

**Consultation
on
2017-18 Budget**

3 January 2017

Content

I. The Economy	2-4
II. Fiscal Discipline	5-8
III. Expenditure	9-16
IV. Revenue	17-24
V. Fiscal Reserves	25-28
VI. Long-Term Fiscal Challenges Ahead	29-37

The Economy

Latest forecasts for 2016

GDP real growth	1.5%
Consumer price inflation	
Underlying	2.3%
Headline	2.4%

- The global economy has remained on a modest growth track recently, rendering support to Asia's trade and our exports. Locally, full employment and favourable income conditions should provide the key positive factors underpinning consumption growth. Meanwhile, hectic infrastructure works, coupled with solid growth in private construction activity, should also render impetus to overall economic growth.
- Taking account of the actual GDP growth outturn in the first three quarters of 2016 and in cognizance of a likely further modest growth in the fourth quarter, the real GDP growth for 2016 as a whole is forecast at 1.5%.
- On prices, inflation pressure should remain contained in the near term, given the generally low global inflation and modest local cost pressures. The underlying and headline consumer price inflation rates for 2016 as a whole are forecast at 2.3% and 2.4% respectively.

Economic uncertainties

- Fragile recovery in some major advanced and emerging markets
- Pace of US interest rate normalisation and policy divergence among major central banks
- The US economic situation and policy directions after the general election
- Brexit still unfolding; Europe's political developments
- Elevated geopolitical tensions in the world
- Developments in inbound tourism

- Economic recovery in the euro area and Japan is constrained by deep-seated structural issues, while some emerging markets including Brazil and Russia are still lacklustre. Moreover, the pace of future US interest rate hikes remain uncertain. This, coupled with the opposing policy actions by other major central banks, could shift capital flows abruptly and heighten volatility in international financial markets, threatening those emerging market economies with weaker fundamentals.
- There is market concern about the US economic situation and policy directions of the new administration. The possible ramifications could be profound, given the prominent position of the US in global trade and finance. The continued favourable trend in the US economy is of paramount importance to the global, Asia's as well as Hong Kong's economic outlook.
- The direct impact of Brexit on our economy is not significant at present. That said, Brexit is still unfolding, and several important general elections will be held in Europe this year. The possibility of further repercussions on the global economic and financial environment could not be ruled out.
- The prolonged sluggishness in the major advanced economies underscores the importance of forging closer ties with our economic partners in Asia, particularly the Mainland, and of capturing the vast opportunities from the Belt and Road Initiative.

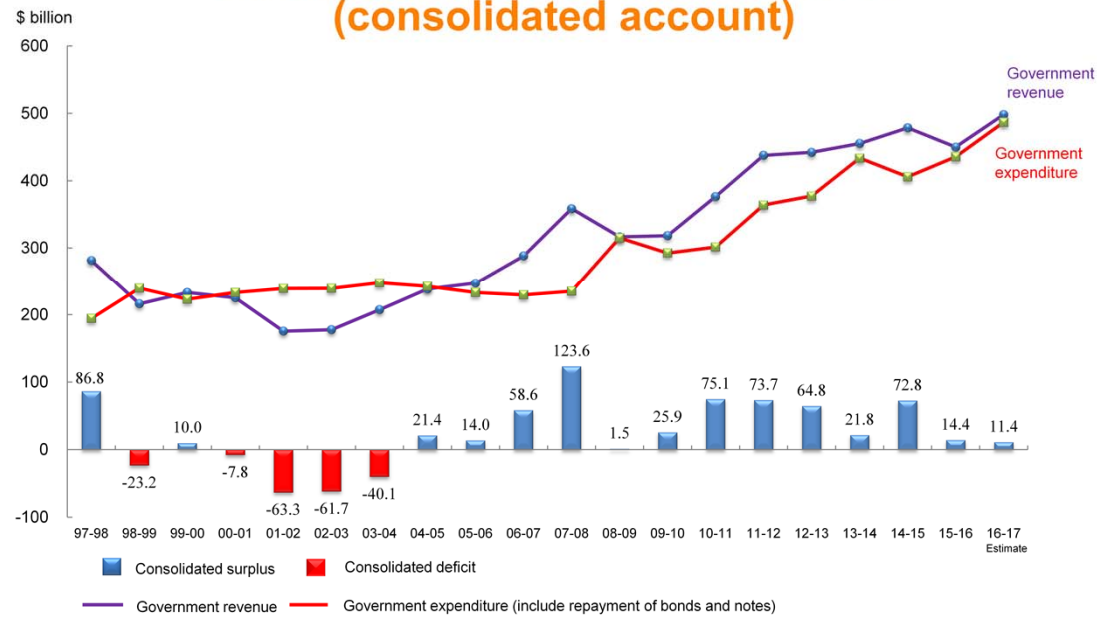
Fiscal Discipline

Fiscal discipline enshrined in Basic Law

- Basic Law Article 107
 - ... follow the principle of keeping expenditure within the limits of revenues
 - ... strive to achieve a fiscal balance, avoid deficits
 - ... keep the budget commensurate with the growth rate of its gross domestic product

- Fiscal prudence has been the guiding principle of the HKSAR Government. Under the Basic Law (BL), we shall -
 - (a) follow the principle of keeping expenditure within the limits of revenues in drawing up the budget;
 - (b) strive to achieve a fiscal balance, avoid deficits; and
 - (c) keep the budget commensurate with the growth rate of the Gross Domestic Product (GDP).
- All three prongs of BL Article 107 have to be complied with.
- These principles are integral to sustaining the health of the Hong Kong economy and maintaining the confidence of local and international investors.

Financial highlights since 1997-98 (consolidated account)

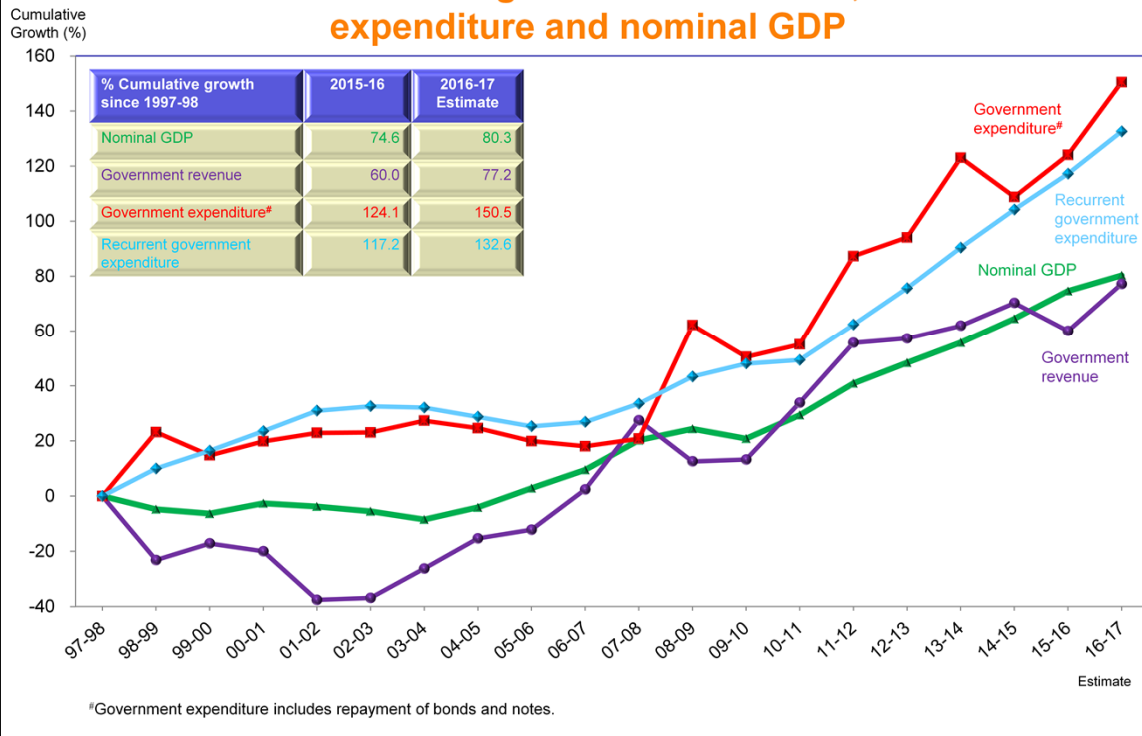


- The Basic Law requires us to strive to achieve a fiscal balance and avoid deficits.
- We have achieved budget surpluses for 14 years since 1997-98. But budget deficits had beset us for five years between 1998-99 and 2003-04 and the drain on the fiscal reserves was substantial.

Fiscal Discipline

- 8 -

Growth of government revenue, expenditure and nominal GDP



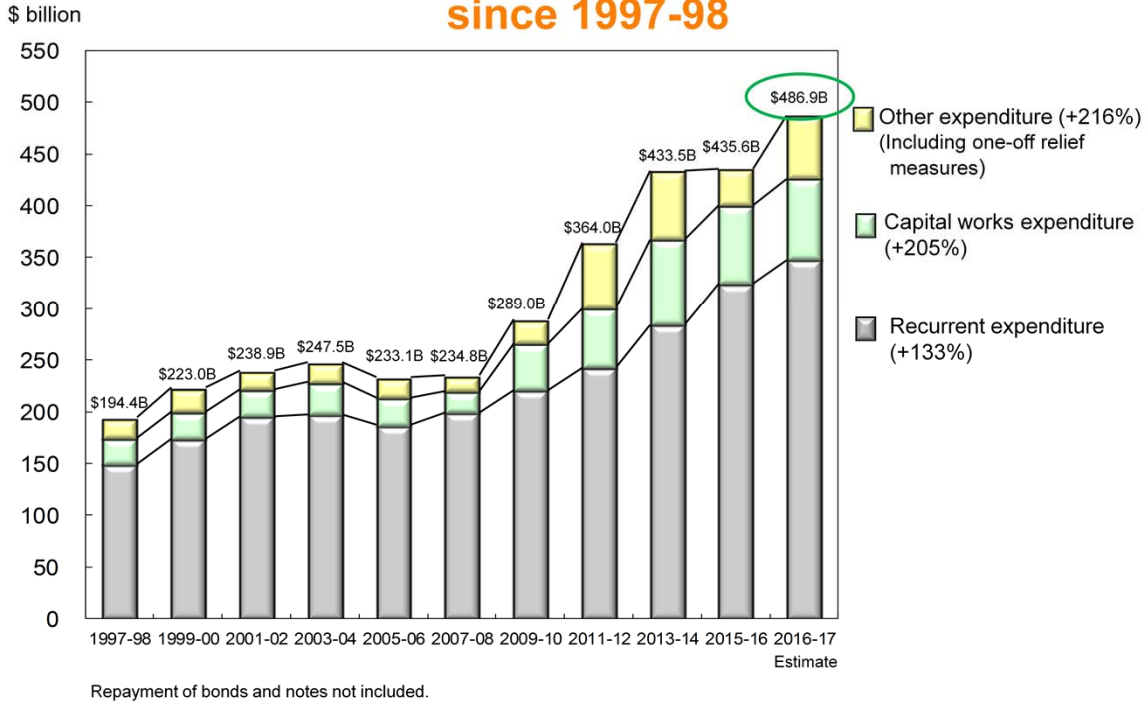
- The Basic Law requires us to keep the budget commensurate with the growth rate of the GDP.
- By the end of 2015-16, GDP had grown 75% since 1997-98.
- Government expenditure had grown by 124%, from \$194 billion in 1997-98 to \$436 billion in 2015-16.
- Recurrent expenditure had surged by 117%, from \$149 billion in 1997-98 to \$325 billion in 2015-16.
- Government revenue has grown broadly in line with GDP - by 60%, from \$281 billion in 1997-98 to \$450 billion in 2015-16 as reflected in the cash-based accounts, or by 82% if revenue forgone through budget relief measures and the impact of the Housing Reserve are taken into account.
- There is a clear need to contain the growth of government expenditure.

Expenditure

Expenditure

- 10 -

Total government expenditure grew by 151% since 1997-98



- Total government expenditure for 2016-17 was estimated to reach \$486.9 billion, representing an increase of \$51.3 billion, or 11.8%, against the actual expenditure for 2015-16, mainly due to the increase in provisions for recurrent expenditure and capital works expenditure. It is more than doubled when compared with 1997-98 –

Compared with 1997-98

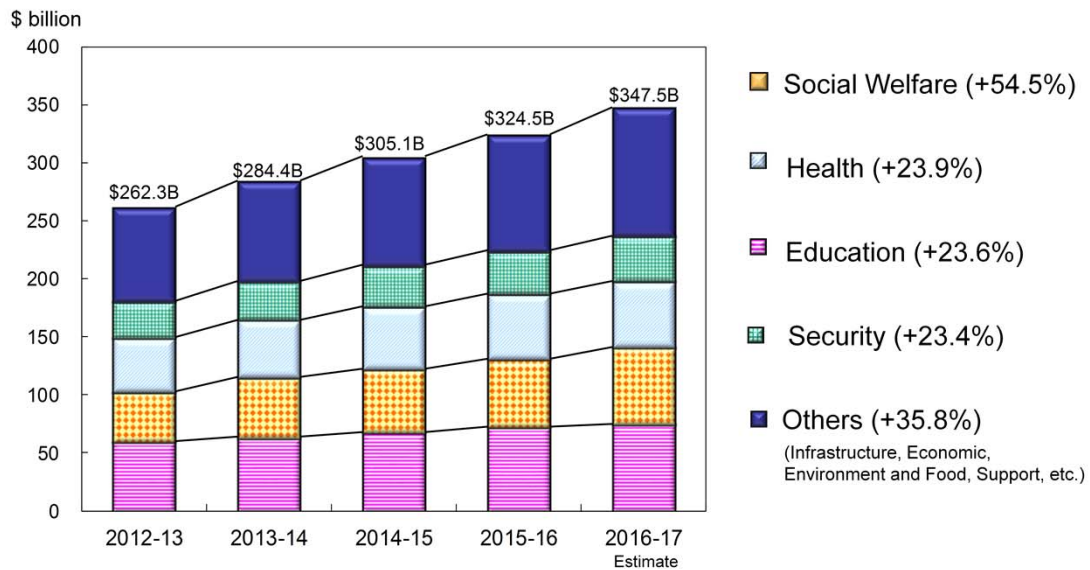
- Capital works expenditure +205%
- Recurrent expenditure +133%

- Since Finance Committee had approved the \$10 billion endowment fund to the Hospital Authority for Public-Private Partnership Initiatives within 2015-16, the provision built into the 2016-17 Original Estimate would need to be adjusted downward by \$10 billion to avoid double counting. Government expenditure for 2016-17 should read \$476.9 billion with the adjustment.

Compared with 1997-98

- Total government expenditure +145%
- > Other expenditure +164%

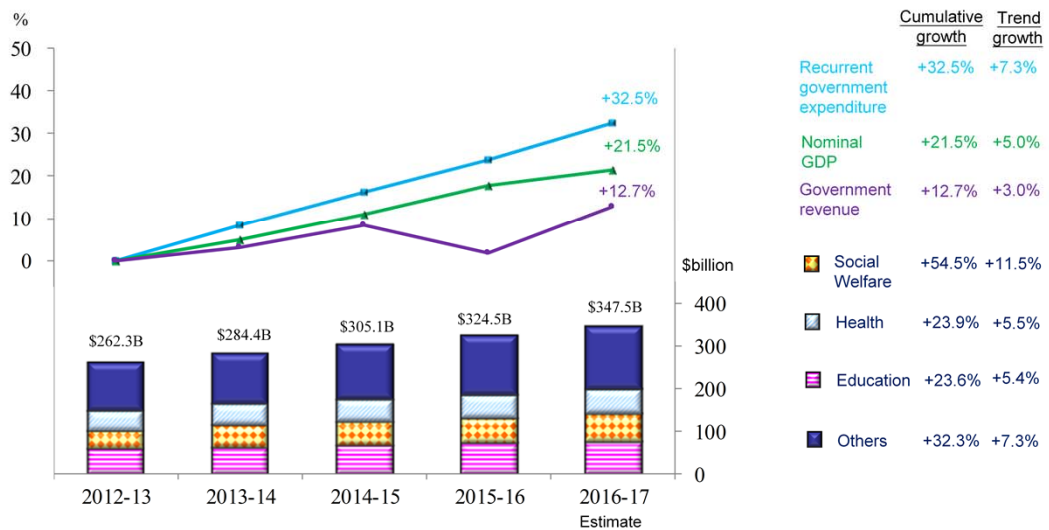
Recurrent expenditure grew by 32% since 2012-13



- Recurrent expenditure for 2016-17 is estimated to reach \$347.5 billion, representing an increase of \$23.0 billion (or 7.1 %) over the actual expenditure for 2015-16. It is growing steadily since 2012-13 at a trend rate of 7.3%. The increase in provisions for recurrent expenditure reflects the Government's long term commitment to improving people's livelihood.
- Our recurrent expenditure on social welfare, health and education has been increasing –

	<u>Compared with 2012-13</u>
➤ Social Welfare	+54.5%
Comprehensive Social Security Assistance Scheme	+14.5%
Social Security Allowance Scheme	+110.7%
Other welfare expenditure	+68.2%
➤ Health	+23.9%
➤ Education	+23.6%





Recurrent government expenditure vs GDP and revenue growth



- The cumulative and trend growths from 2012-13 to 2016-17 Estimates are as follows –

	<u>Cumulative growth</u>	<u>Trend growth</u>
Recurrent government expenditure	+32.5%	+7.3%
➤ Social Welfare	+54.5%	+11.5%
➤ Health	+23.9%	+5.5%
➤ Education	+23.6%	+5.4%
➤ Others	+32.3%	+7.3%
Nominal GDP	+21.5%	+5.0%
Government revenue	+12.7%	+3.0%

Major initiatives introduced in recent years

	2016-17 Provision (\$Billion)
 Old Age Living Allowance	13.5
 Low-income Working Family Allowance Scheme	2.9
 Public Transport Fare Concession Scheme for the Elderly and Eligible Persons with Disabilities	1.1
 Converting the Elderly Health Care voucher (EHV) Scheme into a recurrent programme and increasing the annual EHV value from \$250 to \$2,000 for each eligible elder	1.3 [^]

[^] Exclude \$380M which was included in 2016-17 Estimates for deferred payment of Elderly Health Care Voucher Scheme arising from 2015-16.

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

	2009-10	2012-13	2013-14	2016-17	Average growth rate since implementation
	(Year of implementation)				
OALA [*]			\$11.1B	\$13.5B	7% p.a.
LIFA				\$2.9B	- (first implemented in 2016-17)
\$2 Scheme		\$0.2B		\$1.1B	113% p.a.
EHV Scheme [‡]	\$49M [#]			\$1.3B [^]	365% p.a.

* Exclude back pay for the period from December 2012 to March 2013.

Implemented in Jan 2009. The actual expenditure for Jan to Mar 09 (3 months) was \$7M.

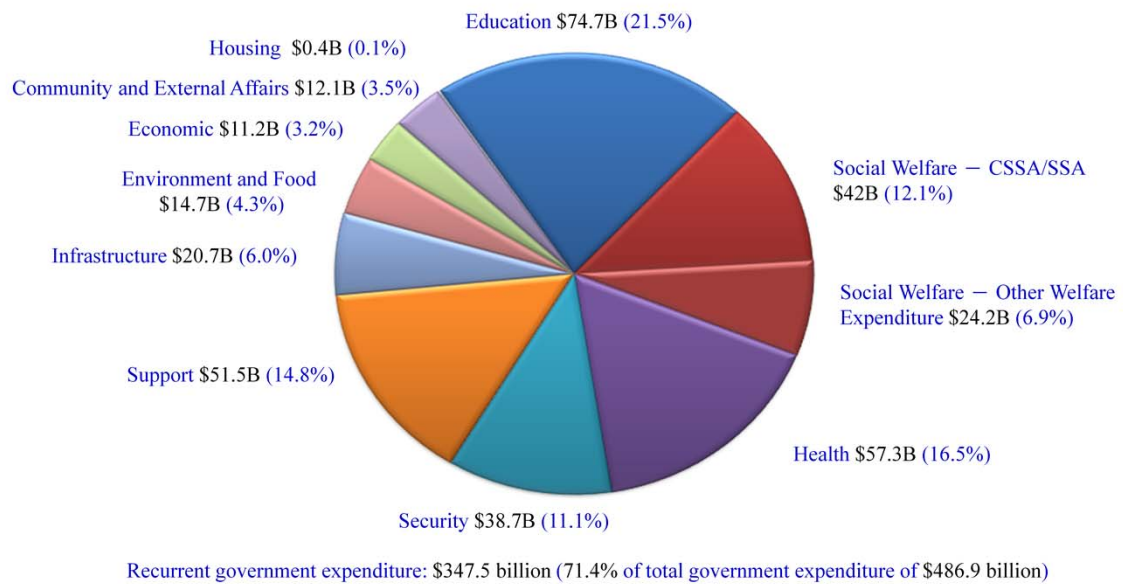
[^] Exclude \$380M which was included in 2016-17 Estimates for deferred payment of Elderly Voucher Scheme arising from 2015-16.

[‡] EHV Scheme voucher amount has been increased from \$250 to \$2,000 as follows -

\$250 for implementation	Jan 2009 (2008-09)
\$250 → \$500	Jan 2012 (2011-12)
\$500 → \$1,000	Jan 2013 (2012-13)
\$1,000 → \$2,000	Jun 2014 (2014-15)

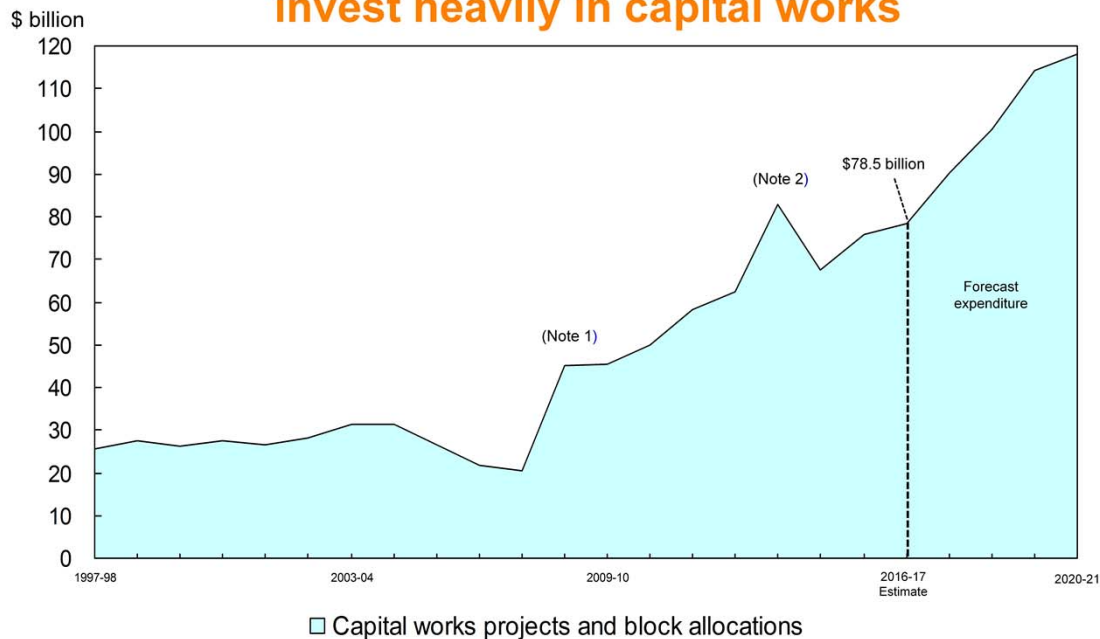
Expenditure

Recurrent expenditure for 2016-17



- Based on the 2016-17 Estimates of Expenditure, the spending on Education (21.5%), Social Welfare (19%) and Health (16.5%) together accounts for 57% of total recurrent government expenditure.

Government continuing to invest heavily in capital works



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

- The 2016-17 estimated expenditure on capital works under the Capital Works Reserve Fund will reach \$78.5 billion (including \$9.1 billion allocation for minor works), accounting for about 3.6% increase from 2015-16 actual expenditure. The 2015-16 actual expenditure (\$75.8 billion) has increased about 10% as compared with the actual expenditure of 2014-15 (\$68.8 billion).
- Compared with the actual expenditure for 1997-98 (\$25.7 billion), the level of expenditure has increased by about 205%.
- With the various major infrastructure projects at their construction peak, capital works expenditure is expected to maintain at the current high level over the next few years.

Capital works projects

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



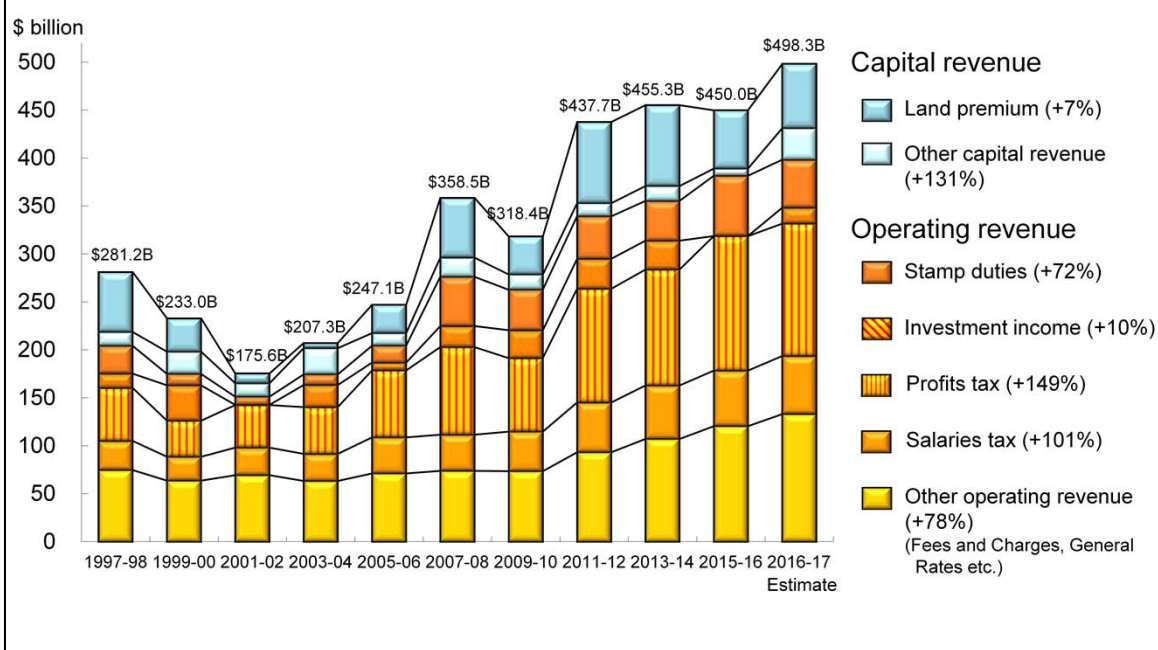
- Strategic infrastructure projects under way –
 1. Hong Kong – Zhuhai-Macao Bridge
 2. Hong Kong Section of Guangzhou-Shenzhen-Hong Kong Express Rail Link
 3. Tuen Mun – Chek Lap Kok Link and Tuen Mun Western Bypass
 4. Shatin to Central Link
 5. South Island Line (East)
 6. West Kowloon Cultural District
 7. Kai Tak Development
- Other projects include –
 8. Health – e.g. redevelopment of Kwong Wah Hospital and Kwai Chung Hospital, expansion of Haven of Hope Hospital, extension of Operating Theatre Block for Tuen Mun Hospital and refurbishment of Hong Kong Buddhist Hospital
 9. Environmental protection – e.g. development of the organic waste treatment facilities at Siu Ho Wan and treatment and recycling facilities for waste electrical and electronic equipment at the EcoPark in Tuen Mun
 10. Education – primary and secondary schools, and special school projects
 11. Sports, recreational and cultural – e.g. sports Centre at Choi Wing Road, Kwun Tong, sports centre, community hall and football pitches in Area 1, Tai Po and the East Kowloon Cultural Centre

Revenue

Revenue

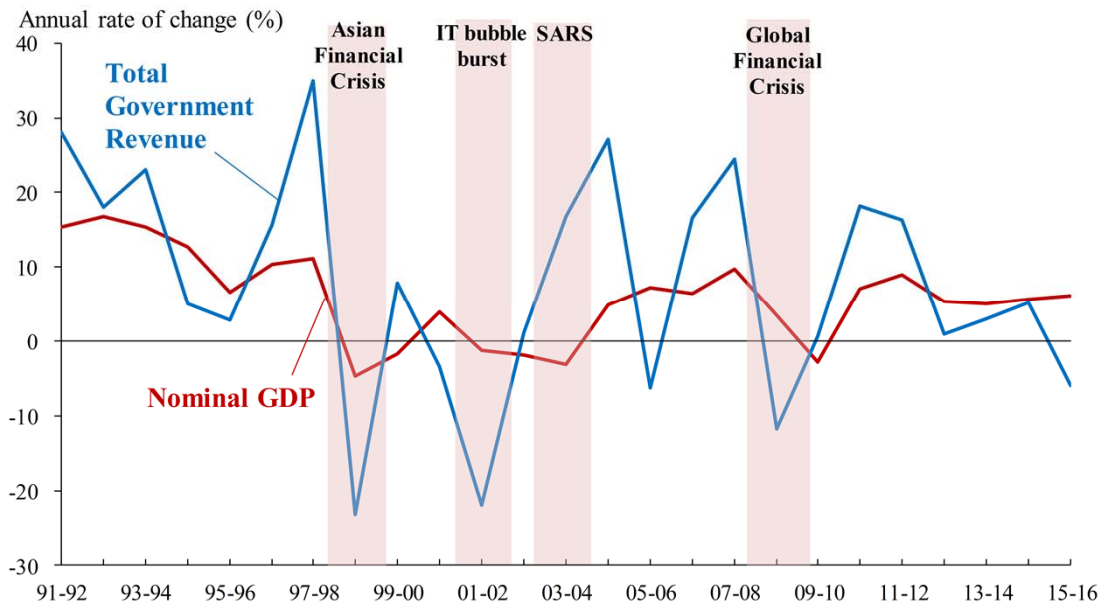
- 18 -

Total revenue grew by 77% since 1997-98



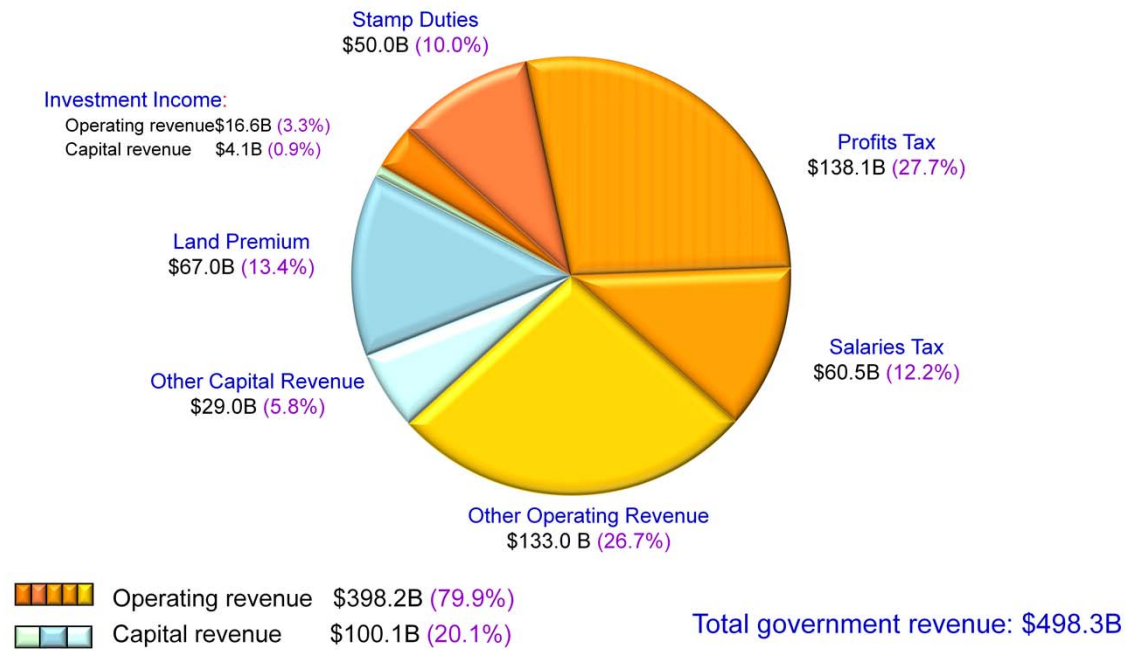
- Profits tax has been our largest operating revenue. It varied from \$37.7 billion (1999-2000) to \$140.2 billion (2015-16).
- Salaries tax has been our second or third largest operating revenue. It varied from \$24.8 billion (1999-2000) to \$59.3 billion (2014-15).
- Stamp duties varied from \$7.5 billion (2002-03) to \$74.8 billion (2014-15).
- Since 1 April 2007, we have adopted an arrangement whereby the rate of investment return is pre-determined based on past returns. This has greatly reduced the volatility of investment income. The average annual revenue from this source was \$36.3 billion from 2007-08 to 2013-14. The investment income in respect of the fiscal reserves for 2014 (\$27.5 billion) and 2015 (\$45.2 billion) was set aside and retained within the Exchange Fund for the Housing Reserve.
- As for capital revenue, land premium has been most volatile, fluctuating from \$5.4 billion (2003-04) to \$84.6 billion (2011-12) in the period.
- The volatility of our revenue income poses challenges to the management of public finances.

Volatility of government revenue



- Hong Kong is a small and open economy. Our tax base is narrow and government revenue is sensitive to economic fluctuations depending on the broader economic changes beyond government's control.
- The volatility of our revenue poses challenges to the management of public finances. Profits tax, salaries tax, stamp duties and land premium account for 71.5% of the 2015-16 total government revenue.

Revenue estimates for 2016-17



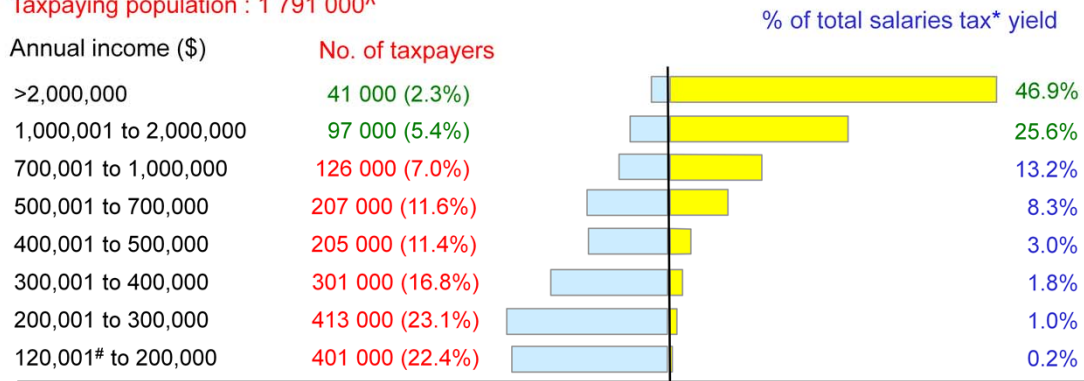
- The five major revenue items are profits tax (27.7%), land premium (13.4%), salaries tax (12.2%), stamp duties (10.0%), and investment income (mainly from placement of the fiscal reserves with the Exchange Fund) (4.2%). Together they account for 67.5% of total government revenue.

The top 5% paying about 63% of the total salaries tax

Salaries tax

2014-15 (Year of assessment)

Taxpaying population : 1 791 000[^]



[^] Of the 3 770 000 working population, only 48% pay salaries tax

* After the one-off tax reduction up to \$20,000

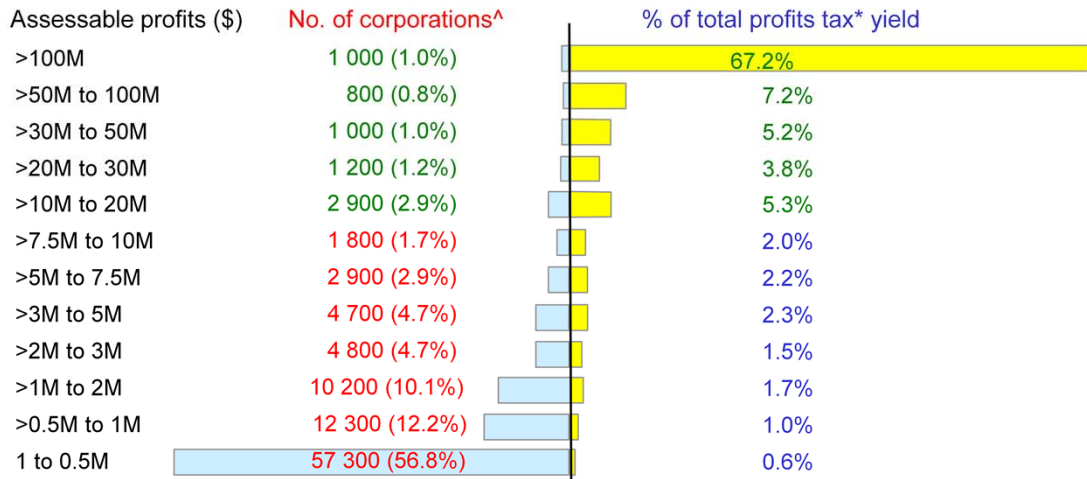
[#] The basic allowance for individuals in the 2014-15 year of assessment is \$120,000

- In the year of assessment 2014-15, of the 3.77 million working population, about 1.98 million or 52% of the working population need not pay any salaries tax.
- Of the 1.8 million who paid salaries tax, the top 5% taxpayers (i.e. about 90 000 taxpayers) contributed 63% of the revenue from salaries tax.

The top 5% paying about 86% of the total profits tax

Profits tax

2014-15 (Year of assessment)

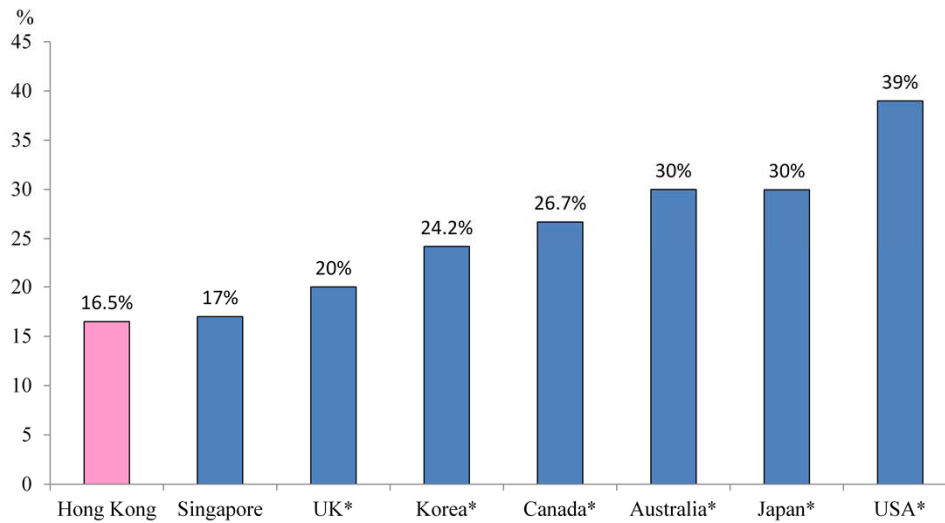


[^] Registered Corporations: 1 149 000, with 100 900 (9%) taxpaying.

* After the one-off tax reduction up to \$20,000

- In the year of assessment 2014-15, about 86% of our profits tax is contributed by the top 5% taxpaying corporations (i.e. about 5 000 corporations). Around 1 048 100 registered companies (about 91% of the total registered corporations) do not pay any profits tax.

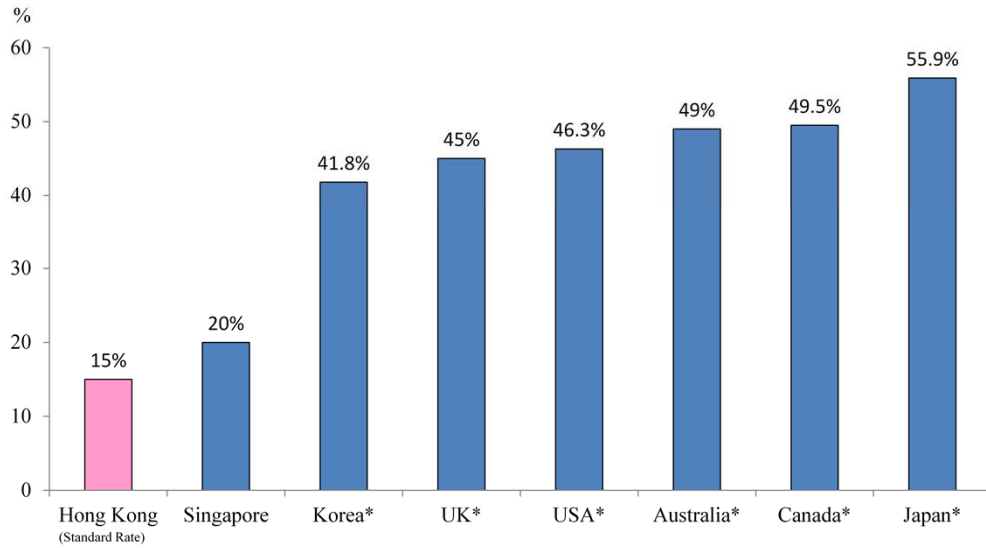
Comparison of profits tax rates



*Source: OECD Statistics (2016)

- Hong Kong has a simple tax system anchored by a low tax rate. Our profits tax rate is a flat 16.5% for corporations, and is among the lowest in the world (figures are up to 2016).

Comparison of top statutory personal income tax rates



*Source: OECD Statistics (2015)

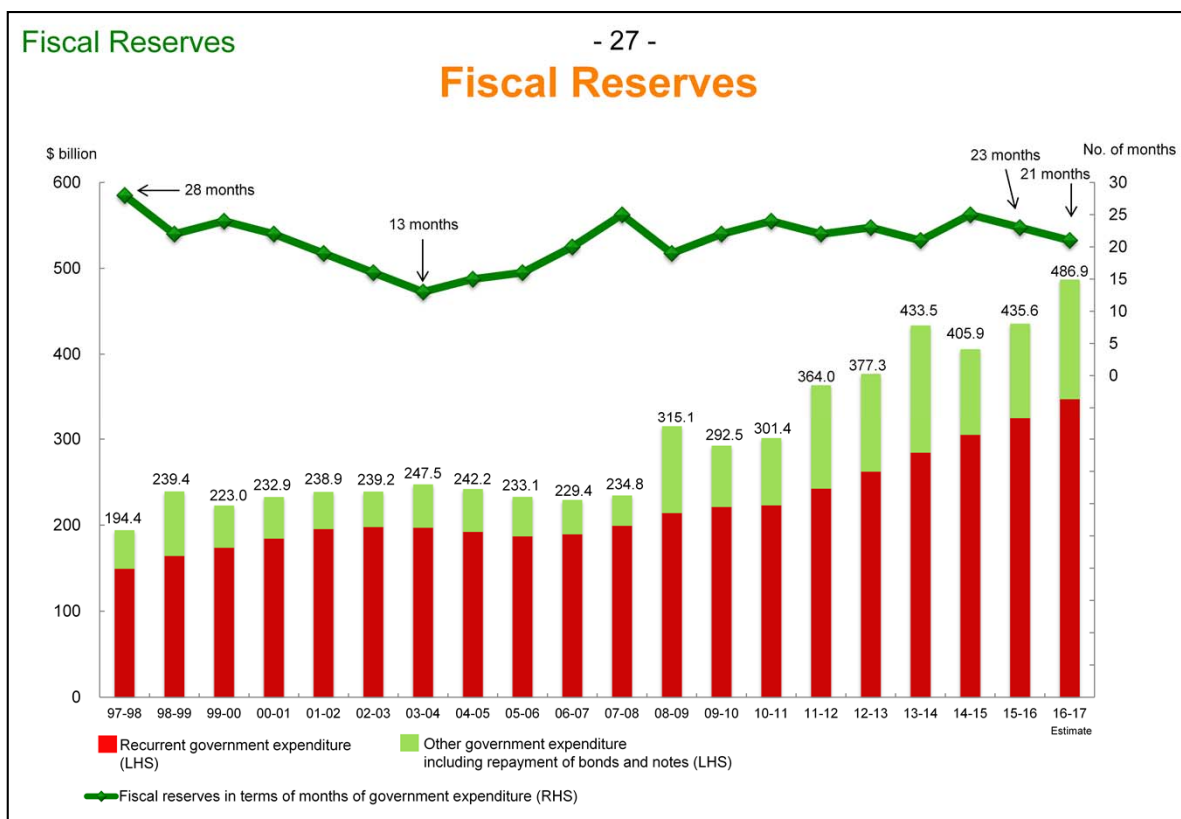
- The same applies to our salaries tax rate, which is now capped at a standard rate of 15% (figures are up to 2015).

Fiscal Reserves

Fiscal Reserves

(\$ Million)	2015-16 Actual
General Revenue Account	508,486
Funds with designated use	114,672
Capital Works Reserve Fund	58,170
Capital Investment Fund	2,835
Civil Service Pension Reserve Fund	27,129
Disaster Relief Fund	14
Innovation and Technology Fund	42
Loan Fund	4,468
Lotteries Fund	22,014
Land Fund	219,730
Total	842,888

- “Fiscal Reserves” stands for the total of the balances under the General Revenue Account and eight Funds established for specific purposes under s 29 of the Public Finance Ordinance. Much of the fiscal reserves is locked up in funds with designated use.
- This is all we have to meet our day-to-day operational needs, outstanding commitments (including about \$300 billion for capital works (as at end Mar 2016)) and liabilities (such as public officers’ pensions, the present value of which as at 31 March 2016 was \$874.7 billion).



- How much is \$800+ billion for Hong Kong?
- By the end of 2015-16, the Fiscal Reserves was equivalent to 23 months of government expenditure.
- By the end of 2016-17, the Fiscal Reserves is forecast to stand at about 21 months of government expenditure.

Financial Year	Fiscal Reserves (\$ billion)	Nominal GDP (\$ billion)	Fiscal Reserves in terms of % of GDP
1997-98	457.5	1,373.1	33.3%
2015-16	842.9	2,397.1	35.2%
2016-17 OE (Note)	854.3	2,475.1	34.5%

Note - The forecast fiscal reserves balances for 2016-17 are revised to take into account the actual results in 2015-16.

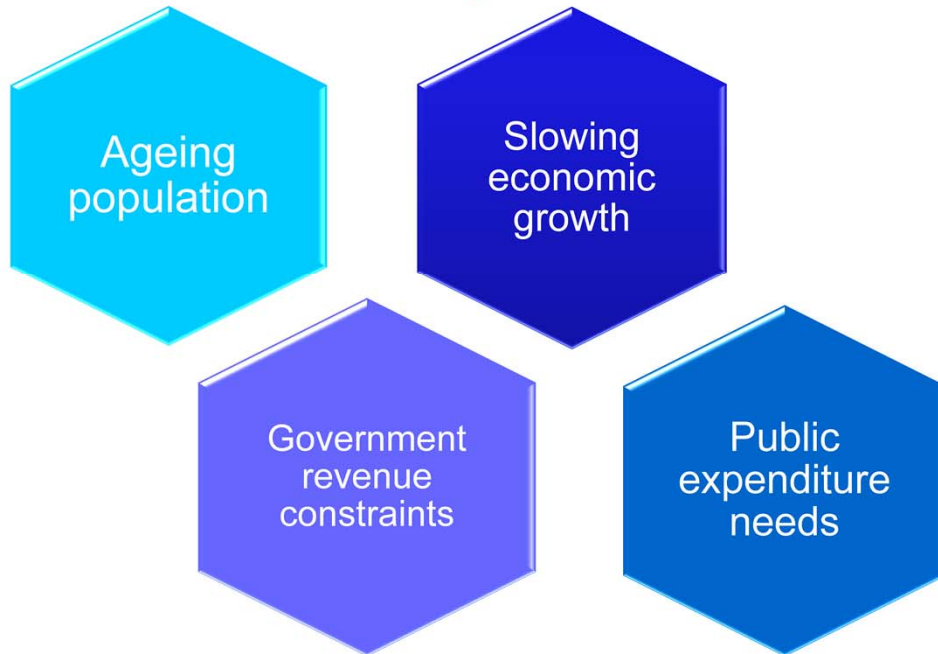
Unfunded Liabilities and Outstanding Commitments

Outstanding Commitment of Capital Works Projects	~\$300B
Unfunded pension liabilities for the coming decade	~\$450B
Contingent liabilities	~\$80B

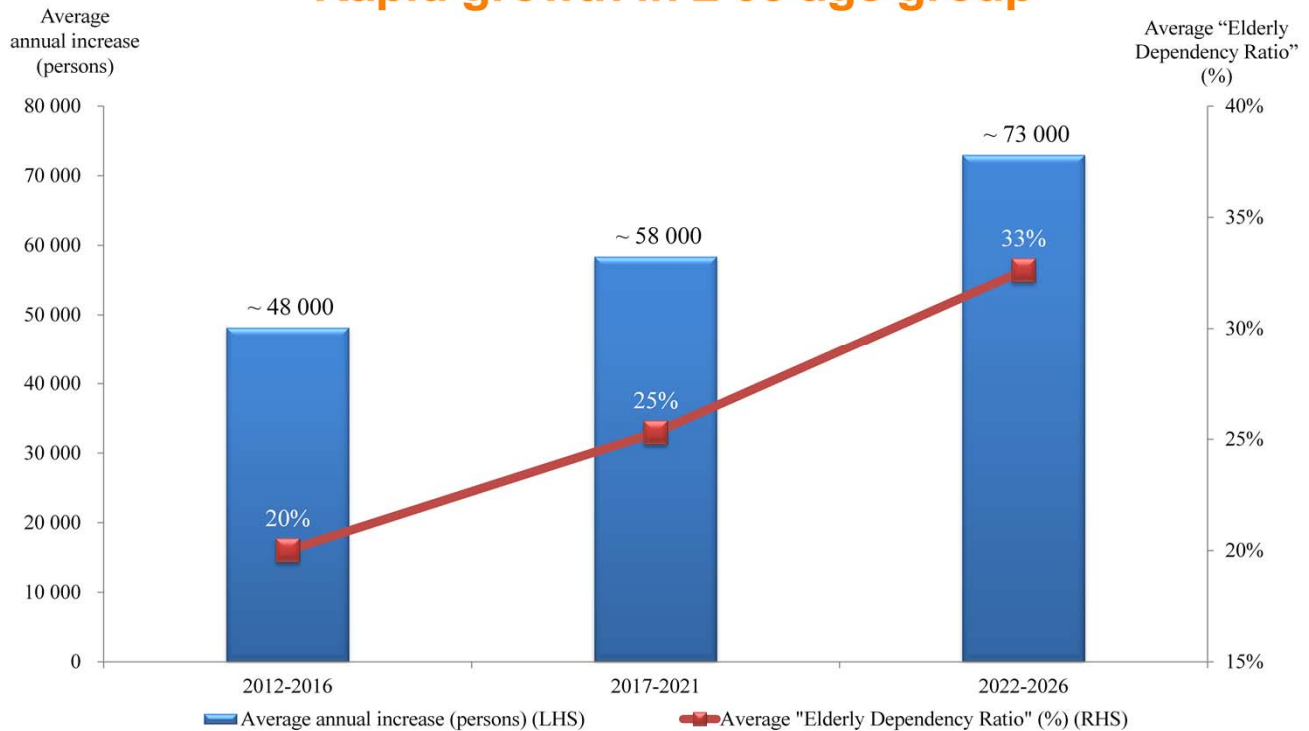
- As at end March 2016, outstanding commitment of capital works projects approved by the Finance Committee was \$296.7 billion in money-of-the-day prices.
- Key unfunded liabilities include public officer's pensions and outstanding notes issued in 2004. The 2016-17 pension expenditure is estimated to be \$33 billion. Pension liabilities for the coming decade are estimated to be \$451.9 billion.
- Contingent liabilities of the Government as at 31 March 2016 amounted to about \$86.3 billion.

Long-Term Fiscal Challenges Ahead

Challenges ahead



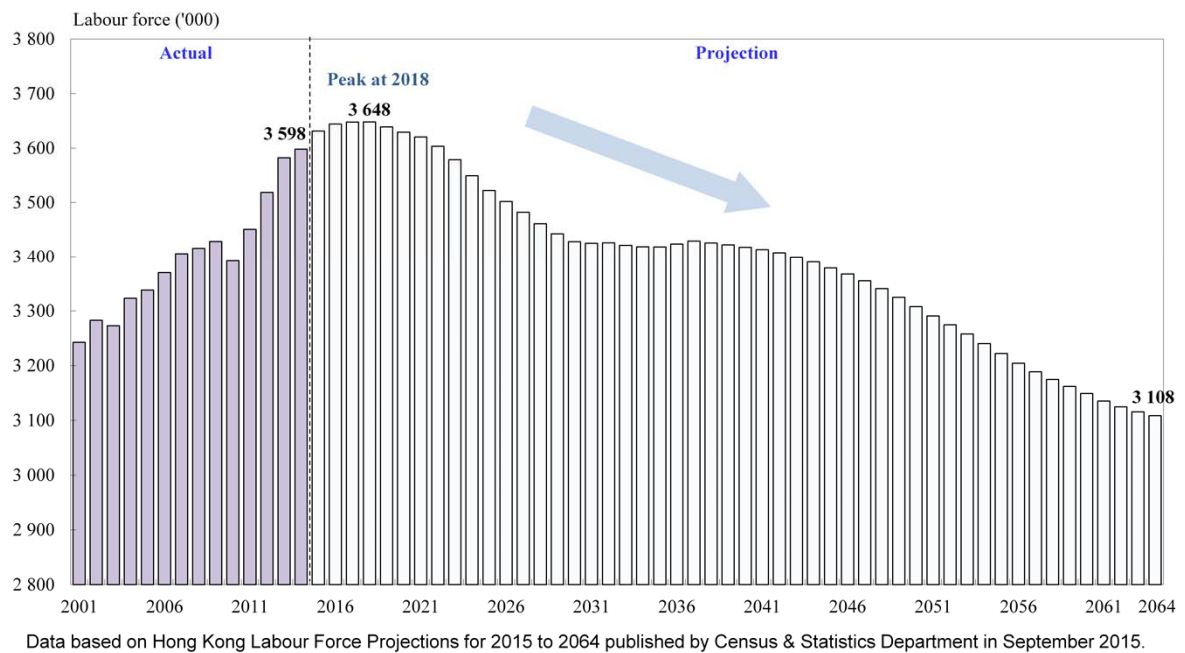
Rapid growth in ≥ 65 age group



Data based on Hong Kong Population Projections for 2015 to 2064 published by Census & Statistics Department in September 2015.

- The population in Hong Kong is ageing fast. The proportion of population aged 65 and over is projected to rise markedly from 16% in 2016 to 23% in 2026, 29% in 2036, 31% in 2046, 33% in 2056 and also 33% in 2064.
- On the other hand, the proportion of the population aged between 15 to 64 is projected to decrease from 73% in 2016 to 58% in 2064.
- The elderly dependency ratio (Aged 65 and above / Aged 15-64) is projected to rise from 22% in 2016 (average ratio for 2012-2016: 20%) to 36% in 2026 (average ratios for 2017-2021: 25% and for 2022-2026: 33%), 47% in 2036, 52% in 2046, 56% in 2056 and 57% in 2064.

Labour force is expected to decline after 2018

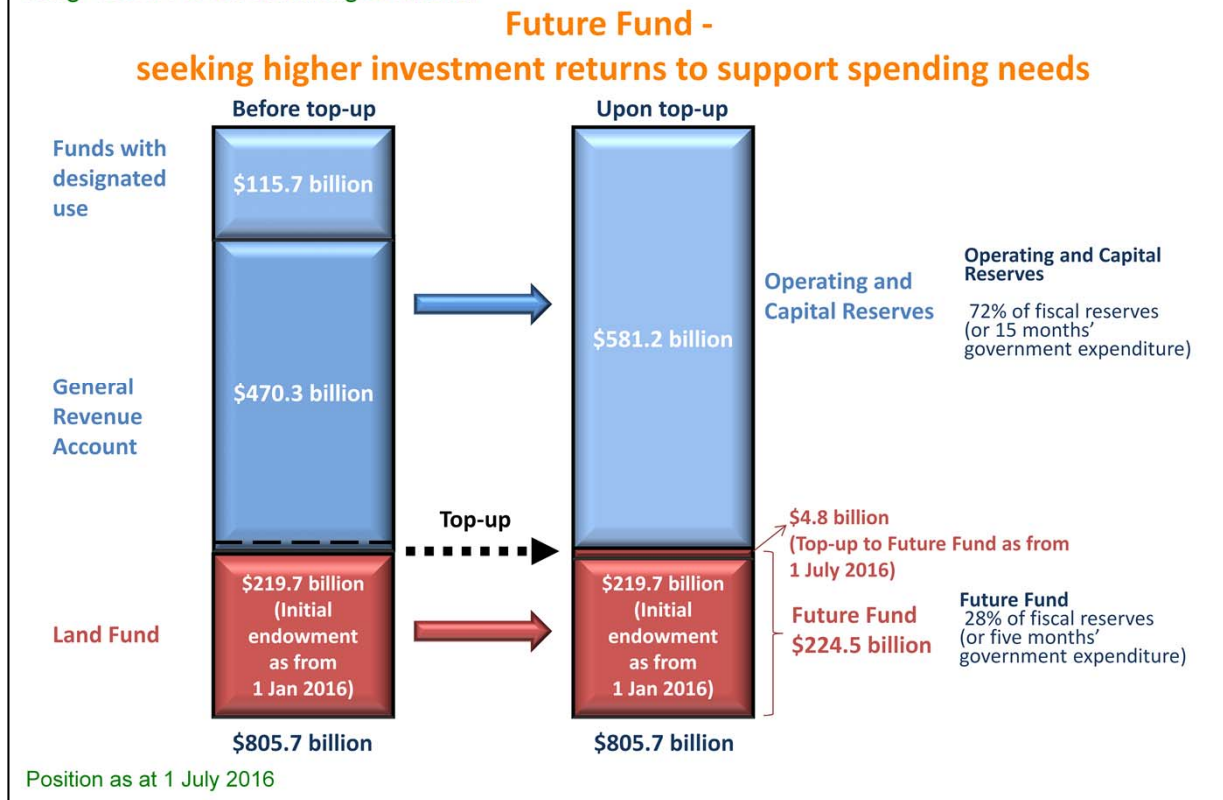


- Our local labour force is expected to peak by 2018 and then gradually decline until 2030s. Hong Kong's long-term growth prospect in the coming three decades will unavoidably be constrained.

Long-term fiscal sustainability

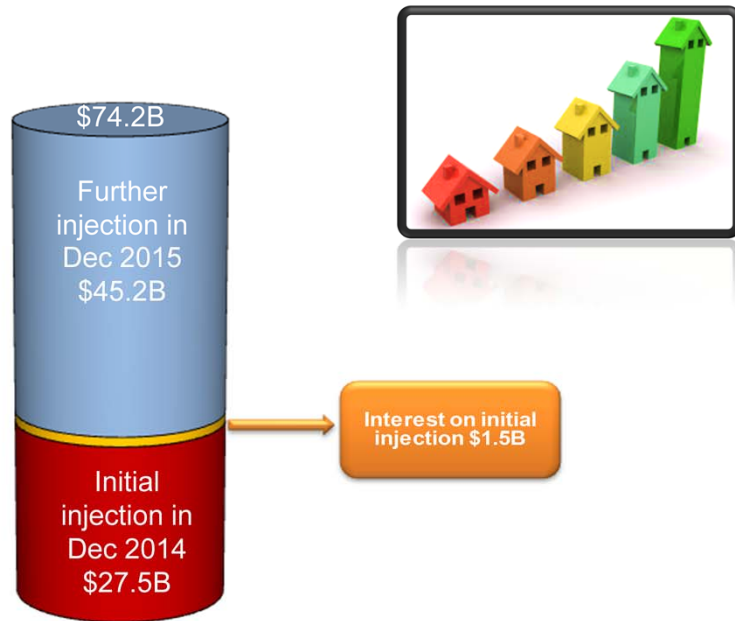
- Government's fiscal position remains healthy in the short to medium term
- Ageing population will put massive pressure on public finance
- A structural deficit could soon surface should government expenditure growth keep exceeding GDP/ revenue growth
- Resolute and effective fiscal measures required

- The Working Group on Long-Term Fiscal Planning published its report in early March 2014, providing a scientific and objective basis on Hong Kong's fiscal sustainability.
- According to the Working Group, if government expenditure keeps growing and outpacing economic and revenue growth amid an ageing population and slower economic growth, a structural deficit would be inevitable.
- While it is important for the Government to continue promoting the growth of the economy, the key to resolving the anticipated structural deficit or deferring its onset is to –
 - contain the growth of government expenditure,
 - preserve, stabilize and broaden the revenue base, and
 - save for the future by setting up the Future Fund.



- The Future Fund was set up on 1 January 2016 administratively within the fiscal reserves with an “initial endowment” of \$219.7 billion notionally held against the Land Fund. Thereafter, the Government may provide periodic top-ups for the Future Fund. Government would have flexibility to adjust the top-up percentages having regard to the prevailing fiscal situation and community needs.
- The Future Fund remains an integral part of the fiscal reserves. The part of the fiscal reserves outside Future Fund is referred to as “Operating and Capital Reserves”.
- The Future Fund is not a total solution but would help alleviate the pressure of our future generations.
- As from 1 July 2016, the Future Fund also includes \$4.8 billion, being one-third of the actual surplus in 2015-16 as top-up.

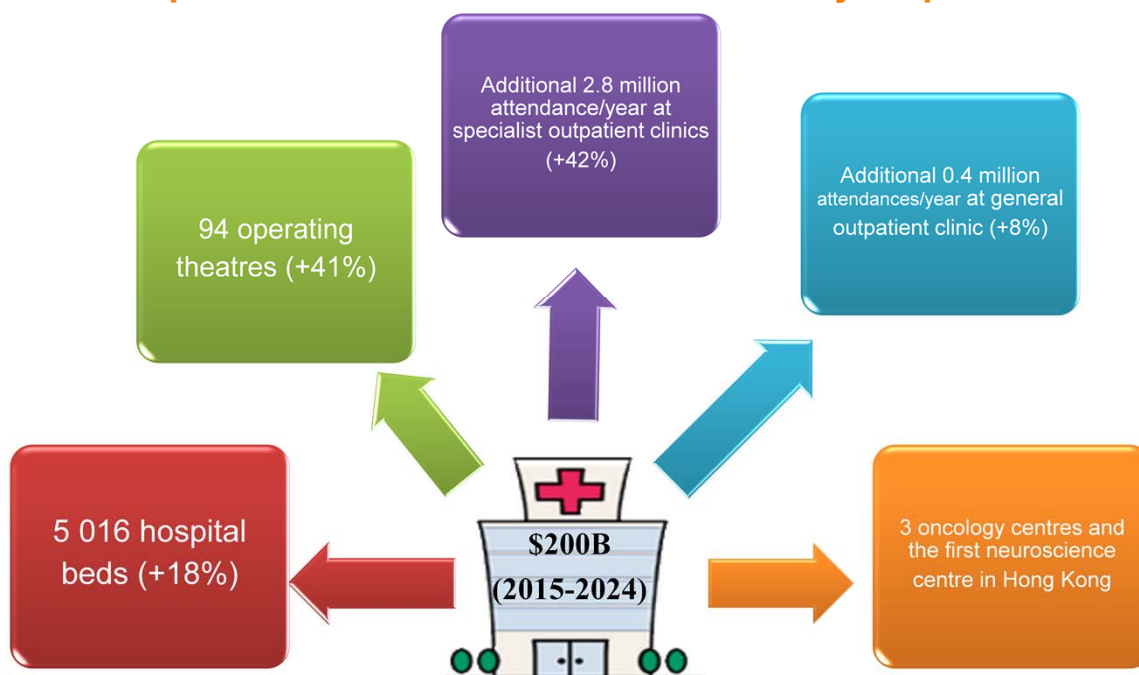
Housing Reserve - making provision for known housing needs



Position as at 1 July 2016

- The Housing Reserve set up in 2014 with injection of \$27.5B underlines the Government's commitment to support the 10-year public housing supply target. Taking into account the interest accrued of \$1.5B, the initial sum of \$27.5 billion earmarked for the purpose last year measured \$29.0B in December 2015.
- The Government decided to make a further injection of \$45.2B to the Housing Reserve in December 2015. Taking this injection together with the 2014 allocation and accumulated investment returns, the balance of the Housing Reserve stood at \$74.2B as at 31 December 2015.

Hospital Development Plan - committing resources to upgrade public healthcare facilities over a ten-year period



- We have announced a 10-year hospital development in both the Policy Address and the Budget Speech this year. \$200 billion will be set aside to enable the Hospital Authority to expand and upgrade various public healthcare facilities. It is expected that the capacity of hospital facilities including out-patient clinics, hospital beds, operating theatres and medical centres will be enhanced.
- It is estimated that the Government needs to set aside about 23% of the resources under the Capital Works Resource Allocation Exercise for 10 years from 2015 onwards for implementing this plan.



- To address fiscal sustainability concerns, the growths in expenditure, revenue and GDP ought to be aligned.

Thank you