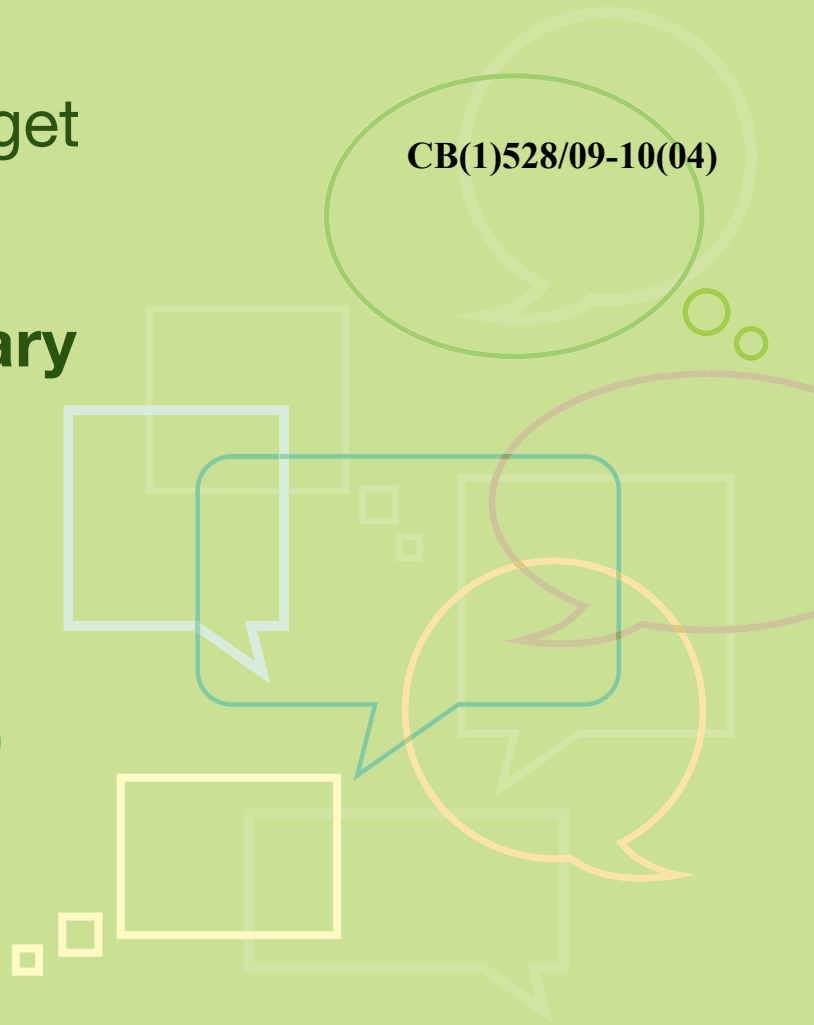




The 2010-11 Budget

CB(1)528/09-10(04)

The Financial Secretary
invites
your
views



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invites your views

The Financial Secretary is consulting Members of the Legislative Council, representatives from various sectors and the people of Hong Kong on the 2010-11 Budget.

We welcome and value your advice on the Budget. You can provide us with your advice via the budget website www.budget.gov.hk or in writing to the Financial Secretary's Office, 5th floor, Main Wing, Central Government Offices, Lower Albert Road, Hong Kong.

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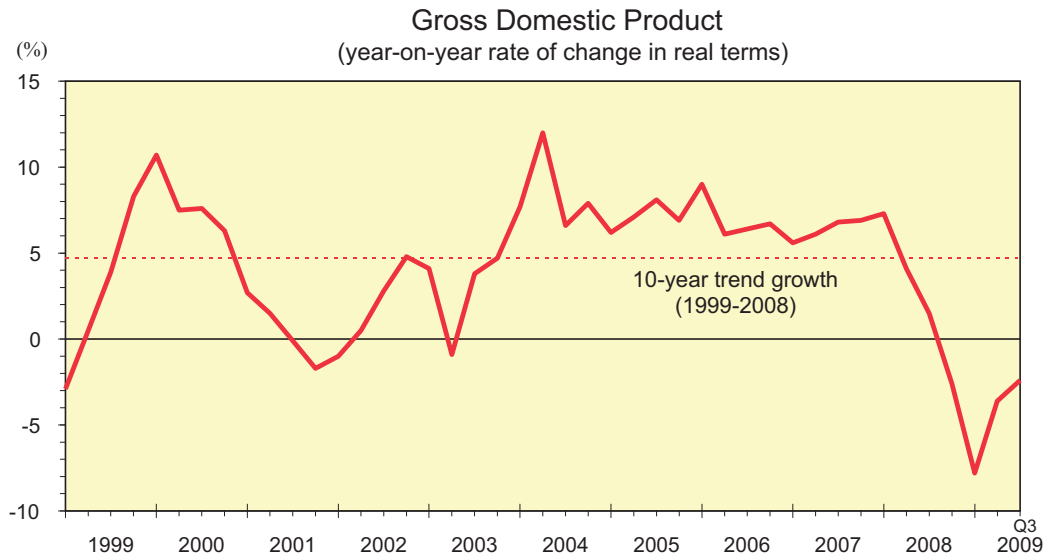
Latest 2009 economic indicators

GDP real growth	January to September	-4.6% (Third quarter -2.4%)
Unemployment rate	August to October	5.2% (May to July 5.4%)
CCPI inflation	January to October	0.4% (October 2.2%)

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

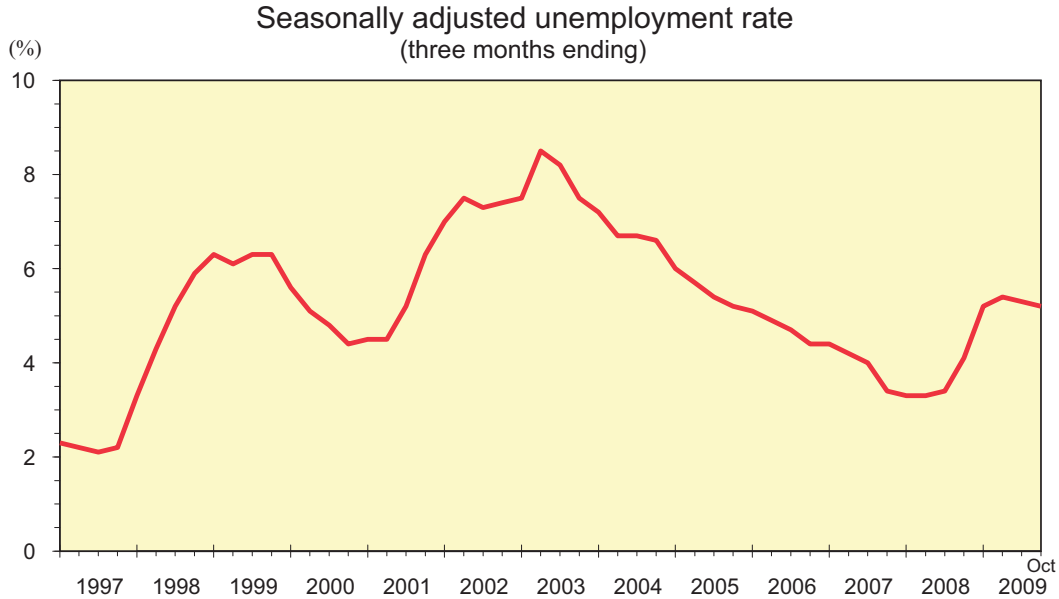
- Hong Kong was severely hit by the global financial crisis and the ensuing recession in the world economy, the worst in more than 60 years. The economy rebounded notably in the second quarter and then improved further in the third quarter, benefiting from the return to faster growth in the Mainland and the waning of recessionary pressure in advanced economies.
- Underpinned by the gradual revival of the local economy, the labour market began to show signs of improvement. The unemployment rate edged down to 5.3% in July-September 2009 (further to 5.2% in August-October), the first decline since the onset of the global financial crisis in September 2008. Meanwhile, consumer prices were on an easing trend as local price pressure remained subdued and import prices stayed soft.
- As a small and open economy, a sustained and solid recovery will hinge on a fundamental improvement in the external environment. The recovery path may still be uneven and the possibility of a double-dip in the global economy in the period ahead cannot be dismissed.
- Our economic policies are guided by pro-market principles, and the Government will continue to promote economic development wherever warranted. *Should the Government play a more active role in our economic development?*

Economy in the early phase of recovery but still subject to considerable uncertainties ahead



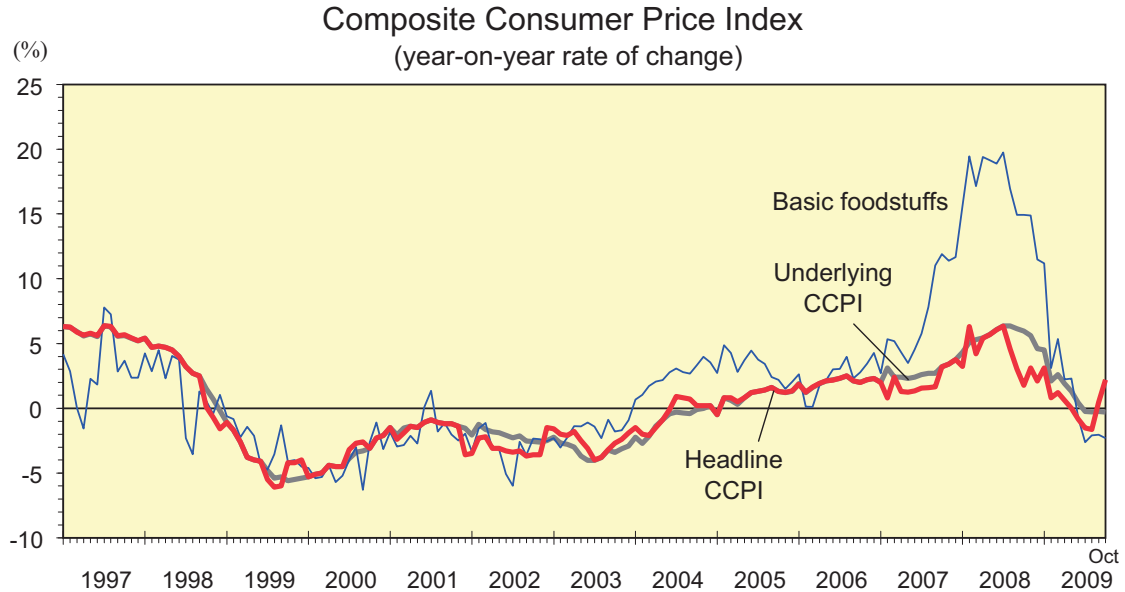
- Following the strong policy actions taken by governments around the world, the global economy is finally taking a breather after a dismal first quarter in 2009. The Hong Kong economy has also entered the early phase of recovery. The external environment remains challenging and is still subject to considerable uncertainties.
- We introduced a series of measures to stabilise the financial markets, ease credit conditions, support enterprises, accelerate public works, and create employment. These measures have provided a stabilising effect on the economy. We will continue with this strategy until economic recovery is on solid ground. We are mindful that an appropriate exit strategy is important to ensure sustainable growth and to avoid undue influence on the market.
- On the fiscal side, the several rounds of relief measures amounted to some \$87.6 billion, equivalent to 5.2% of the GDP. *With the economy gradually beginning to recover, how should we prioritise the usage of our limited resources?*

Labour market showing much resilience



- The unemployment rate became more stable in recent quarters, having risen notably after the outbreak of the financial crisis. This is testimony to the resilience and flexibility of our labour market. As business conditions gradually improve, employers are taking a more positive attitude towards recruitment. This is expected to ease the pressure on unemployment in the near term, though earnings and wages would continue to face downward pressure. Improvement in the employment situation is the key indicator of economic recovery.
- The Government's various measures to preserve and create employment have yielded positive results. The economic recovery has taken hold and the unemployment rate has come down. But there is no room for complacency. *What can we do to help sustain the encouraging trend in the labour market?*
- Consistent with our pro-market economic policy, we will follow the principle of “from welfare to self-help” in tackling poverty, creating job opportunities, mobilising the business community to support social initiatives, and improving the livelihood of low-income groups and the disadvantaged. We have been investing heavily in education to enhance social mobility and alleviate cross-generational poverty. *What more can we do to further enhance social mobility? How do we become an even more caring society?*

Prices on an easing trend



- Consumer prices eased further as local and external price pressures were virtually absent in the midst of the global economic downturn. This is part of a global phenomenon. The more imminent threats to the global economy, and hence the Hong Kong economy, are the risk of deflation and the uncertainties surrounding the global recovery.

Latest forecast for 2009

GDP real growth	-3.3%
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CCPI

Underlying	0.9%
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Headline	0.5%
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- The external sector should continue to see relative improvement along with the stabilisation in the global economy and faster economic growth in the Mainland. Consumer sentiment is likely to be supported by a relatively stable labour market, low interest rates and government relief measures.
- Taking into account the GDP decline of 4.6% in the first three quarters of the year, the economy is forecast to contract by 3.3% for 2009 as a whole.
- Inflationary pressure is likely to remain subdued as global economic activity is still well below the pre-crisis level. Headline CCPI inflation for 2009 as a whole is forecast to average 0.5%.
- *What can the Government do, without compromising fiscal prudence and market efficiency, to ensure a more sustainable economic recovery?*

Economic uncertainties

Short term

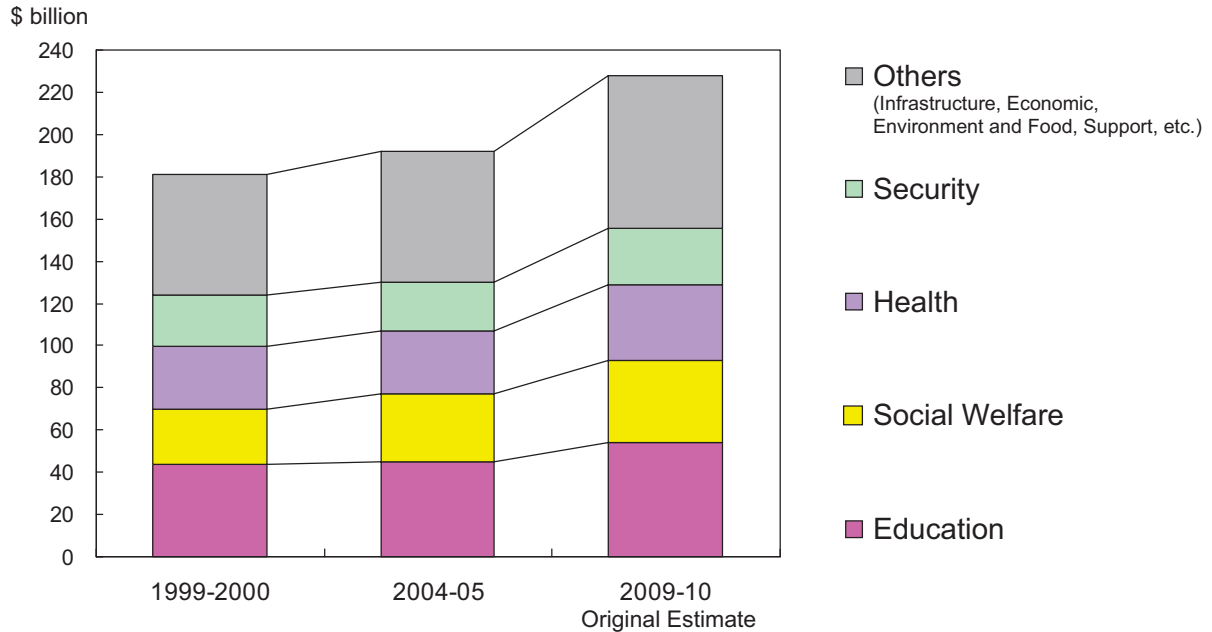
- Risk of gyrations in asset markets
- Rising unemployment undermining the strength of recovery in the advanced economies
- Persistent deflation and the risk of prolonged sluggishness in the global economy

Medium term

- Deleveraging in the US and Europe and the health of the financial sector
- Timing of implementing exit strategies in the major economies
- Persistence of global imbalances and rise of protectionist sentiments
- Return of higher inflation

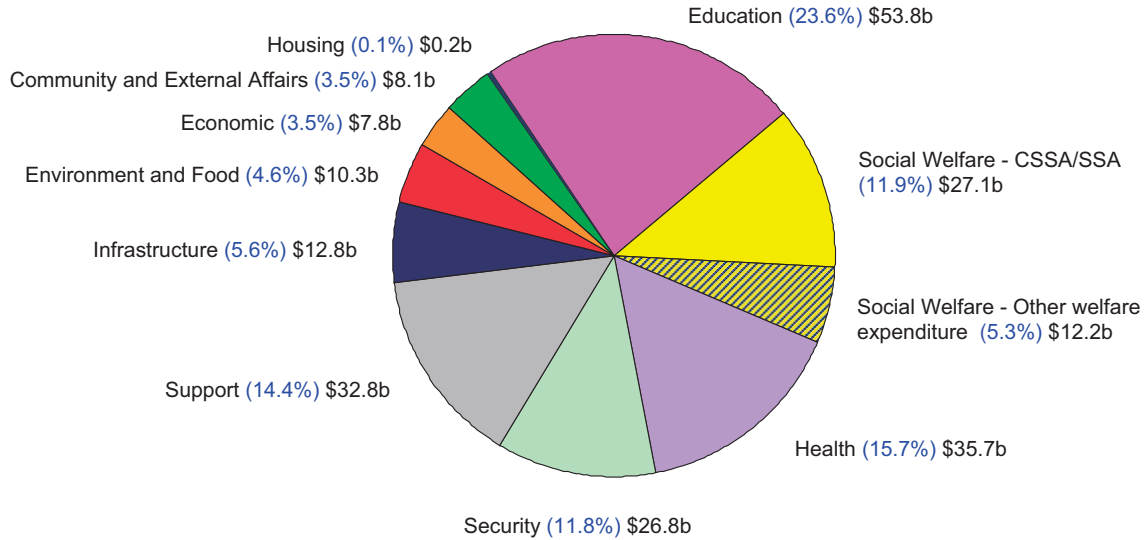
- Being a small and open economy, Hong Kong's well-being is inevitably affected by global fluctuations. We need to constantly review our strengths and weaknesses, thereby better positioning ourselves to cope with changes in this uncertain environment. We need to better manage risks in the financial markets based on the lessons learnt from the global financial crisis. *How can we better manage risks?*
- As the global financial and economic landscape goes through turbulent changes, there lie new economic opportunities. *How should we respond and capture these opportunities?* We should also bear in mind medium-term issues, such as fiscal sustainability, while dealing with short-term challenges.
- While continuing to tackle the challenges posted by the global financial crisis, we should not lose sight of the longer term development needs of our economy. *How can we accelerate the pace of economic integration with the Mainland? What should we do to promote economic development?*

Recurrent expenditure in past 10 years



- Total recurrent government expenditure increased by some \$46.5 billion or 26% over the past 10 years.
- As part of wealth redistribution and to improve the well-being of lower income groups, we have been increasing our spending on education, social welfare and health –
 - Education + 23%
 - Health + 20%
 - Social Welfare + 49%
 - *Comprehensive Social Security Assistance (CSSA) Scheme* + 34%
 - *Social Security Allowance (SSA) Scheme* + 80%
 - *Other welfare expenditure* + 55%
- Higher expenditure in Social Welfare and Health is expected in future with the ageing population. *How can we cope with this challenge?*

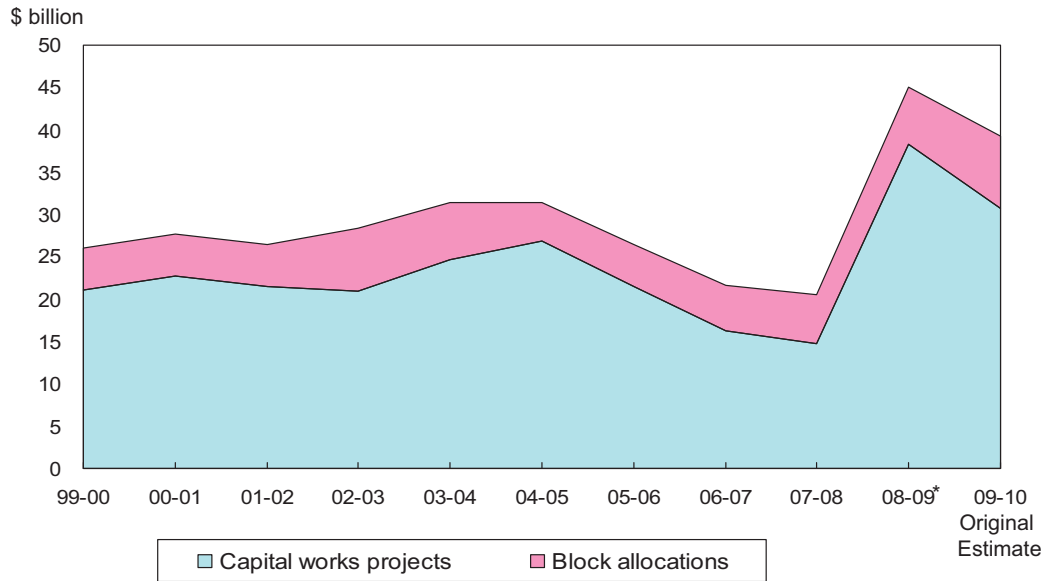
Recurrent expenditure for 2009-10



Total recurrent government expenditure: \$227.6 billion (75% of total government spending of \$301.6 billion)

- Based on the 2009-10 Original Estimate, the spending on Education (23.6%), Social Welfare (17.2%), Health (15.7%) and Security (11.8%) together accounts for 68.3% of total recurrent government expenditure.
- We will ensure optimal allocation and efficient utilisation of resources according to strategic priorities. The Government has committed to increasing the share of health care expenditure to 17% of its recurrent expenditure by 2011-12. Inevitably the allocation in terms of percentage to some other policy areas will have to be reduced even though the allocation in dollar terms is still higher than the 2009-10 level. We need to prioritise the use of government resources to provide for changing needs. *Are there any existing services which are no longer essential or cost-effective, and which public funding should be reduced to make way for more pressing initiatives?*

Essential infrastructure

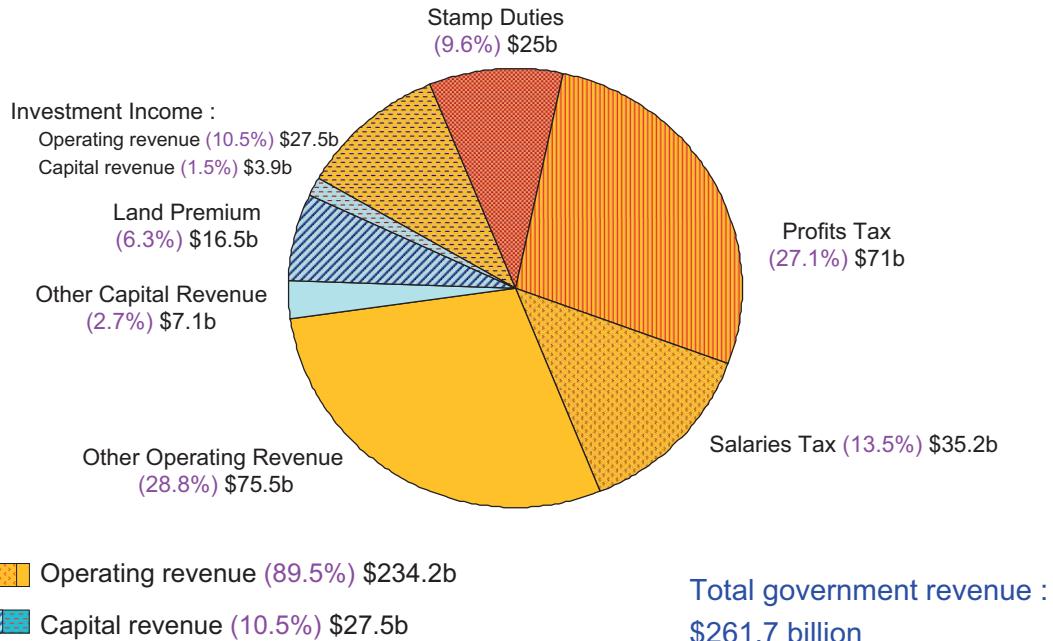


* including the upfront endowment of \$21.6 billion to the West Kowloon Cultural District Authority

Capital works expenditure

- The Government remains committed to investing in infrastructure to facilitate economic growth, create jobs and enhance the long-term competitiveness of Hong Kong.
- In the past, we earmarked on average \$29 billion a year for spending on public works projects. This year, the budget is \$39.3 billion. Over the next few years, we envisage that capital works expenditure will grow considerably with the major infrastructure projects, including the Ten Major Infrastructure Projects announced by the Chief Executive in the 2007-08 Policy Address, entering their construction peaks. Our annual capital works expenditure is expected to stay at a very high level over the medium term, averaging some \$50 billion per year. This amount of annual expenditure is unprecedented.
- In view of the rapid growth in infrastructure investment, we will monitor closely the construction industry's capacity and avoid bunching of projects that may cause tension in the supply of construction labour and contract price fluctuations. In devising our public works programme, we will also take into account private sector construction activities to avoid unnecessary competition for resources between the public and private sectors, which may in turn push up construction costs. *How should we manage our expenditure on infrastructure projects in order not to pose pressure to the construction industry while promoting sustainable economic growth?*

Revenue for 2009-10

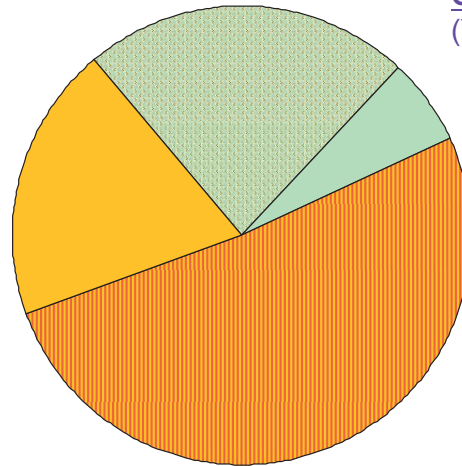


- Profits and salaries taxes are the major sources of government revenue, accounting for 40.6% of total government revenue in the 2009-10 Original Estimate. This is followed by investment income which accounts for 12% of the total.
- The rate of investment return for 2009 is 6.8%. This source of revenue has provided sizeable resources to fund government expenditure. The amount of investment income depends in part on the level of our fiscal reserves. If we continue to draw down the fiscal balance, revenue from this source will be adversely affected.
- Five major revenue items contribute 68.5% of total revenue. They are highly affected by the economic situation. *Should we introduce new revenue items or increase the rates of other revenue items to reduce our reliance on these high yielding revenue sources?*

Taxpayers

Actual Revenue 2007-08

Profits and salaries
taxes: \$128.9 billion
(36% of total
government revenue)



Contribution from taxpayers (Year of assessment 2007-08)

- Top 100 000 people paying salaries tax
- Remaining 1 316 000 people paying salaries tax
- Top 1 200 corporations paying profits tax
- Remaining 78 500 corporations paying profits tax

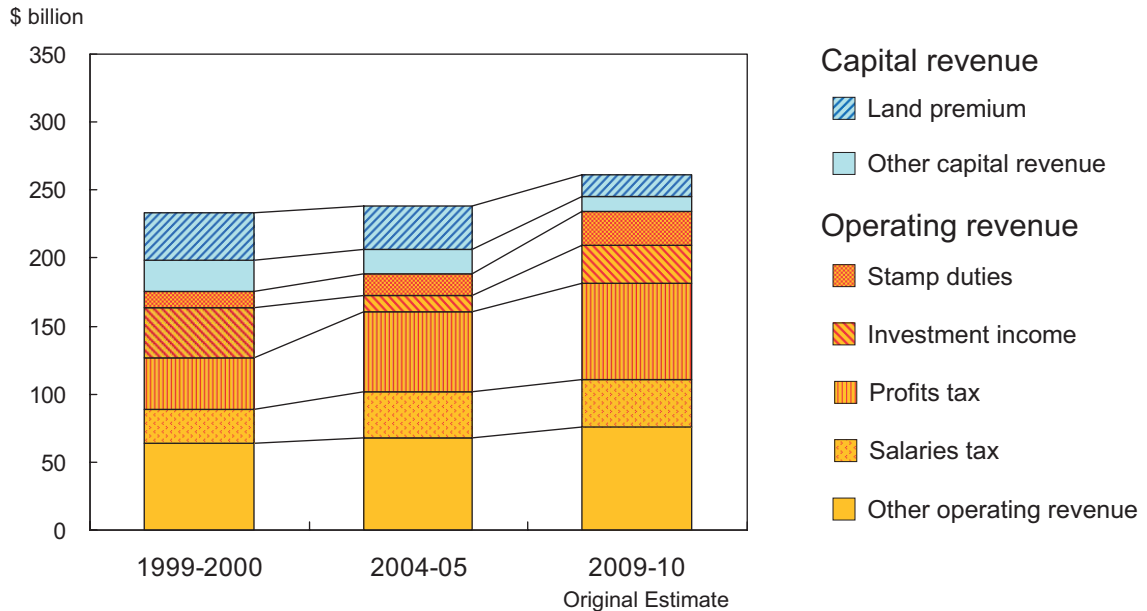
- Of the 7 million population, only 3.5 million people fall into the category of working population and only 1.4 million people pay salaries tax.
- In the year of assessment 2007-08, the top 100 000 salaries tax payers (1.4% of the total population) contributed 79.4% of the revenue from salaries tax or 8.3% of total government revenue.
- For the same year, about 72.6% of our profits tax, or 18.5% of total government revenue, was contributed by the top 1 200 taxpaying corporations. Most small businesses pay little or no tax.
- *Do we need to broaden the tax base? If so, how?*

Salaries Tax Effective Tax Rate for 2007-08

Annual Income	No. of Taxpayers	Average effective tax rate (before one-off tax reduction)	Average effective tax rate (after one-off tax reduction)
(\$)		(%)	(%)
100,001 – 150,000	251,622	0.4	0.1
150,001 – 300,000	572,066	2.2	0.5
300,001 – 600,000	404,492	5.7	2.0
600,001 – 900,000	91,440	9.9	6.5
900,001 – 1,500,000	55,566	12.4	10.2
1,500,001 – 3,000,000	26,818	14.4	13.2
Over 3,000,000	13,504	15.8	15.4
Total	1,415,508	8.3	6.2

- Because of our generous allowances and deductions under salaries tax, some 87% of the taxpayers were subject to an average effective tax rate of less than 6% for 2007-08, even if we discount the effect of the one-off tax reduction.
- The overall average effective tax rate for all salaries tax payers for 2007-08 (before one-off tax reduction) was 8.3%.
- Our salaries tax payers, particularly those in the lower and middle income group, enjoy one of the lowest effective tax rates in the world.

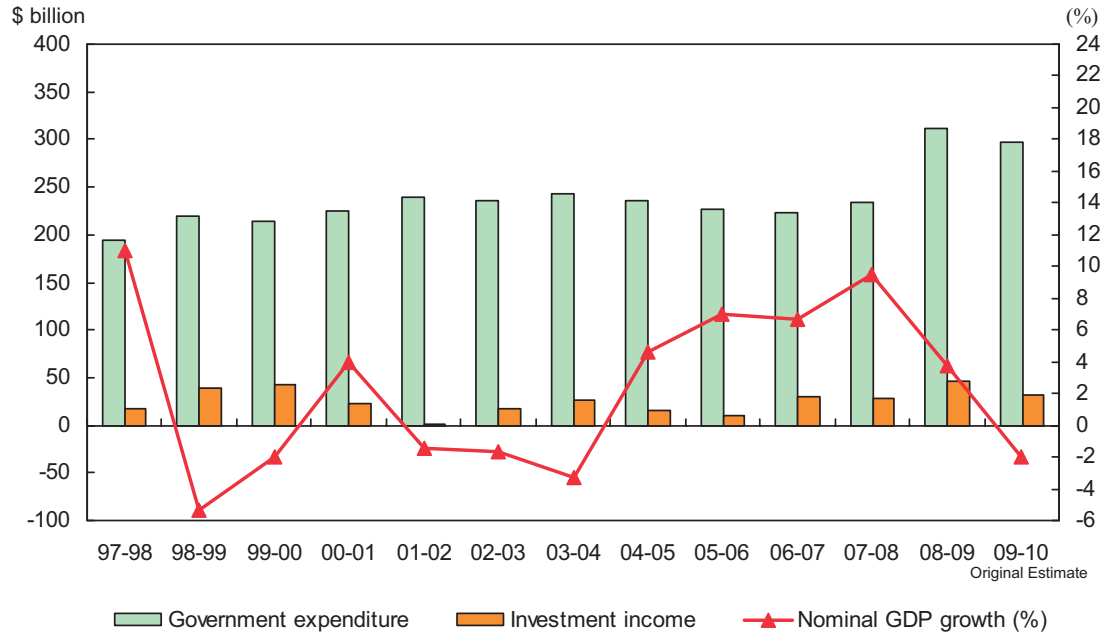
Revenue in past 10 years



Total government revenue

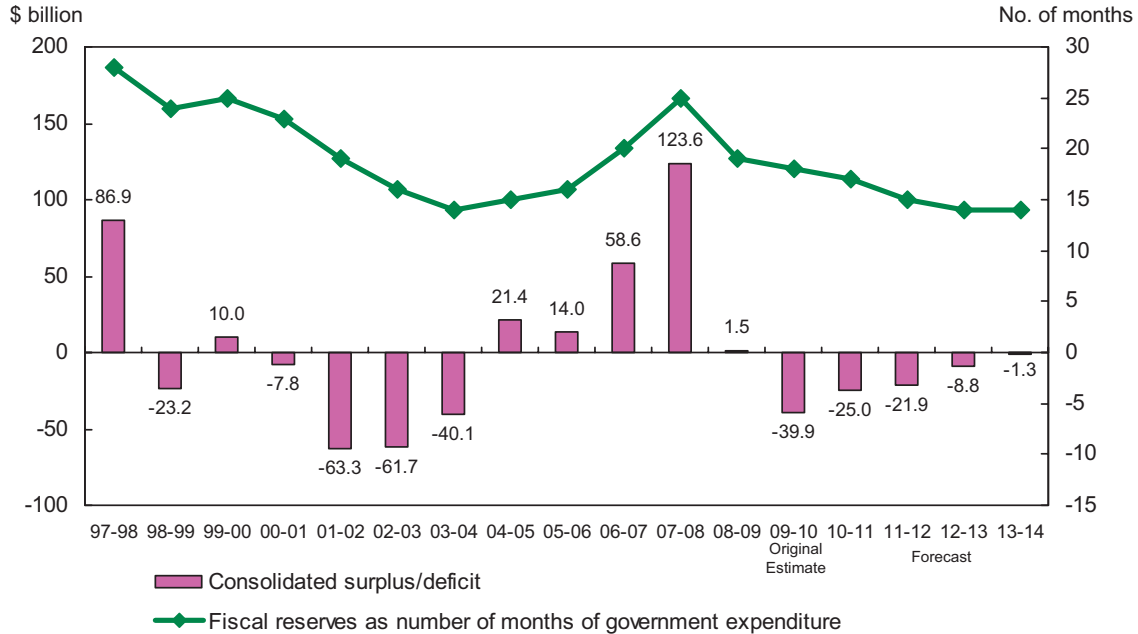
- Profits tax has been our largest operating revenue. It varied from \$37.7 billion in 1999-2000 to \$104.2 billion in 2008-09.
- Salaries tax has been our second or third largest operating revenue. It varied from \$24.8 billion in 1999-2000 to \$39 billion in 2008-09.
- Stamp duties varied from \$7.5 billion to \$51.5 billion for the period.
- While, since 1 April 2007 we have adopted an arrangement whereby the rate of investment return is pre-determined based on past returns, investment income from fiscal reserves is still rather volatile. Revenue generated from this source varied from \$27.9 billion in 2007-08 to \$46.6 billion in 2008-09.
- As for capital revenue, land premium has been most volatile, fluctuating from \$5.4 billion to \$62.3 billion in the past 10 years.
- *What measures should the Government adopt to cope with the challenges posed by the volatility of our revenue income?*
- In the past, we have explored measures to identify additional sources of revenue and/or to broaden the tax base. A public consultation exercise on Goods and Services Tax was conducted. *What other ideas should we explore?*

How we have used the fiscal reserves



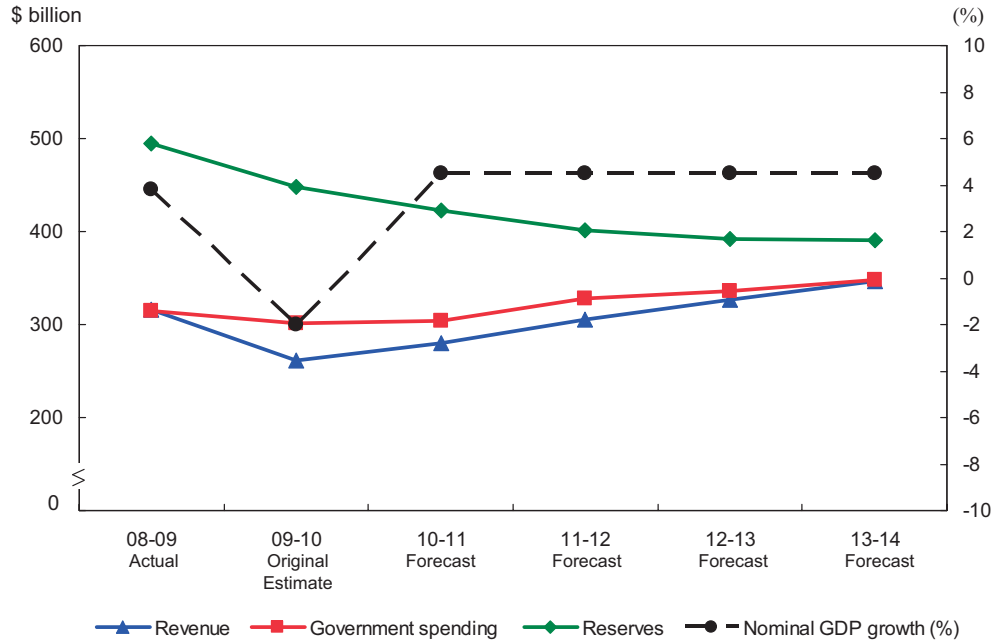
- Our fiscal reserves have served us well, helping us iron out income volatilities.
- We have been using investment income from the fiscal reserves as a source of revenue. For 2009-10, this investment income is our third largest revenue source, accounting for 12% of our total revenue. Without this income, taxes and government charges would need to be increased or services reduced.
- In times of economic and fiscal difficulties, we have used the reserves to fund budget deficits, making it possible for us to maintain our expenditure at a relatively stable level despite reductions in GDP and revenue. In the six years from 1998-99, we recorded deficits for five years, depleting the reserves by some \$200 billion.

How we have used the fiscal reserves



- In the Medium Range Forecast (MRF) announced in the Budget this February, we were projecting a drawing down of the fiscal reserves to fund a counter-cyclical response to our current economic difficulties. Fiscal reserves were around \$500 billion which is equivalent to 19 months of government expenditure at the start of 2009-10, and are projected to fall to \$400 billion which is equivalent to 14 months of government expenditure by the end of 2013-14.
- Over a period of time, we need to achieve fiscal balance. The fiscal reserves provide a safety cushion shielding us from the year-on-year volatility of our revenue.
- In the longer term, we need to rebuild our reserves. *In the coming year, how should we balance expenditure, revenue and fiscal reserves?*

Medium Range Forecast in 2009-10 Budget



- This is the MRF announced in the Budget last February.
- Over the period covered by the MRF, government spending is projected to continue to increase to enable us to fund capital works expenditure which may average some \$50 billion a year, and to provide for new or improved services that our society needs. However, we cannot sustain deficits indefinitely, and must return to fiscal balance at an appropriate time.
- Over time, we need to keep expenditure within the limits of revenues and keep expenditure growth commensurate with the growth rate of GDP. Looking ahead –
 - *What will be our GDP performance in 2010-11, and the rest of the MRF period?*
 - *What is the appropriate fiscal policy for 2010-11?*

Opportunities and challenges

- Six industries
- Sustainable economic recovery
- Volatile and narrow revenue base
- Ageing population
- Better home

- The Government and the community need to act together to meet the challenges ahead.
- The Task Force on Economic Challenges identified six industries with good potential : education services, medical services, testing and certification services, environmental industries, innovation and technology, cultural and creative industries. *How can the Government and the private sector work together to facilitate the development of these six industries?*
- *How should we position ourselves to ensure a more sustainable economic recovery?*
- We need to address the challenges posed by the volatile nature of our revenue. *Broaden the tax base? Increase our fiscal reserves to cushion against economic uncertainties? Other suggestions?*
- We need to prepare Hong Kong for the challenges of an ageing population. *How can this be achieved?*
- *How can we encourage Hong Kong people to work together with Government to make a better Hong Kong?*

Your views are welcome!

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