastructural works to enable Hong Kong to develop in the 1990's and beyond.

3. I shall have more to say about all three, but Members might find it useful if I make some preliminary comment on their inter-relationship. In so doing, I shall set the scene for the presentation of my Budget.

4. The inflation we are experiencing is caused by the very success of our economy. Quite simply, demand for various resources, including labour, is outstripping supply. This strong demand is being translated into higher prices and costs of production. In due course, the economy will adjust and inflationary pressures will ease. But in the meantime, we must endeavour to ensure that our policies do not make matters worse.

5. The accumulation of budget surpluses, while appropriate in an inflationary situation, does create other problems. There is an understandable expectation by the public that the surpluses should be used to fund new or improved services. My colleagues within the Administration who provide these services are naturally keen to respond positively. However, given that the economy is already operating at full capacity, if the Government were to reduce the surpluses by increasing its expenditure substantially, inflationary pressures would be intensified.

6. If expenditure is not to increase, then there will no doubt be calls to reduce the surpluses by introducing tax concessions. But tax concessions themselves can be just as inflationary as increased government expenditure.

7. This brings me to the third factor that I have mentioned; the need to provide for a number of large and expensive infrastructural developments. The dilemma, of course, is that rapidly increasing expenditure on capital works runs counter to my conclusions on expenditure generally. But we simply cannot afford to delay unduly the upgrading of our infrastructural framework if Hong Kong's economy is to continue to develop in the years ahead.

8. These, then, are the major conflicting pressures that I have had to reconcile in the formulation of the Budget for 1989-90. The task has been complex and the solutions I have adopted inevitably represent a compromise. I remain acutely aware of the need for stability and continuity in the management of our public finances.

9. I shall now start by describing the performance of the economy in 1988.

THE ECONOMY IN 1988

10. Following two consecutive years of double-digit growth, the economy slowed down to a more moderate pace last year. It is estimated that our gross domestic product (GDP) grew by about 7.5% in real terms in 1988. This compares with about 14% in 1987

11. The economy escaped largely unscathed from the stock market crash in October 1987, and business confidence had generally returned by the early part of 1988. The slow-down in economic growth can thus be attributed mainly to supply-side constraints. As Members are well aware, the labour market remained tight, with the unemployment rate falling to a record low of 1.3% in the fourth quarter of the year. As the economy continued to operate virtually at full capacity, keen competition for resources drove up costs.

12. In overall terms, our external sector performed remarkably well. The single most noteworthy feature has been the development of our re-export trade, and in 1988, re-exports overtook domestic exports. Our role as an entrepot serving China and the Asia-Pacific region has again become of major significance. As regards domestic exports, substantial increases were attained in China, the United Kingdom and Japan, while we experienced a decline in respect of the United States market. We are thus witnessing the continuation of a useful diversification of our markets. Imports also rose rapidly, with the result that our visible trade account showed a larger deficit last year than in 1987

13. Domestic demand continued to be boosted mainly by consumer spending and by investment in plant and equipment. In national accounts terms, public sector expenditure grew more slowly than that of the private sector⁵. Let me add that, in the current inflationary situation, there is particular merit in seeking to keep down the share of available resources absorbed by the public sector.

14. As domestic exports grew by nearly 9 % while domestic demand grew by about 7 %, the forces driving economic growth in 1988 were more balanced than in the previous two years⁶. However, the growth rate of demand exceeded that of output⁷. Thus, with full employment, not only was there a deficit on visible trade, but also the rate of inflation increased during the year⁸.

Inflation

15. Indeed, one of the main problems we have to face is inflation. During the Budget Debate last year I shared Members' concern that there was a risk that inflation would rise, and my forecast of an average rise in consumer prices of 7 % reflected this. In the event, consumer prices in 1988 rose by 7.5 %⁹. For Hong Kong, this is high. And I am aware that for some the increase in the cost of living may be even higher, having regard to personal spending patterns. It is, therefore, appropriate that I should devote some time to discussing this important issue, which touches every member of our community.

16. Over the past three years we have enjoyed a remarkable period of sustained economic growth. In real terms, GDP has increased by 11 % per annum on average. This growth has been largely export led. Our domestic exports have remained highly competitive internationally, and have grown by an average of 16 % per annum over the past three years. Re-exports have increased by an average of 34 % per annum over the same period.

17. To meet this export demand and the additional domestic demand associated with it, the economy has expanded rapidly and unemployment has fallen to an historic low. The resultant overheating has led to an increase in inflation. Then there is the effect of inflation elsewhere.

18. Some have expressed concern about the impact on our economy of inflation in China. While China's inflation is running ahead of that in Hong Kong, so far this has had only a limited effect on prices here. Import prices of Chinese goods increased by about 1.5 % in 1988 and although at the retail level the prices of Chinese goods rose more rapidly than this, the increases were not significantly out of line with those of goods from other sources, both domestically produced and imported.

19. As I intimated earlier, inflation is part of the economy's adjustment process.

If the growth rate of demand outruns the growth rate of supply, wages and prices rise. This process can be accommodated within the economy for a while. But as inflation feeds through to export prices, the competitiveness of our products will be reduced. This reduction in competitiveness should slow down the growth rate of exports, which in turn will ease the inflationary pressure and thus inflation itself.

20. There are signs that this adjustment process is already underway, in the sense that the growth rate of demand was lower in 1988 than in 1987¹⁰. The adjustment process has, however, not gone as far as was implicit in my budget forecast last year for the growth rate of the economy. Domestic inflation has not yet been fully reflected in the rate of increase of export prices, and as a result, domestic exports have grown more strongly than expected.

21. There appear to be a number of reasons for this. The prices of imported raw materials and semi-manufactures have been rising quite slowly¹¹. Furthermore, the transfer of some or all of their production processes to China has enabled a number of manufacturers to hold down their costs. In addition, market pressures, especially in overseas markets with weak demand, appear to have resulted in some exporters being prepared to accept narrower profit margins in defence of their market share.

22. What, then, can we do to curb inflation? The plain fact of the matter is that there are few viable policy options open to a small, externally-oriented economy like ours.

23. On the monetary side, as far as possible, interest rates should be kept high. But it is important to recognize that what we can do in this area is constrained by the over-riding need to ensure exchange rate stability within the linked exchange rate system. Hong Kong dollar interest rates generally have to follow those of the US dollar. In recent months, US dollar interest rates have firmed up significantly in response to the threat of higher inflation in the United States. They seem likely to remain high for the time being. If so, this would be of some help to us in curbing inflation.

24. On the fiscal side there is again little scope for action primarily because the small size of the public sector and the openness of the economy limit the leverage that can be exerted through changing either tax rates or the level of public expenditure. Nevertheless, it is necessary for the Government to ensure that its actions help rather than exacerbate the situation. In this respect, running a larger

than planned budget surplus in the current year is, in economic terms, entirely the right course to take in the face of the inflationary pressures. In our present circumstances, increased public sector expenditure is acceptable only so long as the increase is manageable, and only so long as revenue rises more rapidly, with the result that, overall, the Government is removing spending power from the economy¹².

25. So, beyond keeping our own house in order, there is only a limited amount we can do to alleviate inflation. In due course, possibly over a longer period of time than we would wish, the economy will adjust. To indicate how I see this adjustment taking place, I turn now to the prospects for our economy in 1989.

ECONOMIC PROSPECTS FOR 1989¹³

26. With the momentum in the latter part of 1988 expected to continue at least through the first half of 1989, the economy should be able to enjoy another year of satisfactory growth. However, because we remain up against capacity constraints, I expect the GDP growth rate for this year to be somewhat below that achieved last year.

27. The major markets for our domestic exports are expected to show a mixed performance. Domestic exports to the United States may pick up somewhat, but those to the Federal Republic of Germany are expected to remain sluggish. Re-exports should continue to increase, partly because of the expansion of output processing activities and partly because of the fast growth in indirect trade between China and some of the other industrializing economies in the region. Overall, I expect domestic exports to rise by 7% and re-exports by 22% this year. In addition, trade in services should continue to contribute significantly to economic growth.

28. In the domestic sector, private consumption expenditure should remain buoyant. Investment in plant and equipment should also increase, but probably more moderately than in the past two years. Building and construction output will continue to be affected by capacity constraints. The growth rate of government consumption expenditure in national accounts terms is expected to remain below that of the GDP.

29. Bearing in mind the uncertainties inherent in economic forecasting, I expect a 6% growth in the GDP for 1989¹⁴.

30. I should like to draw Members' attention to some of the implications of this forecast. First, as in 1988, a fairly close balance is expected to be maintained between the growth rates of domestic demand and external demand¹⁵. However, given the pressure of demand on the economy as a whole, it is likely that more imports will be required and that the visible trade deficit will increase¹⁶.

31. Secondly, considerable inflationary pressures still exist, and these will tend to push the inflation rate higher before it begins to fall, probably in the latter part of the year. This year I expect the Consumer Price Index (A) to rise by an average of 8.5%¹⁷.

32. Thirdly, the labour market is likely to remain tight. The pressure to adopt labour-saving processes and techniques will thus be sustained. While employers are experiencing labour shortages and increased labour costs, it should be remembered that employees as a group should continue to be able to share in the fruits of prosperity through ample job opportunities and better pay.

33. Fourthly, as a reflection of growing affluence, per capita GDP in current price terms is expected to rise to US\$11,000. This is a remarkable achievement, of which we can be justly proud¹⁸.

MONETARY ISSUES

34. Before dealing with the public finances, I would like to digress to say a few words about some monetary issues. We have seen in 1988 the introduction of various arrangements helpful to the maintenance of exchange rate stability, and I shall now describe briefly some of the more significant. I shall also outline our current thinking in relation to the development of the local financial markets.

35. In the early part of last year, the Hong Kong Association of Banks introduced the Specified Rate Rules and the subsequent amendments to the Rules on Interest Rates in order to make it possible to have negative interest rates should the need arise. In July, the Government introduced the New Accounting Arrangements, which enabled the Administration to exert more effective influence on monetary conditions in the interbank market. I am grateful to all in the banking community who have contributed towards putting together these arrangements. Those involved have given a clear

demonstration of their support to our firm policy of maintaining exchange rate stability and of their commitment to ensuring the general stability of our monetary system.

36. When intervention through the New Accounting Arrangements is necessary, money market operations are carried out and the market informed. So far, these operations have taken the form of direct borrowing or lending, and the buying or selling of foreign currency. The same effect could be achieved through the buying or selling of Hong Kong dollar financial assets of acceptable quality. In other financial centres these assets are usually in the form of debt instruments issued by the Government. Such instruments provide a flexible, low-risk, and possibly more cost-effective alternative for conducting money market operations. But there is in Hong Kong a lack of such instruments because there is virtually no government debt.

37. We have carried out a study of this matter, and there has been informal consultation with the Hong Kong Capital Markets Association and with leading banks. I have also sought the advice of the Exchange Fund Advisory Committee. Following upon this consultation and advice, my present intention is to develop a programme for the issue of short-term Exchange Fund bills. The bills would constitute direct, unsecured, unconditional and general obligations of the Government for the account of the Exchange Fund. Given that the bills would be used for monetary purposes, they would be for the account of the Exchange Fund and not for the general revenue as is the case for Treasury bills elsewhere. I must emphasize that the proceeds could not be used for the purpose of financing fiscal deficits or public expenditure. They would be suitably invested along with other assets of the Exchange Fund and would be available only for those purposes for which the resources of that Fund may properly be used. In other words, we would not be borrowing to finance public expenditure.

38. Operational details are still being worked out. There will need to be further discussion with potential market makers and market participants on secondary market development, which I regard as being of some importance. Before we started issuing such bills I would make a further statement in this Council.

39. Our policy has always been to leave the initiative of market development to those who deal in the market itself. But where fiscal or institutional factors are identified as inhibiting development, we are prepared to consider appropriate modifications. This policy remains unchanged.

40. The under-developed state of the Hong Kong dollar paper market has been attributed by some market participants not only to the lack of government debt but also to the incidence of interest tax. The issue of Exchange Fund bills, as I have explained, should be helpful to the development of this market. Furthermore, I have considered the difficult question of interest tax and I shall come back to this latter subject when presenting my revenue proposals.

41. Lastly, in relation to monetary issues, I intend to seek amendments to the Protection of Investors Ordinance in order to streamline the authorization procedures for advertisements concerning the issue of commercial paper and for the issue of certificates of deposit. We are in the process of consulting the parties concerned and, subject to the advice of the Executive Council, I hope to be able to introduce a Bill into this Council in the not too distant future.

42. So, without undue drama, I am seeking to create a more favourable environment for the development of the Hong Kong dollar paper market. Of course, those who use the market must themselves decide on where the market goes from here. My task is to remove impediments to healthy growth.

PRESENT STATE OF PUBLIC FINANCES AND REVISED ESTIMATES 1988-89

43. I turn now to the present state of our public finances. The revenue out-turn at the end of 1988-89 will be significantly higher than forecast, while for the first time for some years expenditure will also exceed the forecast.

44. General Revenue Account expenditure, excluding transfers to funds, of \$43.3 billion exceeds the original estimate by about 2 %; the bulk of the increase is due to the implementation of the "Rennie" report on pay for the disciplined services¹⁹.

45. The revised estimate of expenditure on General Revenue Account of \$49.6 billion, including transfers to funds, is close to the original estimate. The transfer of \$1.1 billion to the Development Loan Fund allowed for in the original estimate will not now be made because the revised financial arrangements with the Housing Authority have reduced that authority's drawings on the fund.

46. Expenditure of \$14.5 billion from our various funds is about 12 % above budget.

This considerable increase was caused largely by the revised financial arrangements with the Housing Authority, which required the handing over to the authority of the balance on the Home Ownership Fund. Other increases in fund expenditure were from the Capital Works Reserve Fund, because of higher than expected cost increases in the construction industry and some acceleration of capital projects.

47. Spending in cash terms from the General Revenue Account and from the funds together is likely to be about 20 % above the actual figure for 1987-88 and about 4 % above the original estimates.

48. Consolidated Account expenditure, which includes Housing Authority and Urban and Regional Councils expenditure, is in cash terms expected to be about 22 % above the actual figure for 1987-88. Expressed in real terms the increase is about 9 % compared with an original estimate of 7 %.

49. The growth in the establishment of the Civil Service is about 3.3 %. This is still in excess of our guideline of 2.5 %, and we must continue our efforts to control the size of the Civil Service as well as overall expenditure²⁰.

50. On the revenue side, the higher than expected out-turn is particularly noteworthy. In preparing the 1988-89 estimate we made allowance for the anticipated effects of the events of October 1987. As I have already said, those events had remarkably little impact. Furthermore, the estimate was based on a GDP growth of around 14 % in 1987 and 5 % in 1988. The GDP grew faster in 1988 than expected, and the revised estimate for general revenue exceeds the budget by about 21 %.

51. Revenue for the account of the various funds is now expected to be about 7 % below the estimate mainly because revenue which was expected to accrue to the Home Ownership Fund will now accrue to the Housing Authority. But this reduction was largely offset by higher than expected proceeds from land sales. Combining General Revenue Account and fund account revenue the increase on the original budget is 18%²¹.

52. On the basis of this increased revenue out-turn, and despite expenditure being above the estimate, I expect an overall surplus in 1988-89 of \$14.2 billion compared with a budgetted surplus of \$5.5 billion²². This substantial surplus, which is clearly more than sufficient to maintain our reserves in real terms, is the product of three years of exceptional economic performance. But it should be seen in the context of our total economic activity during the year; the GDP in 1988 amounted to

\$426 billion.

53. In sum, Consolidated Account expenditure in 1988-89 is estimated to be 15.4 % of GDP. Recurrent expenditure absorbed only two-thirds of recurrent revenue, thus leaving a comfortable margin to finance capital expenditure. This enabled about half of our capital expenditure to be so financed, in accordance with our aim of limiting dependency on capital revenue.

54. Here I must add that some disturbing trends are becoming evident. First, growth in public sector expenditure exceeds the growth rate of the economy. Secondly, the growth in civil service establishment remains higher than our target. Thirdly, although recurrent revenue is buoyant, it is increasingly dependent on direct taxes, which are vulnerable to the volatility of the economy.

STRATEGY FOR PUBLIC FINANCES

55. Against this economic and financial background, I shall now say a few words about my overall strategy for managing the public finances. Central to this strategy is the discipline that public expenditure should be based on the trend growth rate of GDP. In this connection, clearly, the assumptions built into the Medium Range Forecast are fundamental²³. For planning purposes I have, during the current financial year, adjusted the trend growth rate assumption for the forecast period from 5.5% to 6%. Recently, we have experienced particularly rapid economic growth, and we can expect reasonable growth in the next few years. I therefore consider 6% as a trend growth rate to be an appropriate planning assumption.

56. It is inevitable that we will experience considerable year to year variations in revenue, dependent as it is on our economic performance. Notwithstanding this, we seek to maintain stability in public expenditure growth. Such steady growth within our budgetary guidelines is essential to the orderly development and expansion of public services. If we are to manage our finances effectively we need to plan ahead and determine over a period of four or five years the levels of public expenditure that we can sustain without the public sector claiming too great a share of the territory's resources.

57. By establishing budgetary guidelines, we seek to ensure that spending levels are planned by reference to what the economy can support and not by the revenue available.

At the same time, there is a need for essential infrastructural development, and this may require us to accept levels of expenditure which from time to time take us outside our guidelines. It must be remembered, however, that capacity constraints in the economy can mean that higher spending translates into higher prices with little real gain.

Strategy for expenditure

58. I turn now specifically to my strategy for expenditure. Average annual real growth in Consolidated Account expenditure over the forecast period is projected to be 4.8%, which is within the 6% trend growth rate of the GDP. This average is affected to some extent by the phasing of capital expenditure. It also includes a projection of an overall growth rate of 9% in the coming year 1989-90. Furthermore, because there is a tendency to underestimate expenditure in the later years it is possible that the actual average growth rate of expenditure over the forecast period will significantly exceed this figure of 4.8%. Thus, we must continue to monitor carefully the growth in public expenditure. This is particularly so in relation to recurrent expenditure, which is already projected to grow by an average of 5.5% a year over the forecast period.

59. There are obviously implications for staff growth. I have already indicated my concern regarding the growth of the Civil Service. The estimates I shall be presenting make provision for a 3.9% growth in the size of the Civil Service in 1989-90 compared with our target of 2.5% growth per year. We had already planned for increases in staff numbers which are required for new medical facilities and for the build up of the police force, partly to assume the duties of the British garrison. In addition we now have to provide for higher staffing levels in, for example, the Immigration Department and the Post Office to meet the increased demand for their services.

60. We have identified probable commitments and requirements for increased expenditure on capital account over the next decade. When consideration was given to the allocation of the resources available to fund new or improved services for the period to 1992-93, the planned level of spending on capital account was increased by \$2 billion in total over the four years up to and including 1992-93. This reduced the additional resources available for recurrent account spending on new or improved services, but I would stress that it should still be possible to make some provision for such services during the period.

61. In the light of the constraints I have described and in order to improve services to the public within available resources, I look to policy Secretaries and controlling officers to carry out a rigorous examination of on-going or baseline expenditure. Over time it is inevitable that some fat accumulates, and periodic dieting is good for health.

62. I might add that during the period of sustained growth we have been experiencing it has been possible to allow more to be spent in real terms on public services. But it is important to ensure that value for money is obtained. I have, in presenting the supporting documents to the Budget, attempted to provide a more complete picture of the pattern of public expenditure. The printed estimates give an analysis of spending by programme area, and for each head of expenditure a report by the controlling officer indicates the extent to which objectives are being met. We will continue to improve this analysis and focus attention on results rather than cash flows.

63. Overall, the profile of total government expenditure indicates that the allocation of resources over the various programme areas has remained fairly steady in recent years. Social services and education make up about 32 % of the total Consolidated Account expenditure, and housing 14 %. Spending on infrastructure accounts for 15%, and on security also 15 %. However, over the forecast period the social services and education programmes are expected to account for an increasing share of resources²⁴.

64. Before I describe my strategy for public revenue, I should mention one important matter concerning the establishment of authorities outside the Administration. We continue to look for better means of delivering services to the public. Some services can be more efficiently provided by agencies freed from the Civil Service structure. However, this is not always so. In any event, the hiving off of services should not be interpreted as an abdication of responsibility by the Government. The bodies established will remain a part of the public sector, most will still rely on public funds for their operations and all will be expected to provide their services to the satisfaction of the community. Management will be autonomous and, I believe, should be more responsive to changing needs.

65. The Housing Authority and the Urban and Regional Councils are already well established and the new Hospitals Authority will be set up next year. As a result,

in money terms almost half our public services will be provided by statutory bodies or agencies²⁵. But it still remains necessary for the Government to exercise overall financial control and to set objectives and targets.

66. About a year ago, the new financial arrangements for the Housing Authority came into operation. Similar arrangements will be made with other bodies appropriate to their individual circumstances, and we are formulating plans to modify the role of the Development Loan Fund to accommodate such arrangements.

Strategy for Revenue

67. I turn now to my strategy for public revenue. In line with the performance of the economy, our revenue continues to be buoyant. But we cannot expect the rates of economic growth we have seen in the last three years to continue unabated and my plans for revenue are as usual based on an assessment of the position over the next few years. Whilst we must avoid adding to inflationary pressures there is some scope for lowering the tax burden and I shall have more to say about this later. Before I do so, however, I would like to inform Members as to where we stand on that much debated subject -- the sales tax.

68. Last year when discussing the value of a wider and more stable tax base I informed Members that our researches had suggested that a form of sales tax, though probably not at a retail level, best met the criteria that I described. I said that many factors remained to be considered and that more work had to be done. We have now carried out considerably more research and are preparing a consultative document. We should be in a position to issue this document to a number of professional bodies and other organizations towards the middle of this year. The purpose of this consultative document will simply be to enable me to examine, with the assistance of those to whom the document will be issued, the technical aspects of tax diversification and any possible difficulties in my proposals.

69. I am conscious of the fact that the introduction of a sales tax in Hong Kong would represent a fundamental shift in our taxation policies. Nevertheless, I am anxious to reduce our dependence on sources of revenue which are most vulnerable to the vicissitudes of the economy. I shall not go over all the arguments at this stage but I would like to repeat the criteria that I consider must be met if we are to introduce any indirect tax of the nature that I have described. First, such a tax should produce a stable and worthwhile revenue yield at a low tax rate; secondly,

it should cause minimal distortion to the economy; and thirdly, it should be simple and cheap to administer. The type of sales tax that I am examining is a tax at the wholesale level and our researches so far have indicated that such a tax does, indeed, meet the criteria that I have mentioned.

70. I believe that a wholesale sales tax could bring to Hong Kong some significant benefits. It would give us scope to reduce some existing taxes, both direct and indirect. We must ensure that the present advantages that we enjoy from our tax system are not eroded over time. Members will be aware that the rest of the world is moving towards lower direct taxes.

71. The introduction of a tax such as I have described would have to be carefully timed. At the moment we are suffering from inflation, and in these circumstances I do not believe that we are yet ready for this tax. But the preparatory work must be done now.

The Government's reserves

72. I shall now say a few words about our reserves. The consolidated reserves are expected to show a balance of about \$60 billion at the end of 1988-89 rising to about \$71 billion at the end of 1989-90 after allowing for the taxation proposals I shall be making this afternoon. The Medium Range Forecast shows that, in the period to 1992-93, although the level of reserves will be more than maintained in real terms over the forecast period, the reserve balances, when expressed as a percentage of annual spending, will fall from 91% to 87%²⁶.

73. I am not proposing any guidelines as to what level of reserves is appropriate. We are comfortable but not excessively so. The position has improved since last year when I forecast that the level of reserves as a percentage of annual expenditure would fall to about 65% by 1991-92. Nevertheless, it is wrong to look upon the reserves as a "pot of gold" available to be spent regardless. Our budgetary guidelines are related to the growth of the economy, and not to the size of the reserves. Furthermore, we have to protect our spending programmes against cyclical changes in revenue levels, and we have contingent liabilities which have to be covered²⁷.

74. As I have already indicated, we need to make provision for some major infrastructural projects that are likely to start in the years ahead, such as road and rail networks, port development and drainage and sewage projects. Some of these

may have to proceed outwith our on-going basic public works programme. Whilst the scope and cost are not yet clear, it is obvious that the Government will be required to make a major financial contribution.

75. Also, Sir, as you said in your opening address to this Council last October, it is increasingly clear that Hong Kong is going to need a new airport. This will be a massive undertaking. It will, of course, involve not only the airport itself, but also a vast amount of infrastructural development including roads, tunnels, possibly bridges and perhaps a railway link. Our studies, including our examination into the financial and institutional arrangements, are progressing well, and we expect to be in a position to announce a decision before the end of this year.

76. The time has come when we should begin putting some money aside. In order to anticipate some of the considerable expenditure involved on infrastructural development, I propose, beginning in the forthcoming financial year, 1989-90, to make regular transfers from the General Revenue Account to appropriate funds. In this way we will be earmarking some of our accumulating surpluses to finance our infrastructural development programme over the next 10 to 15 years. The detailed accounting arrangements are not yet finalized but I envisage transfers both to the Capital Works Reserve Fund in respect of those projects which will be a part of the public works programme, and also to a new fund for investment in those projects which might attract the private sector or which might be implemented by statutory authorities.

77. These transfers, which will be in addition to the transfers we normally make to the various funds, will not alter the overall consolidated reserve balance. They are, however, a clear indication of our intentions. After these transfers, the unassigned reserves will still provide cover for our contingent liabilities and protection against short-term cash flow fluctuations, and will assist in maintaining fiscal stability.

DRAFT ESTIMATES 1989-90

78. I now present the draft estimates of expenditure and revenue for 1989-90.

Draft estimates of expenditure

79. The draft estimates show expenditure on General Revenue Account, including

transfers to funds, of \$70 billion. Expenditure on our various funds is estimated to be \$16.8 billion. Total government expenditure excluding transfers to funds is estimated

to be 19 % above the revised estimate for 1988-89²⁸. The estimate of \$70 billion for General Revenue Account includes \$4.3 billion for additional commitments to cover those items of expenditure which either cannot be foreseen or are likely to arise but for which we do not yet have firm estimates of cost.

80. Total Consolidated Account expenditure is expected to grow by 9 % in real terms²⁹. This is three percentage points above our guideline, namely, the trend growth rate of GDP of 6 % over the period of the Medium Range Forecast.

81. The estimates provide for the cost of maintaining existing services, opening new facilities in 1989-90 and meeting increasing demand for government services. I have allowed provision for some new services to be introduced in 1989-90 and a list of the major items is given in an appendix to the printed version of this speech³⁰.

82. Expenditure on capital account allows for an increase in spending on the capital works programme, including the clearance of the Kowloon Walled City, on which expenditure is expected to peak in 1989-90. Expenditure on capital programmes is expected to be \$14.5 billion or 33 % higher in cash terms than in 1988-89. A list of the major capital projects due to start in 1989-90 is also given in an appendix to the printed version of this speech³¹.

83. Provision is made for further equity investment in the Housing Authority in 1989-90 and for the redemption of the government bonds for \$1 billion issued in 1984, which are repayable on 9 April this year.

84. In terms of Consolidated Account expenditure we plan to spend \$11.9 billion on social services (an increase of 13% in real terms over 1988-89); \$13.1 billion on education (an increase of 5%); and \$10.6 billion on housing (an increase of 5%). Spending in these areas will represent 45% of total expenditure. Expenditure on security, the environment, and the transport, works and water supply group will, taken together, increase by 10%.

85. These increases in expenditure, which I would emphasize are in real terms, represent the Government's continuing efforts to secure an improvement in the living standards of the community, especially of those who rely heavily on public services.

86. As I have already said, the projected growth rate in the Civil Service in 1989-90 is 3.9%³². This increase includes about 5 700 posts in the Government alone. Of this increase 40% is for posts in the disciplined services and 25% for the Health and Hospital Services departments.

87. The draft estimates provide for transfers to funds from General Revenue Account totalling \$17.7 billion. Of this, \$10.7 billion will cover the net expenditure on the various funds and will maintain their balances in real terms. I have already spoken of my intention to set aside funds for some of the major infrastructural projects that I have mentioned. For this purpose I am transferring \$7 billion to the Development Loan Fund.

88. As a result of these expenditure estimates, Consolidated Account expenditure as a proportion of GDP will increase from 15.4% in 1988-89 to 16.4%.

Draft estimates of revenue

89. I turn now to the draft estimates of revenue. General Revenue Account revenue before my budget proposals is estimated to be \$73.4 billion, an increase of about 13% over 1988-89³³. Revenue from direct taxes is expected to be 18% above the figure for 1988-89, and for other revenue, 8%.

90. On the basis of this forecast, direct taxes will represent 65% of the total of direct and indirect taxes taken together, compared with 62% in 1988-89 and 60 % in 1987-88. Members will note the inexorable trend. Revenue accruing to the various funds is estimated at \$7.8 billion, an increase of about 13 % over 1988-89. This is largely accounted for by revenue from expected land sales. Combined revenue on General Revenue Account and the funds will thus be about \$81.2 billion, an increase of 13% over 1988-89.

91. As our tax revenues will continue to reflect our recent economic performance, revenue will remain buoyant next year despite the slow down in the rate of economic growth which I have forecast. Generally, fees and charges will be adjusted in line with inflation.

Summary of draft estimates

92. The draft estimates of expenditure and revenue for 1989-90, before revenue measures, indicate a surplus on General Revenue Account of \$3.4 billion and an increase in the balances of the funds of \$8.7 billion giving an overall surplus of \$12.1 billion 34.

REVENUE MEASURES

93. I have earlier described the features of the economy that I think are particularly relevant in relation to the formulation of my Budget for 1989-90. In putting together my revenue proposals, I have been conscious of the fact that despite the large forecast surplus for the year ahead, there is a need to ensure that the proposals are compatible with the overall economic situation. The package includes a number of revenue raising measures which will yield some \$550 million in 1989-90, equivalent to \$620 million in a full year. This additional revenue is more than offset by tax concessions estimated to cost \$1.1 billion in 1989-90, and \$1.7 billion in a full year 35. The effect will be to reduce the surplus on General Revenue Account in 1989-90 from \$3.4 billion to \$2.8 billion and the overall surplus from \$12.1 billion to \$11.5 billion.

Dutiable commodities

94. Sir, I shall deal first with dutiable commodities. The principle underlying my proposals remains that specific duty rates should be maintained in real terms by regular small adjustments.

95. The duty rates on hydrocarbon oils, liquor and tobacco were all revised last year 36. To maintain the revenue yield, I propose to increase the duty rates on these commodities broadly in line with inflation.

96. I am aware that these increases may be criticized by some as adding to inflationary pressures. I consider, however, that the danger of not maintaining specific duty rates is simply that we would be faced with much larger increases at a later date.

Imported hydrocarbon oils

97. I propose to increase the duty rate on motor spirit from \$2.55 a litre to \$2.75 a litre, and on diesel oil for road vehicles from \$1.27 a litre to \$1.37 a litre.

The refund on diesel oil to the franchised bus companies will remain at 65 cents a litre. I estimate the additional revenue arising from these increases to be some \$143 million in 1989-90.

Intoxicating liquor and alcohol

98. This year I have a number of proposals in relation to intoxicating liquor and alcohol. The first concerns beer. Duty on beer is currently assessed on the quantity and the original specific gravity of the product released to the local market. The antiquated procedures involved, which date back to the early years of this century, are cumbersome and expensive to administer, and are not appropriate in today's rapidly expanding beer market.

99. To overcome these problems, I propose that duty be assessed solely on the volume of beer, whether released from a local brewery or imported. I expect both the trade and the Customs and Excise Department to benefit from the improved efficiency and reduced costs this new arrangement will bring. After taking account of the increase required to maintain the revenue yield in real terms, the revised duty rate will be \$220 a hectolitre. I might add that the full duty increase is equivalent to less than one cent on a can of locally brewed beer.

100. My next proposal is to increase the specific duty rate on liqueurs, whisky, gin, rum, vodka and all other spirituous liquors except brandy by \$4 a litre from \$48 to \$52.

101. I also propose to eliminate the differential on specific duty rates, which exists at present, between brandy and all other spirituous liquors, by reducing -- I should say that again -- by reducing the specific duty rate on brandy by \$3 a litre from \$55 to \$52.

102. In order to restore their real value, I propose to increase by 8% the specific duty rates in respect of champagne and sparkling wines, still wines, cider and perry, non-European type wines and Chinese type spirits.

103. My last proposal in relation to duties on intoxicating liquors and alcohol is to increase the basic rates for ethyl alcohol and methyl alcohol from \$455 to \$490 a hectolitre.

104. Details of the new rates are given in an appendix to the printed version of this speech³⁷. Assuming no consumer resistance, I estimate the additional revenue yield to be \$21 million in 1989-90.

Tobacco

105. I propose to increase the duty on cigarettes from \$175 to \$190 per 1 000 sticks. The duty on cigars will be increased from \$233 to \$250 a kilogram; on smoking tobacco from \$212 to \$230 a kilogram; and on Chinese prepared tobacco from \$45.50 to \$50.00 a kilogram. Assuming no consumer resistance, I estimate the additional revenue yield to be \$102 million in 1989-90.

Fees and charges

106. I turn now to fees and charges. The policy on fees and charges continues to be that services should generally be paid for by those who use them³⁸. For 1989-90, I propose to increase the following fees and charges: first, the business registration fee; secondly, vehicle and driving licence fees; thirdly, deposit-taking company licence and registration fees; and, lastly, passenger embarkation and port related fees.

Business registration fees

107. In my 1987 Budget the business registration fee was increased to \$550³⁹. With effect from 1 April 1989, I propose to increase this fee to \$630. The fee will apply to all registered businesses, but small businesses will continue to be granted exemption if their monthly turnover does not exceed certain prescribed limits. I estimate the additional revenue arising from this increase to be some \$37 million in 1989-90. The levy of \$100 for the Protection of Wages on Insolvency Fund is separate and not affected by this proposal.

Vehicle and driving licence fees

108. I propose to increase vehicle registration and driving licence fees by 8 % from the levels set last year. Details are given in an appendix to the printed version of this speech⁴⁰. I estimate the additional revenue arising from these increases to be \$103 million in 1989-90.

Deposit-taking company licence and registration fees

109. As revenue from the licensing and registration of deposit-taking companies does not cover the costs of supervision, I propose to increase their licence and registration fees by 15%. The estimated additional yield of \$3 million in 1989-90 will reduce, though not eliminate, the under-recovery of supervision costs. Details of the new fees are given again in an appendix to the printed version of this speech⁴¹.

Port related fees

110. A new vessel traffic management system for the port will be commissioned later this year. Currently, a passenger embarkation fee of \$15 is payable by those departing from the Macau and China Ferry Terminals. To defray in part the costs of installing and operating the new system, I propose to increase this fee by \$2 to \$17. This increase will be implemented when the new vessel traffic management system is commissioned. At the same time, port and light dues will also be increased. I estimate the total additional revenue yield in 1989-90 to be \$14 million, and \$29 million in a full year.

Other fees and charges

111. A number of other fees and charges, including water charges, are scheduled for normal review in 1989. From these sources, I expect additional revenue of about \$130 million in 1989-90, and \$180 million in a full year.

Tax concessions

112. I turn now to tax concessions. I propose a reduction in the standard rate of tax, increases in personal allowances, increases in child and dependent parent allowances, and the introduction of a new allowance for single parents who are responsible for the care of dependent children. I also propose a reduction in the rate of tax applicable to corporations, an increase in the initial allowance for machinery and plant, and a number of other concessions of relevance to the business community.

Personal taxation

113. For personal taxation, I propose --

first, to reduce the standard rate from 15.5% to 15%;

secondly, that the basic personal allowance be increased from \$29,000 to \$32,000 for a single person, and from \$60,000 to \$66,000 for a married couple. Taken together, the new basic allowance plus the existing additional personal allowance will total \$39,000 for single persons and \$80,000 for married couples; below these income levels there will be no liability to tax. At their maximum levels, the new allowances will be slightly more than 8 % higher than the present combined basic and additional personal allowances⁴²;

thirdly, that the child allowance be increased, for a first child, from \$12,000 to \$13,000, and for a second child from \$8,500 to \$9,000;

fourthly, that the allowance for a dependent parent be increased from \$10,000 to \$11,000. The total allowance in respect of a dependent parent who resides with a taxpayer will be \$14,000; and

lastly, I propose that a new allowance of \$20,000 be provided for those parents, such as widows or single parents, who are solely or predominantly responsible for the care of dependent children, but who are currently ineligible for a personal allowance at the higher rate applicable to married persons.

114. I intend to introduce these concessions with effect from the year of assessment commencing 1 April 1989. Therefore, the first occasion on which they will apply will be to provisional and final tax assessments for 1989-90, and also to 1989-90 personal assessments. I estimate that the cost to the revenue in 1989-90 will be about \$465 million, and \$650 million for a full year.

115. Examples of the effects of these personal taxation concessions upon various categories of taxpayers, together with comparative tables, are set out in an appendix to the printed version of this speech⁴³.

Profits tax

116. I propose a reduction in the rate of tax on corporate profits from 17% to 16.5%. I estimate the cost of the proposed reduction to be \$345 million in 1989-90, and \$695 million in a full year. The new corporate rate of 16.5% will apply to provisional and final assessments for 1989-90.

Capital allowances

117. Sir, the initial allowance for expenditure incurred on qualifying machinery and plant was last revised, to 55%, in 1982⁴⁴. In general, I hold the view that it is better to reduce the rate of tax on business profits, leaving it open to businessmen to make their own decisions about investment. However, a more generous reduction in the rate of tax on profits than I have proposed would be inappropriate at this time, having regard to inflationary pressures. I believe, therefore, that this year it is preferable to give an increase in capital allowances by way of direct encouragement, because much of the additional investment expenditure by businesses is likely to be spent on imported goods and should not therefore contribute to inflationary pressures.

118. Accordingly, I propose that the initial allowance be increased from 55% to 60% for qualifying expenditure. The new initial allowance will apply to provisional and final assessments for 1989-90. I estimate the cost to the revenue of this increased allowance to be some \$110 million in 1989-90, and \$150 million in a full year.

Interest tax

119. I turn now to the taxation of interest. The Inland Revenue Ordinance provides for an interest withholding tax. Exemptions from this tax were given in 1982 and 1983 respectively to interest on foreign currency deposits and Hong Kong dollar deposits, where these were held with financial institutions. This has resulted in the yield from this tax declining significantly.

120. Against this background, and because the present discrimination between interest paid by financial institutions and interest paid by other entities is said to have inhibited the development of Hong Kong as an international capital and financial market, I propose to simplify our taxation system by the complete abolition of interest tax with effect from the year of assessment commencing 1 April 1989. I estimate the overall cost of this concession to be some \$140 million in 1989-90.

Profits tax paid by unincorporated businesses; property tax

121. The reduction in the standard rate of tax will affect the amount of profits tax to be paid by unincorporated businesses, and reduce yields from property tax. Taken together, I estimate that this will cost a further \$40 million in 1989-90, and \$100 million in a full year. The new standard rate will apply to provisional and final assessments on unincorporated businesses, and to provisional and final property tax assessments, for 1989-90.

Stamp duty

122. A concession on stamp duty was recommended by the Securities Review Committee where the lending and borrowing of share scrip are used as the means of expediting the settlement of transactions. Stock lending and borrowing are internationally accepted methods of resolving legitimate temporary settlement problems. Provided certain safeguards are introduced, I support the committee's recommendation and, subject to the advice of the Executive Council, I shall shortly be introducing a Bill into this Council providing for the exemption from stamp duty of stock lending transactions entered into for this purpose. The full year cost would amount to some \$40 million.

IMPLEMENTATION

123. My proposals for the business registration fee, deposit-taking company licence and registration fees, dutiable commodities, and vehicle and driving licence fees were the subject of Public Revenue Protection Orders signed by you, Sir, yesterday. During the current Session a Bill to amend the Inland Revenue Ordinance will be introduced into this Council to give effect to the tax concessions proposed. Other increases in fees and charges will be implemented during the year when the relevant costing reviews are completed.

OTHER TAXATION MATTERS

124. Before concluding, I wish to mention certain other taxation matters.

Taxation of married women

125. First, Members will wish to know what progress is being made on separate taxation for married women. In my speech concluding the debate on last year's Budget, I undertook to introduce separate taxation as soon as practicable, hopefully during 1990-91. Since then, much work has been done on the necessary administrative and legal arrangements. Subject to the advice of the Executive Council, I hope to be able to put detailed proposals to this Council later this year.

126. Assuming this timetable can be met, it should be possible to give effect to these proposals in final tax assessments for 1989-90.

Unit trusts and mutual funds

127. Secondly, there have been calls for an amendment to the Inland Revenue Ordinance to alter the definition of securities so that a wider range of profits made by authorized unit trusts is excluded from profits tax. I have also received representations that mutual fund corporations be exempted from profits tax in similar manner to unit trusts. There has already been consultation with the securities industry and we are giving further thought to these proposals.

Taxation of the shipping industry

128. Thirdly, as regards taxation on shipping, we have in recent months consulted with the United States authorities as to how the local shipping industry might overcome the problems posed by the 1986 US Tax Reform Act. We have agreed that the best way to resolve the present difficulties is to formalize arrangements for the reciprocal tax exemption of income derived from the international operation of ships. I hope to be in a position to announce details of the arrangements in the not too distant future.

Venture capital

129. Lastly, there has been growing interest in Hong Kong in the use of venture capital. This is a form of financing whereby venture capitalists make equity investments in new businesses with growth potential. The major return to the venture capitalist arises when he disposes of his investment. One of the restrictions on the growth of venture capital financing in Hong Kong is said to be the uncertainty which presently exists as to whether profits arising on disinvestment are liable to

profits tax. In some other jurisdictions the problem has been resolved by complex legislation. I am always wary of complicating our tax system unnecessarily but I am, nevertheless, giving this matter careful consideration in order to assess whether a suitable concession would be helpful to the further development of industry in Hong Kong.

SUMMING UP

130. Sir, I began this speech by identifying the three dominant factors which I have had to take into account in preparing my Budget this year; namely, inflation, budget surpluses, and the need to provide for our major infrastructural requirements. Because the situation is complex, I have considered it more important than ever to explain the precise nature of the problems we are facing and the rationale behind my proposals.

131. I have dwelt at some length on the subject of inflation. I have made the point that increased public expenditure in present circumstances runs the risk of fuelling inflation. Tax concessions can have the same effect. I could not, however, rule out all expenditure increases, since that could damage our future economic growth and the well-being of our community. Neither could I rule out all tax concessions, when clearly the size of the budget surplus leads to strong expectations of some reduction in tax rates. My proposals have been consciously framed with due regard to the risks involved, and I do not believe that this Budget will add significantly to inflation.

132. The reductions I have proposed in the rates of salaries tax and profits tax will restore us to the position which obtained five years ago, when the rates had to be raised in the face of a sharp slowdown in the economy. The restoration has been achieved steadily and without disturbing the stability of our public finances.

133. As to expenditure, I have throughout this speech stressed that activities in the public sector must not be revenue led. We should not spend more simply because we have collected more. The principal consideration must be to establish and then maintain a proper relationship over time between public expenditure and the performance of the economy.

134. There may be occasions when the breaching of our budgetary guidelines can

be justified. Some argue that the public sector's share of the economy should be increased to provide the kind of qualitative improvements in services that our economy now expects. But the public sector share of GDP must not be increased to the point where the wealth-producing capacity of the private sector is seriously impaired. I mention this matter not as a precursor to a change in budgetary policy, but as an indication of the problem that we face.

135. It is clear that in order to provide resources for new or improved services, we will have to be increasingly vigorous in our attack on our baseline expenditure. In other words, we must ensure that we make maximum use of the redeployment of existing resources in order to achieve the nature and quality of services that are needed today and in the future. I know that I can rely on policy secretaries and controlling officers to play their part in this task.

136. Sir, I believe this Budget successfully meets the challenge of reconciling the conflicting pressures that I have described. Our direct taxation rates are back to where they were before we faced a deficit in our public finances. Our programme of public expenditure has been maintained, and we have begun to set aside funds towards the considerable infrastructural programme that is vital to our future economic growth. I have proposed other taxation measures designed to promote investment and to stimulate and encourage further the development of Hong Kong as a financial centre and capital market. This is a Budget which I can commend to this Council.

137. Sir, I move the debate on this matter be now adjourned.

Debate adjourned pursuant to Standing Order 54(2).

Adjournment and next sitting

HIS EXCELLENCY THE PRESIDENT: In accordance with Standing Orders I now adjourn the Council until 2.30 pm on Wednesday, 8 March 1989.

Adjourned accordingly at eighteen minutes to Five o'clock.

Note: The short titles of the Bills listed in the Hansard have been translated into Chinese for information and guidance only; they do not have authoritative effect in Chinese.

Appendices

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- A. Medium range forecast 1988-89 to 1992-93 1037-1046

Forecasting Government's expenditure and revenue in the period up to 1992-93 and setting these forecasts in a historical context.

- B. Trends in public expenditure 1984-85 to 1992-93 1047-1060

Showing the past and projected allocation of resources between programme areas.

- C. Contingent liabilities 1061

Setting out the more significant contingent liabilities of Government.

- D. The recurrent cost implications of major new or improved services to begin in 1989-90 to 1992-93 1062-1063

Listing new items selected by the Chief Secretary's Committee for implementation in 1989-90 to 1992-93.

- E. Major capital works projects to begin in 1989-90 1064

Listing projects each with a project cost of \$100 million or over budgetted to begin in 1989-90.

F. Budget revenue measures 1065-1083

Containing further details of the revenue proposals made.

1 See '1988 Economic Background' for further details.

2 This is a preliminary estimate. Unless otherwise indicated all growth rates for the economy are in real terms. The growth rates of the various major components of expenditure on the GDP in 1988 are as follows:

| | % |
|--|------|
| Private consumption expenditure | 7.8 |
| Government consumption expenditure | 6.0 |
| Gross domestic fixed capital formation | 5.5 |
| of which, building and construction | -0.1 |
| plant and equipment | 12.6 |
| Total exports of goods | 26.3 |
| domestic exports | 8.9 |
| re-exports | 45.7 |
| Imports of goods | 26.6 |
| Net exports of services | 15.5 |
| | |
| Gross domestic product | 7.4 |

3 This is a provisional estimate.

4 Hong Kong's visible trade in 1988:

% increase
\$ million in money terms

| | | |
|-----------------------|---------|--------|
| Domestic exports | 217,664 | 11.5 |
| Re-exports | 275,405 | 50.7 |
| Total exports | 493,069 | 30.4 |
| Imports* | 501,174 | 31.9 |
| Visible trade balance | | -8,105 |

Visible trade deficit as a
percentage of the total value
of imports of goods 1.6%+

* including an estimate of imports of gold for industrial and commercial use.

+ 0.5% in 1987

5 Public sector expenditure in national accounts terms differs from that shown in the Consolidated Account. Details of the difference are given in Appendix A. In national accounts terms, public sector expenditure grew by 4.2% in 1988; the corresponding growth rate of private sector expenditure was 7.5%.

6 Growth rates (%): 1986 1987 1988

| | | | |
|------------------|------|------|-----|
| Domestic exports | 16.1 | 23.1 | 8.9 |
| Domestic demand | 10.1 | 11.9 | 7.2 |

7 Growth rates in 1988 (%) :

| | |
|--|------|
| Total final demand | 17.3 |
| Total final demand (excluding re-exports) | 8.7 |
| Gross Domestic Product | 7.4 |

8 Year-on-year rates of increase in the CPI(A) (%):

| | | |
|---------|----|-----|
| 1988 | Q1 | 6.8 |
| | Q2 | 7.0 |
| | Q3 | 8.1 |
| | Q4 | 7.9 |
| Average | | 7.5 |

9 According to the CPI(A), the most broadly-based measure of consumer prices.

10 Growth rate of total final demand (%):

| | including re-exports | excluding re-exports |
|------|-------------------------|-------------------------|
| 1986 | 12.8 | 12.6 |
| 1987 | 21.9 | 16.2 |
| 1988 | 17.3 | 8.7 |

11 Prices of retained imports of raw materials and semi-manufactures were, on average, about 5% higher in 1988 than in 1987.

12 If GDP in money terms rises faster than expected, spending power is removed from the economy automatically. Growth in government expenditure is constrained by financial control while the structure of our revenue system means that revenue rises sharply in response to faster economic growth and to higher inflation.

13 See "1989 Economic Prospects" for further details.

14 The forecast growth rates of the various major components of expenditure on the GDP in 1989 are as follows:

| | % |
|---------------------------------|-----|
| Private consumption expenditure | 7.0 |

| | |
|--|---------|
| Government consumption expenditure | 4.6 |
| Gross domestic fixed capital formation | 5.8 |
| of which, in building and construction | 3.0 |
| in plant and equipment | 8.1 |
| Total exports of goods | 15.2 |
| domestic exports | 7.0 |
| re-exports | 22.0 |
| Imports of goods | 15.5 |
| Net exports of services | 14.1 |
| Gross domestic product | 6.0 |

15 The forecast growth rate of domestic demand, at 5.9%, is close to that of domestic exports, at 7%.

16 As an indication of the pressure of demand, total final demand (excluding re-exports) is forecast to increase by 6.9% (11.2% if re-exports are included), which is higher than the growth rate of the GDP, or net output, of 6%. As a result, retained imports are forecast to grow by 9.5% (total imports of goods by 15.5%) and the visible trade deficit to increase from \$8.1 billion to \$12.6 billion.

17 The forecast rate of increase in the GDP deflator is 9%, and that of the domestic demand deflator is 9.3%. A much faster rate of increase is, however, expected for building and construction costs, at an average of around 20%.

18 Per capita GDP is forecast to increase by 14.3% in money terms, or 4.8% in real terms. At current prices, it would amount to \$85,600, or about US\$11,000, in 1989.

19 Expenditure from General Revenue Account and from the Funds

EXPENDITURE 1988-89 \$M

| | REVISED ESTIMATE | ORIGINAL ESTIMATE |
|-------------------------|------------------|-------------------|
| General Revenue Account | 49,610 | 49,976 |

| | | |
|--|--------|--------|
| Less transfers to Funds | 6,310 | 7,410 |
| | 43,300 | 42,566 |
| Capital Works Reserve Fund | 10,905 | 10,180 |
| Development Loan Fund | 580 | 1,790 |
| Home Ownership Fund | 2,795 | 800 |
| Mass Transit Fund | 90 | 95 |
| Student Loan Fund | 110 | 109 |
| Total - Funds | 14,480 | 12,974 |
| TOTAL (GENERAL REVENUE ACCOUNT + FUNDS) | 57,780 | 55,540 |

20

Growth in the Civil Service

Posts Strength

31.3.87 185,682 + 2.3% 179,986 + 2.0%
31.3.88 191,830 + 3.3% 183,654 + 2.0%
31.3.89 (Estimate) 198,240 + 3.3%
31.3.90 (Estimate) 206,000 + 3.9%

21 Revenue to the General Revenue Account and to the Funds

REVENUE 1988-89 \$M

| ESTIMATE | REVISED ESTIMATE | ORIGINAL |
|----------------------------|------------------|----------|
| General Revenue Account | 65,130 | 53,740 |
| Capital Works Reserve Fund | 6,340 | 4,480 |
| Development Loan Fund | 415 | 786 |

| | | | |
|---------------------|----|-------|-------|
| Home Ownership Fund | -- | 1,981 | |
| Mass Transit Fund | -- | -- | |
| Student Loan Fund | | 85 | 83 |
| Total - Funds* | | 6,840 | 7,330 |

TOTAL (GENERAL REVENUE ACCOUNT + FUNDS) 71,970 61,070

* Excluding transfers from General Revenue Account.

22

General Revenue Account and the Funds

SURPLUS / (DEFICIT) 1988-89 \$M

| | REVISED ESTIMATE | | | ORIGINAL | |
|---|------------------|-----------------|------------------|---------------------|------|
| | BEFORE TRANSFERS | AFTER TRANSFERS | (AFTER TRANSFERS | ESTIMATE TRANSFERS) | |
| General Revenue Account | 21,830 | (6,310) | 15,520 | 3,764 | |
| Capital Works Reserve Fund | (4,565) | 6,200 | 1,635 | 500 | |
| Development Loan Fund | (165) | -- | (165) | 96 | |
| Home Ownership Fund | (2,795) | -- | (2,795) | 1,181 | |
| Mass Transit Fund | (90) | 100 | 10 | 5 | |
| Student Loan Fund | (25) | | 10 | (15) | (16) |
| Total - Funds | (7,640) | 6,310 | (1,330) | 1,766 | |
| TOTAL (GENERAL REVENUE ACCOUNT + FUNDS) | 14,190 | -- | 14,190 | 5,530 | |

23 Appendix A

24 Appendix B

25 In this context, statutory bodies and agencies also include the Kowloon Canton Railway Corporation, the Mass Transit Railway Corporation and government-subsidized educational, medical and other organizations.

26 Appendix A, paragraph 15. A surplus of \$3 billion per annum would maintain the level of reserves in real terms.

27 See Appendix C for details of contingent liabilities.

28 Expenditure from General Revenue Account and from the Funds

| | DRAFT ESTIMATES | EXPENDITURE 1989-90 | REVISED ESTIMATES |
|--|--------------------|------------------------|----------------------|
| | \$M | \$M | 1988-89 |
| General Revenue Account | 70,005 | 49,610 | |
| Less transfers to Funds | 17,740 | 6,310 | |
| | 52,265 | 43,300 | |
| Capital Works Reserve Fund | 14,490 | 10,905 | |
| Development Loan Fund | 2,090 | 580 | |
| Home Ownership Fund | -- | | 2,795 |
| Mass Transit Fund | 90 | | 90 |
| Student Loan Fund | 130 | | 110 |
| Total - Funds | 16,800 | | 14,480 |
| TOTAL (GENERAL REVENUE ACCOUNT + FUNDS) | 69,065 | | 57,780 |

29 Appendix A

30 Appendix D

31 Appendix E

32 In this context, the Civil Service comprises employees in government departments, the Housing Authority and the Urban and Regional Councils.

33 Revenue to the General Revenue Account and to the Funds

| | DRAFT REVENUE ESTIMATES 1989-90 | | REVISED ESTIMATES 1988-89 |
|---|---------------------------------|-------|---------------------------|
| | \$M | \$M | |
| General Revenue Account | 73,415 | | 65,130 |
| Capital Works Reserve Fund | 7,040 | 6,340 | |
| Development Loan Fund | 630 | | 415 |
| Home Ownership Fund | -- | | -- |
| Mass Transit Fund | -- | | -- |
| Student Loan Fund | 90 | | 85 |
| Total - Funds* | 7,760 | | 6,840 |
| TOTAL (GENERAL REVENUE ACCOUNT + FUNDS) | 81,175 | | 71,970 |

* Excluding transfers from General Revenue Account.

34

General Revenue Account and the Funds

| | ESTIMATED SURPLUS / (DEFICIT) 1989-90 (BEFORE REVENUE MEASURES) \$M | | |
|-------------------------|--|-----------|-----------------|
| | BEFORE TRANSFERS | TRANSFERS | AFTER TRANSFERS |
| General Revenue Account | 21,150 | (17,740) | 3,410 |

| | | | |
|---|---------|--------|--------|
| Capital Works Reserve Fund | (7,450) | 8,800 | 1,350 |
| Development Loan Fund | (1,460) | 8,900 | 7,440 |
| Home Ownership Fund | -- | -- | -- |
| Mass Transit Fund | (90) | -- | (90) |
| Student Loan Fund | (40) | 40 | -- |
| Total - Funds | (9,040) | 17,740 | 8,700 |
| TOTAL (GENERAL REVENUE ACCOUNT + FUNDS) | 12,110 | -- | 12,110 |

35 Details can be found in Appendix F.

36 1988 Budget Speech, paragraphs 75, 76 and 81

37 Appendix F(1)

38 Of the 5 310 fees and charges presently collected, 4 147 are set at levels to ensure full cost recovery. The remainder are grouped into six different categories, that is, nominal, subsidized, deterrent, tax-loaded, utilities and others, to each of which different criteria are applied to determine an appropriate level of fee or charge.

39 1987 Budget Speech, paragraph 118

40 Appendix F(2)

41 Appendix F(2)

42 The present basic and additional allowances are --

| | Basic Allowance | Additional Allowance | Total |
|--------|-----------------|----------------------|----------|
| Single | \$29,000 | \$ 7,000 | \$36,000 |

Married \$60,000 \$14,000 \$74,000

43 Appendix F(3)

44 1982 Budget Speech, paragraph 81

45 Speech concluding the Debate on the Second Reading of the Appropriation Bill, 1988, paragraphs 48 and 49