OFFICIAL REPORT OF PROCEEDINGS

Wednesday, 27th February 1974

The Council met at half past two o'clock

[MR PRESIDENT in the Chair]

PRESENT

HIS EXCELLENCY THE GOVERNOR (*PRESIDENT*)
SIR CRAWFORD MURRAY MACLEHOSE, KCMG, MBE
THE HONOURABLE THE COLONIAL SECRETARY
MR DENYS TUDOR EMIL ROBERTS, CBE, QC, JP
THE HONOURABLE THE FINANCIAL SECRETARY
MR CHARLES PHILIP HADDON-CAVE, CMG, JP
THE HONOURABLE THE ATTORNEY GENERAL
MR JOHN WILLIAM DIXON HOBLEY, QC, JP
THE HONOURABLE THE SECRETARY FOR HOME AFFAIRS
MR DENIS CAMPBELL BRAY, JP
THE HONOURABLE DAVID RICHARD WATSON ALEXANDER, CBE, JP
DIRECTOR OF URBAN SERVICES
THE HONOURABLE JAMES JEAVONS ROBSON, CBE, JP
SECRETARY FOR THE ENVIRONMENT
THE HONOURABLE JOHN CANNING, JP
DIRECTOR OF EDUCATION
DR THE HONOURABLE GERALD HUGH CHOA, CBE, JP
DIRECTOR OF MEDICAL AND HEALTH SERVICES
THE HONOURABLE IAN MACDONALD LIGHTBODY, CMG, JP
SECRETARY FOR HOUSING
THE HONOURABLE DAVID HAROLD JORDAN, MBE, JP
DIRECTOR OF COMMERCE AND INDUSTRY
THE HONOURABLE LI FOOK-KOW, JP
SECRETARY FOR SOCIAL SERVICES
THE HONOURABLE GEORGE PETER LLOYD, CMG, JP
SECRETARY FOR SECURITY
THE HONOURABLE DAVID AKERS-JONES, JP
DISTRICT COMMISSIONER, NEW TERRITORIES
THE HONOURABLE DAVID WYLIE MCDONALD, JP
DIRECTOR OF PUBLIC WORKS
THE HONOURABLE WOO PAK-CHUEN, CBE, JP
THE HONOURABLE SZETO WAI, CBE, JP
THE HONOURABLE WILFRED WONG SIEN-BING, OBE, JP
THE HONOURABLE WILSON WANG TZE-SAM, OBE, JP
DR THE HONOURABLE CHUNG SZE-YUEN, OBE, JP
THE HONOURABLE LEE QUO-WEI, OBE, JP
THE HONOURABLE OSWALD VICTOR CHEUNG, OBE, QC, JP
THE HONOURABLE ANN TSE-KAL OBE, JP
THE HONOURABLE ROGERIO, HYNDMAN LOBO, OBE, JP
THE HONOURABLE MRS CATHERINE JOYCE SYMONS, OBE, JP
THE HONOURABLE PETER GORDON WILLIAMS, JP
THE HONOURABLE JAMES WU MAN-HON, JP
THE HONOURABLE HILTON CHEONG-LEEN, OBE, JP
THE HONOURABLE GUY MOWBRAY SAYER, JP
THE HONOURABLE LI FOOK-WO, OBE, JP

IN ATTENDANCE

THE CLERK TO THE LEGISLATIVE COUNCIL
MR KENNETH HARRY WHEELER

Papers

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

Subject	*LN No*
Subsidiary Legislation:	
Drug Addiction Treatment Centres Ordinance.	
Drug Addiction Treatment Centres (Amendment) Regulations 1974	24
Training Centres Ordinance.	
Training Centres (Amendment) Regulations 1974	25
Clean Air Ordinance.	
Declaration of Smoke Control Area (Cheung Sha Wan and Sham Shui Po) Notification 1974	29
Rating Ordinance 1973.	
Rating (Areas of Hong Kong) (Amendment) Order 1974	30
Public Revenue Protection Ordinance.	
Public Revenue Protection Order 1974	31
Marriage Reform Ordinance.	
Designation of Public Officers Notice 1974	32

Sessional Papers 1973-74:

No 48—Annual Report by the Chairman, Urban Council and Director of Urban Services for the year 1972-73 (published on 27.2.74).

No 49—Annual Report by the Commissioner of Labour for the year 1972-73 (published on 27.2.74).

No 50—Annual Report by the Commissioner of Rating and Valuation for the year 1972-73 (published on 27.2.74).

No 51—Annual Report by the Director of Public Works for the year 1972-73 (published on 27.2.74).

No 52—Draft Estimates of Revenue and Expenditure with Explanatory Memoranda for the year ended 31st March 1975 (published on 27.2.74).

No 53—Report of the Establishment Sub-Committee of Finance Committee for the year 1973-74 (published on 27.2.74).

No 54—Report of the Public Works Sub-Committee of Finance Committee (1973 Reviews Leading to the 1974-75 Programme) (published on 27.2.74).

Estimates of expenditure referred to a committee of the whole Council pursuant to Standing Order 54(3) and also referred to the Finance Committee of the Council pursuant to Standing Order 60(8).

Government business

First reading of bill

APPROPRIATION BILL 1974

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 1974

THE FINANCIAL SECRETARY moved the second reading of: —"A bill to apply a sum not exceeding five thousand seven hundred and forty-six million, seven hundred and eighty-five thousand dollars to the Public Service for the financial year ending the 31st day of March 1975."

He said: —Sir, I move that the Appropriation Bill 1974, which was published in an issue of the *Gazette Extraordinary* at 2 o'clock this afternoon, be read the second time.

Sir, in last year's budget speech I predicted that the final accounts for the year 1972-73 would reveal a surplus of $400 million. In the event, the surplus was $637 million, largely because stamp duty on contract notes yielded some $90 million more than I thought it would

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and there was an unexpected number of purchasers electing to pay for their land by lump sums rather than by instalments; and because expenditure brought to account was $66 million less than I thought it would be.

Revenue at $4,936 million was no less than 39% up on 1971-72 and expenditure at $4,300 million was up by 48% (or by 31% if the transfer of $500 million to the Mass Transit Fund is excluded).

Recurrent revenue at $4,175 million increased by 29%, faster than ever before (except in 1949-50). Capital revenue increased by 142% and at $761 million was twice the highest figure previously recorded which was in 1970-71, land sales yielding a phenomenal $670 million.

Recurrent expenditure at $2,700 million increased by 26%, the second highest rate of increase since the war and, in view of what I shall have to say later, I should note that recurrent subventions accounted for a quarter of this increase. Capital expenditure, excluding the transfer to the Mass Transit Fund, increased by 46%, also the second highest figure since the war, if the immediate post-war years are ignored, and this reflects the growing size of our engineering and water development programmes.

I must now draw honourable Members' attention, Sir, to a number of features of the revised estimates for the current year 1973-74.

In last year's budget speech I estimated revenue for 1973-74 at $4,922 million and expenditure at $4,409 million to yield a surplus of $513 million. Although the revenue estimate took account of my various fiscal proposals, the net effect of which was the surrender of about $200 million in revenue, I noted at the time that the draft Estimates of Expenditure excluded a number of known commitments to be met in 1973-74.

Despite these and other commitments for which supplementary provision has had to be sought during the year amounting in all to $667 million up to 9th January, which was the cut-off date for the inclusion of supplementary provisions in the Draft Estimates, the revised estimate for outturn at $443 million is not very different from my original estimate of $513 million for there have been partially compensating delays in expenditure elsewhere and the revised estimate of revenue is up by $355 million.

The revised estimates of revenue and expenditure, as shown in the Estimates for 1974-75 laid today, are put at $5,276 million and $4,833 million respectively, yielding a surplus, as I have just said, of $443 million. Now that a Letter of Intent has been issued to the Japanese Consortium preparatory to entering into a formal contract for the first four stages of the Mass Transit Railway, I intend to invite Finance Committee next month to appropriate a further $300 million under Head 52 Miscellaneous Services for the Government's equity contribution to the Mass Transit Railway Corporation. This sum will then be credited to the Mass Transit Fund and, together with the $500 million already in the fund, will represent the agreed figure for the Government's equity contribution in cash terms for the first four stages of the railway.

Thus the revised estimate of the surplus for 1973-74 must be reduced by $300 million to $143 million but, on the basis of daily receipts and payments recorded in the Treasury's cash book up to 18th February last, it could be that the revised estimate, as published in the Estimates for 1974-75 which went for printing on 31st January, is a little on the low side; and I predict, therefore, that the surplus will be $200 million (net of the $300 million for the Mass Transit Fund). It is this predicted figure of $200 million which I shall use when discussing our likely financial position at 31st March next.

The revised estimate of revenue for this year at $5,276 million represents an increase of $340 million on actual revenue in 1972-73. After discounting the element in actual revenue in 1972-73 for revenue transferred to the Urban Council and the Housing Authority with effect from 1st April 1973, the increase in revenue for the General Revenue Account is $421 million or 8.7%. This is the lowest rate of increase since 1967-68 when it was 4.5%, but it follows a year in which both recurrent and capital revenue were exceptionally buoyant as a result of the high level of turnover on the stock exchanges and the state of the property market.

The difference between the revised estimate of revenue of $5,276 million and the original estimate of $4,922 million is $354 million. This is made up of $292 million on recurrent account and $62 million on capital account and is explained in detail in the Memorandum Notes on the Revenue Estimates, but three points are worth a special mention: first, profits tax is up by $270 million and salaries tax by $112 million, but stamp duty is down by $259 million. Secondly, and not surprisingly, interest on our investments and liquid balances is up by $68 million to $316 million and this figure represents 6.6% of the

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revised estimate of total recurrent revenue of $4,768 million. Thirdly, the increase in capital revenue by $62 million to $509 million is largely due to an additional $44 million from land sales, thanks to the disposal of more sites than anticipated in the New Territories and despite a fall in the market price of land in the urban area.

For the fourth consecutive year, actual expenditure in 1973-74 is likely to exceed the original estimate and by no less than $424 million or by 9.6%. In 1972-73, the excess was 3.9% and, in the previous two years, 1.4% and 2.5% respectively. In all other years since the war, except 1959-60 and 1965-66, actual expenditure was less than the original estimate.

This increase of $424 million is a not figure made up of excesses over original estimates of $558 million and shortfalls of $134 million. On capital account, excesses and shortfalls largely cancel each other out and so I need refer specifically only to the main items on recurrent account. The overall increase of 8% in public service salaries with effect from 1st April, the adjustment to Police rank and file salaries with effect from 1st November and the special adjustment of certain public service salaries with effect from 1st December, account for $133 million of the total figure of excesses. The net cost of additional posts approved and filled during the year accounts for another $35 million. Salary increases by subvented organizations and accepted as a charge to public funds cost no less than $140 million, reflecting the very substantial cost of revising teachers' salaries. Increased rates for public assistance and for infirmity and disability allowances in accordance with the formula for keeping them in line with movements in the cost of living, and a larger than anticipated case load, account for a further $38 million.

In last year's budget speech, I estimated that our available (that is to say, our spendable) fiscal reserves at 31st March 1973 would amount to $2,831 million. I arrive at this figure, which was roughly $1,000 million less than our reserves a year earlier on 31st March 1972, after taking into account three factors: first, the free surplus in the Exchange Fund at 31st March 1971 amounting to $913 million was no longer available owing to the depreciation of the book values of the Exchange Fund's sterling investments and the fund's obligation to make compensation payments to participating banks under the Exchange Fund Guarantee Scheme for the losses in Hong Kong dollar terms incurred by them on their sterling holdings. Secondly, I had to take account of the net cost in Hong Kong dollar terms of adjusting the values of our sterling and other foreign currency assets to the rates of exchange ruling at 31st March 1973. And, thirdly, although the exact figures were not available, I knew that, on revaluation of the book values of our investments, we would show substantial losses at the end of the financial year.

In the event, largely as a result of the surplus for the year being higher than I predicted, our available fiscal reserves at 31st March 1973 stood at $3,179 million comprising $3,089 million in the General Revenue Balance, $65 million being the balance in the Development Loan Fund and $25 million being a modest estimate of expenditure on the Mass Transit Railway charged to the Colony's accounts up to 31st March 1973 and due to be recovered from the Mass Transit Fund. This figure of $3,179 million represented 72% of the original estimate of expenditure in 1973-74 which was $4,409 million or 69% of the unspent balance of approved Public Works Non-Recurrent projects at 1st April 1973 which was $4,615 million. I admitted at the time that it was a matter of judgment what these ratios should ideally be; but, when compared with comparable ratios at 31st March 1972, a year earlier, of 105% and 110% respectively, they were obviously not too re-assuring.

Regreattably, monetary developments during the past year have further weakened our position. Our available fiscal reserves at 1st April 1973 amounted, as I have just said, to $3,179 million. After allowing for net liabilities, including the Mass Transit Fund, $1,554 million was held with our bankers in Hong Kong and $1,625 million was held abroad and formed part of the Colony's foreign exchange resources. These consist of overseas investments owned by the Government and the Exchange Fund and balances with overseas commercial and central banks belonging to the Government and the Exchange Fund and the banking system.

Both the Exchange Fund Guarantee Scheme to the local banks and the Sterling Guarantee Agreement covering the Colony's sterling reserves came to an end on 24th September 1973. The banks' claims against the Exchange Fund have been settled and so has the Hong Kong Government's claim against the United Kingdom Government. On 6th September the United Kingdom Government offered a new scheme, covering the period 25th September 1973 to 31st March 1974, which the Hong Kong Government has now accepted in respect of its own funds. Under this scheme the United Kingdom Government has undertaken to maintain the US dollar value of eligible official sterling balances at US$2.4213 to the £1 providing certain conditions are met.

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For most of the year the Hong Kong dollar has remained relatively strong in the foreign exchange market. This is reflected in the index of its value in terms of a trade weighted average of the currencies of our major trading partners (other than the United States). The cumulative appreciation of the Hong Kong dollar as reflected by this index since 1st April 1973 to date has been 5%. It is not surprising, therefore, that there has been a fall in the value of our foreign currency assets in Hong Kong dollar terms, with the result that about $126 million may have to be written off their book value. This loss has been estimated by the Accountant General after taking into account about $32 million received from the United Kingdom Government under the old Sterling Guarantee Agreement. At prevailing exchange rates, compensation of about $44 million would also be due under the new guarantee ending on 31st March 1974.

The past year has been one of abnormally high interest rates in all major financial centres, but particularly in London, where the prices of gilt edged securities fell to the lowest level recorded in the 47 year history of the Financial Times Government Securities Index. The factors that influence these interest rates have recently changed with such startling rapidity that it is difficult to make even a short term forecast. But, at this time, I expect that, when our assets are revalued at the end of this financial year, there will be a book loss of about $237 million on our sterling investments, and about $28 million in the value of securities denominated in currencies other than sterling. The book value of our investments will, therefore, probably have to be reduced by a total of about $265 million. I should emphasize that, as our money is invested in good quality dated securities, these losses will be made good if the securities are held to maturity and we are not forced, for one reason or another, to sell while their prices are depressed.

I mentioned last year that our available fiscal reserves at 31st March 1972 took into account the free surplus of $913 million in the Exchange Fund, but that the whole of this $913 million had been wiped out largely through the weakness of the gilt edged market and our obligation to make compensation payments to the banks under the Exchange Fund Guarantee Scheme. When the estimate of compensation payable was made the Hong Kong dollar/sterling exchange rate stood at around $12.6 to the £1; but compensation was actually paid at a rate of $12.395 to the £l and, therefore, the cost to the Exchange Fund was greater than I thought it would be when I was preparing last year's budget.

Sir, taking all relevant factors into account I estimate that our available fiscal reserves at the end of the current financial year will amount to $3,066 million, a decline of about $113 million on the position at the beginning of the year, or of $763 million compared with 31st March 1972. This estimate of our available fiscal reserves at 31st March 1974 represents only 53% of estimated expenditure in 1974-75 or 56% of the unspent balance of the approved Public Works Non-Recurrent projects at 1st April 1974.

I shall now turn, Sir, to a review of the performance of the economy in 1973 and the prospects for the coming year. Honourable Members already have before them a technical study of the gross domestic product and its various components from 1966 to 1972 prepared by the Census and Statistics Department. This is an updated edition of the publication produced last year for the first time. The estimates are still limited to the expenditure method but, by this time next year, a cross check using the income method should be ready and, while this may result in the estimates being modified, I doubt whether relative changes between years will be much affected.

This year's edition does, however, contain estimates of the gross domestic product at constant, that is to say 1966, prices. These have been particularly useful in the preparation of the other economic publication laid today, namely, the Economic Background to the Budget, which has been prepared by the Economic Branch of the Secretariat with the assistance of a number of Government departments. It is a much more ambitious effort than our first effort last year and contains a reasoned account of recent developments in the various sectors of the economy in the light of trends over the last few years. I am happy to say a Chinese version has also been prepared and will be published within a day or two.

As I said last year, the advantage of laying these two publications on budget day is that I can take the past largely as read and concentrate on forecasting the future. This is a hazardous business and when, last year, I ventured a view of 1973, I did so with some trepidation in the hope that honourable Members would not find it too difficult to be charitable when I was proved wrong.

Wrong I was, but naturally the fault was not mine! (*Laughter*) My major failure was to foresee the accelerating pace of world inflation during last year, coupled as it has been with shortages of raw materials and some foodstuffs. I also failed to foresee the abnormally wet weather in Hong Kong during the summer. And I, of course, failed

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to predict the oil crisis, although the main effect of that is going to be felt in 1974 and I shall have more to say about it later on.

All of these factors combined—and are still combining—to produce a rise in prices unprecedented in recent years, which has made a nonsense of the forecasts I made in value terms last year. Thus, in the event, the value of domestic exports rose by 28% instead of the 10% I forecast, total exports by 34% instead of 13%, and imports by 33% instead of 8%. The gross domestic product, in fact, increased by some 20% to $28,335 million, instead of the 17% I forecast; and gross domestic fixed capital formation rose by 24% to $6,875 million, almost equal to the 23% I predicted. This was 24.3% of the gross domestic product compared with my forecast of 25%.

These figures show up very clearly the extent to which inflationary forces were affecting our economy from the outside world. For it was the external trade figures which showed by far the biggest jump in value terms. The figures of gross domestic product were less volatile as they reflected also the greater stability of our internal economy.

In fact, Sir, considering the traumatic events of 1973—unprecedented world inflation, continuing wide fluctuations in exchange rates, shortages of some raw materials and the rise and fall of prices of some raw materials and the rise and fall of prices on our stock exchanges—it is remarkable how well the Hong Kong economy performed during the year. The economy was probably growing at a faster rate in real terms than in either of the previous two years 1971 and 1972. At constant prices, the gross domestic product increased by 8½%, and although, when allowance is made for changes in stocks of raw materials, this figure is probably somewhat too high, it is still a very good performance. Domestic exports in quantity terms also increased, by 7¼%; again, a much better performance than the 4% and 4½% respectively recorded in 1971 and 1972. The figure for the first nine months shown in the Economic Background publication was 6%. So it is clear that exports were continuing on a strongly rising trend in the last quarter. And fixed capital formation—the investment in new productive capacity on which our future depends—also rose in constant price terms by as much as 17%. The increasing proportion of our resources being devoted to capital investment in recent years goes a long way to account for the much more rapid rate of growth in recent years compared with the 1950's.

What appears to have happened is that, following the export boom in 1968-70, the economy, under the influence of developments in overseas markets and currency uncertainties, went through a period of pause and consolidation in 1971-72. This led to some slackening in the labour market which, coupled with the effects of the strong expansion in investment in plant and equipment, has led to a significant increase in productivity and a consequent relative improvement in the competitiveness of, especially, our more advanced industrial units. As a result, the growth of exports began to accelerate again in 1973, to some extent in a changed market and product pattern as a result of the exchange rate adjustments which had taken place. The pattern of imports of our raw materials was also changing over this period, relatively more being imported from the United States and relatively less from Japan, following the devaluation of the US dollar and the appreciation of the yen.

On top of these developments, and in some respects independent of them, was the significant acceleration in the growth of the money supply and bank lending in Hong Kong in 1972 and the early part of 1973. This, in turn, served to fuel the stock market and property boom in this period. The profit taking and outflow of funds which preceded and accompanied the break in stock market prices, however, sharply reduced the growth in the money supply and squeezed liquidity from the early summer of 1973 onwards. The result has been not only lower share prices, but also a far less buoyant property market. There is also evidence that rents have begun to flatten out, except for prime commercial property.

All in all, therefore, prior to the emergence of the oil crisis and shortage of raw materials in the latter part of 1973, the year generally saw the Hong Kong economy set on the right course. Internal inflationary tendencies were under control, exports were accelerating, fixed capital formation was at a high level and adjustments were being made to changing currency patterns. We were, indeed, beset by inflation and rising prices, especially for raw materials and foodstuffs, stemming from outside factors and there was a consequent check to rising living standards for the population at large; but this was a problem which was being faced equally by our competitors and the evidence is there to show that our export prices were able to rise sufficiently to offset the rise in import prices and keep therefore the terms of trade more or less stable.

I concluded last year's budget speech by reminding honourable Members that the Year of the Ox should bring prosperity to Hong

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Kong provided we dealt with such problems as beset us with patience and resolution. It should be apparent from what I have just said that 1973 was a year of prosperity and I think we did tackle an exceptionally large number of rather unusual problems with resolution, though perhaps patience was somewhat lacking at times.

So much for the year that has just passed. Despite the obvious difficulties surrounding such an exercise at this time, I must now try to forecast the rate of growth of the gross domestic product for 1974 so as to establish an economic framework for rational budgeting, after making due allowance, when preparing the revenue estimates, for various lags.

The formidable difficulties surrounding this sort of exercise in this particular year stem, of course, from the oil crisis which erupted with such suddenness in the latter months of 1973 and which is bound to have a significant impact on the whole world economy. The Hong Kong economy may be affected in a number of ways. First, there is the direct effect on the supply and price of oil to our own economy. Secondly, and potentially more serious, are the possible shortages of, and higher prices for, oil based raw materials, such as plastics and manmade fibres, for our industries. Thirdly, there is the effect on world trade of possible recessionary influences in our major markets as a result of the crisis. Finally, there are the secondary, or multiplier, effects on our economy of all these factors combined.

We have made a careful study of the likely effects of these factors on Hong Kong's economic performance in 1974, using the latest information available, and we have compared this with study forecasts based on an assumption of no oil crisis. Before telling honourable Members the conclusions we have reached, I should say a word about the nature of the oil crisis itself. It takes two forms. To begin with there is the actual physical cut back of supplies by the oil producing countries in the Middle East. This, of course, if carried far enough and for long enough could, by disrupting energy supplies and the raw materials for oil based products, seriously distort and reduce the productive basis of the whole world economy. But, short of a dramatic switch in policy on the part of the oil producing countries, this no longer appears to be the major danger: the oil crisis is now revealing itself more as a crisis of prices, rather than as a physical cut back in supplies relative to demand.

Let me add that this does not make the crisis any less serious or less difficult to resolve in the short term. The four-fold increase in crude oil prices since the spring of 1973 is bound to have a very serious impact on the world economy, on the volume of world trade and on world wide inflation as and when the increase works its way through the supply and distribution system and is reflected in the prices of end products. I would expect to see some degree of recession in our major markets as a result of this and hence some decline in the rate of growth of demand for our exports compared with 1973. Yet I would not expect any widespread physical shortages of raw materials, although some prices will rise steeply and could add to the difficulty of marketing our exports. Nor would I expect supplies of oil to Hong Kong to be reduced sufficiently to endanger the normal operations of the economy. But our manufacturing industries and the economy as a whole will also have to face the direct effect of higher oil prices. This has been brought home very recently by the very sharp increase in electricity prices, due to the trebling of the cost of fuel oil to the power companies since November. The rough doubling in the price of electricity to bulk users which has resulted could add a further 2% to industrial costs and more so in the case of some industries.

The question is: how should all this influence my forecast for 1974? Had there been no oil crisis and we could have expected normal growth, it seems likely that the gross domestic product would have increased by about 8 % in real terms, that is to say, on the basis of constant (1973) prices. The consequence of the world wide oil crisis will be, I forecast, to reduce this rate of growth by about half, that is, to about 4% in real terms and to 14 - 15 % in money terms. The gross domestic product is, therefore, likely to be about $32,400 million at current market prices in 1974.

This forecast is itself based on several other forecasts (at current market prices): first, that domestic exports will increase by about 24% and that imports will rise by about 27%, that is by rather less than the 28% increase in domestic exports and the 33% increase in imports achieved in 1973. Secondly, that private consumption expenditure will increase by about 20%, compared with 19% in 1973, and Government consumption expenditure by about 14% compared with 18% in 1973; and, finally, that gross domestic capital formation will increase by some 18%, compared with about 24% in 1973.

I should emphasize, Sir, that, given the uncertainties that now exist in the world economy, these forecasts are little more than heroic

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guesses. Although they are internally consistent. They assume, I should add, a significantly higher rate of price inflation than I assumed last year, but nevertheless, not much different from the actual rate of inflation experienced in 1973. But, for both last year and the coming year, the inflationary forces are external with the oil crisis likely to dominate the scene as much as the weather and food prices dominated the scene last year.

As regards the balance of payments as a whole, that is visible and invisible transactions on current account and the net balance of capital movements, I am not expecting any great change over the year, despite the rise in oil prices and an expected slight worsening in the terms of trade. Although I must be very cautious here and must emphasize again the heroic nature of the arithmetic underlying the forecast, this means that I do not expect a worsening of the balance of payments position to exert any further deflationary pressure on the economy.

To conclude with a special reference to the financial sector of the economy: the continuing development of Hong Kong as a financial centre is giving rise to some rather surprising demands for more Government control on the activities of various financial institutions operating here; needless to say, I am not referring to the stock markets. I have said enough on our securities legislation to last two lifetimes. I am referring to finance companies and particularly to deposit taking finance companies. During the past year I have answered questions on this subject on two occasions in this Council and outlined the Government's attitude and response to these demands. I said I had in mind a Protection of Depositors Bill, the main provision of which would be the stipulation of a minimum size of deposit which finance companies could accept from the general public which, incidentally, from the point of view of stabilising the Hong Kong dollar base, is a better and fairer approach than exempting deposits with licensed banks from interest withholding tax. However, in recent weeks it has again been represented to me, somewhat forcibly, though in not very definitive terms, and with fairly scant concern for the secondary consequences that a better approach would be to register and control deposit taking finance companies rather than restrict their area of operation. Consequently, there may now be some delay in bringing the Protection of Depositors Bill forward.

My view is that the draft bill we have prepared is along the right lines for I am not convinced that the Government should introduce a full range of statutory regulations covering finance companies. Such legislation would not only be more complicated than even the Securities Ordinance, but would probably need a small army of enforcement officials. My preference would be to introduce the minimum deposit concept and see it linked with the establishment by the financial community of one or more associations which would aim to set and maintain certain rules and standards and then see these associations co-operating with each other and the banking community to develop our money market.

Certain further amendments to the Banking Ordinance are also under consideration. Most of these will involve little more than administrative tidying up. But there is a proposal to correct an anomaly with regard to deposits of three months or less and powers will also be sought to enable the level of specified liquid assets to be varied administratively. I should hasten to add that there is absolutely no intention of changing the liquidity ratio in the foreseeable future, but I think it would be wise to have this provision readily available in our locker.

Finally, our present policy of a limited moratorium on banking licences seems to me, personally, to have become less logical than when it was devised in October 1972 and I personally think some rethinking is necessary. I accept that for the seven years prior to that date there was a complete embargo on the granting of new licences, but that policy was introduced in exceptional circumstances which do not obtain today. The position now is that applications for licences from some of the most reputable international banks are being refused for they do not qualify in terms of the two criteria laid down in 1972, namely, the servicing of a new trading area or the provision of a new type of banking facility; and I personally am not sure that to circumscribe the development of an industry in this particular way is entirely defensible though, obviously, newcomers must be expected to meet certain quite stiff conditions for a licence.

Sir, it is against these somewhat uncertain prospects for our economy that the Estimates for 1974-75 must be considered and I propose to reverse the order in which I have dealt with them in the past two years. This year I shall begin with the Revenue Estimates for the Draft Estimates of Expenditure have certain implications for fiscal policy which will be more apparent if I can deal with them immediately after the Revenue Estimates and immediately before I take a look at the longer term implications of our developing policies.

The Finance Branch has prepared the Estimates for 1974-75 in more difficult conditions than we have been accustomed to in recent

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years not only because of our economic prospects and, therefore, the revenue outlook, but also because departmental requests were pitched well above the approved estimates for the current year. The effort put into them in terms of man hours of work over several months has been very considerable and I am indebted to the Deputy Financial Secretary and all members of the Finance Branch for their achievement. They, in turn, have been dependent on the co-operation of departments and of policy branches in the Secretariat which has been most willingly given.

The Estimates volume itself is now only one of the publications laid on budget day—though by far the most important—and yet the Government Printer manages to get it ready in time for prior distribution to honourable Members. I must again thank the Government Printer and his staff whose efforts I greatly appreciate; and I am also grateful for the help given by the Design Department of the Information Services Department. The other documents laid today, which have also had to be printed by the Government Printer, are the two economic studies I have already referred to, the Budget Booklet (in both English and Chinese), the abstract of Financial Statements and Statistical Appendices, the Report of the Public Works Sub-Committee for 1973-74 and the Report of the Establishment Sub-Committee for 1973.

The Finance Branch has, in recent years, sought to improve progressively the presentation and format of the Estimates: so far we have introduced the General Memorandum Note, the Memorandum Notes on the Revenue Estimates and the interleaved Memorandum Notes on heads of expenditure; we have developed the statistical analyses in the green pages of the Estimates; and last year we redesigned the Estimates pages themselves and introduced the commitment concept to improve the accuracy of estimating special, that is to say departmental capital expenditure.

This year the Finance Branch has first of all concentrated its attention on the subheads for annually recurrent other charges in departmental heads of expenditure. In the course of time, these have become inconsistent as between heads and a tidying up exercise was overdue. The number of different subheads has been reduced and a degree of standardisation introduced (or re-introduced); items within subheads have been deleted, except where they are required for expenditure control, and thus heads of departments will enjoy a greater degree of flexibility than before. Secondly, the head of expenditure for the Public Works Department has been divided into six separate heads covering headquarters and each sub-department to reflect more clearly the federal nature of this large department. Thirdly, the layout of the interleaved Memorandum Notes has been improved by the use of sub-headings for the paragraphs dealing with ambit and provision, organization, programmes and achievements, and the detailed justification for the vote provision sought for the new financial year. Fourthly, the paragraphs dealing with departmental organization and programmes and achievements have been expanded compared with earlier years. These paragraphs should enable honourable Members to absorb the arithmetic of the Estimates more readily and to relate the vote provision sought to the Government's policy objectives.

Finally, and perhaps the improvement of most general interest—and in fulfilment of an undertaking I gave in last year's budget speech—the statistical tables in Appendices IV to XII of this year's Estimates have been replaced by a new set of tables. These tables distinguish between revenue and expenditure on both recurrent and capital account appearing in the Government's Estimates, on the one hand; and all revenue and expenditure on both recurrent and capital account involving public funds, on the other hand. In these consolidated tables which are at Appendices VII to X we have included the revenue and expenditure of the Urban Council, the Housing Authority, the Development Loan Fund and the Lotteries Fund. I would urge honourable Members to study these tables carefully and, for the benefit of the general public, they are being also published in a separate volume free of charge.

The Revenue Estimates as printed anticipate collections of $5,679 million representing an increase of $403 million or 7.6% over the revised estimate for 1973-74.

The estimate of recurrent revenue is $5,169 million, an increase of 8.4% over the revised estimate for the current year. Earnings and profits taxes account for $1,745 million or one third of the total. As salaries tax, property tax and interest tax are assessed on a current year basis, the estimates have been related to the forecast of the gross domestic product in 1974, suitably adjusted for other relevant factors. Profits tax is still on a preceding year basis and the Commissioner of Inland Revenue has advised me that the yield from 1974-75 assessments will not be such a high proportion of the gross domestic product in 1973 as the yield from 1973-74 assessments was of the gross domestic product in 1972. This is because of the influence of the stock exchange boom on profits in 1972-73 assessed to tax in 1973-74, (and the high

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level of share prices influenced not only the profits of stockbrokers, but also those of finance and property companies and, indeed, corporations generally). Thus the estimate of profits tax in 1974-75 is put at $1,185 million or 5.8% up on 1973-74.

Details of the other changes are included in the Memorandum Note on the Revenue Estimates on pages 18-23 of the Estimates volume and I need only draw attention to three other heads: as a reflection of our growing affluence, duties on liquor and tobacco at $335 million are estimated to yield an extra $23 million or 7,5%, despite the fact that these duties are specific and not *ad valorem*. The General Rate should yield an extra $40 million or 11.3% over and above the revised estimate of $355 million for this year, thanks to further interim assessments and the assessment of properties in Area E (Tsing Yi Island) to rates and the extension of the boundaries of Area D (Tsuen Wan/Kwai Chung). And against a background of exchange rate losses and a weak gilt edged market, I find it comforting to be able to point out to honourable Members that interest earnings on our investments and deposits should increase by $44 million or 14% to $360 million, thereby contributing 7% to total recurrent revenue (compared with about 6.6% this year—1973-74).

At $510 million my estimate of capital revenue is almost the same as the revised estimate for this year, but this is accidental: land sales are expected to yield $459 million compared with $367 million this year, whereas I am advised that nothing is expected by way of premia on taxi concessions owing to a likely change of policy in the issue of licences.

I shall leave it to my honourable Friend the Director of Public Works to explain in detail the land sales programme projected for 1974-75. I need only say that over one million square feet of land will be offered for sale for non-industrial development, of which 40% will be in the New Territories, and about the same (one million square feet) will be offered for sale for industrial development, of which 65% will be in the New Territories. In addition, up to about 50 acres (and possibly more) will be disposed of by private treaty grants for industrial purposes in the New Territories and we hope also to sell another 70 acres for container berth facilities at Kwai Chung.

A summary of General Revenue is contained in Appendix IV and there is an analysis on a Consolidated Account basis by source in Appendices VII and VIII. I anticipate that the ratio of capital to recurrent revenue in 1974-75 will be 9:91. This is hardly consistent with the average ratio of 12:88 over the three years ending 1973-74 and I certainly hope that capital revenue will contribute at least 10% to total revenue in the future.

The other two trends which I think we must watch carefully are in respect of the ratio of direct to indirect taxation and of direct and indirect taxation together to all other recurrent revenue: as to the former, the ratio of direct to indirect taxation, I anticipate the ratio will be 49:51 in 1974-75, the same as in 1973-74. In both 1970-71 and 1971-72 the ratio was 43:57, but direct taxation has now assumed a greater relative importance as a result of the removal of some hydrocarbon oils from the tax not in the 1972 and 1973 budgets. I did this partly for economic reasons—in an open economy such as ours the tax system should not bear on the cost structure—and partly, though I did not say so at the time, to leave room for new and enhanced levies on road users to which unpopular subject I shall revert later on. In the longer term, I think we should aim for a balance of the order of 45:55 between direct and indirect taxation.

As to the balance of the fiscal system as a whole, I anticipate that the ratio of direct and indirect taxation together to all other recurrent revenue in 1974-75 will be 66:34 and, as I said last year, this ratio should be around 65:35 if fees and charges are to play their appropriate role. I shall revert to this subject also later on.

Sir, the draft Estimates of Expenditure provide for expenditure of $5,747 million. This figure represents an increase of $1,338 million, or 30%, over the original estimate for 1973-74 and $914 million, or 19%, over the revised estimate. Although this latter figure is less than the average annual rate of increase of 25% over the three years ending 1973-74, it is very high in relation to the revenue trend and our available fiscal reserves.

In this situation, we must ask ourselves whether the Estimates have been prepared with sufficient care. Departmental submissions amounted in all to $6,252 million of which $4,114 million was on recurrent account and $2,138 million on capital account. After Finance Branch processing to correct errors, to remove expenditure not covered by approved policies and to effect all reasonable economies, these figures were reduced to $3,937 million and $2,015 million respectively, a total of $5,952 million compared with the total of original departmental submissions of $6,252 million. After considering what the overall budgetary strategy should be, and even after I had pushed up the Revenue Estimates as submitted by departments and processed

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by the Finance Branch by $355 million, I had to ask the Finance Branch to take off at least a further $200 million from the first draft of the Expenditure Estimates. In the event, $23 million was lopped off proposed recurrent expenditure; and $182 million off proposed capital expenditure. In the main, this was done by deleting provision against a number of Category A projects tenders for which have yet to be invited. Thus the draft Estimates as printed amount to $3,914 million on recurrent account and $1,833 million on capital account, a total of $5,747 million.

At $3,914 million the increase proposed for recurrent expenditure is $454 million more than the revised estimate for 1973-74 but, at 13%, the increase is lower than the average annual increase of 22% over the three years ending 1973-74 and this is helpful, having regard to the likely rate of growth of recurrent expenditure over the next few years. However, there is one aspect which is distressing and that is the proportion of recurrent revenue absorbed by recurrent expenditure; according to the Draft Estimates it will be 76% in 1974-75 compared with 73% in 1973-74 (on the basis of the revised estimates) and compared with an average of 67% over the three years ending 1972-73. As I said in my two previous budget speeches, we simply must ensure that recurrent expenditure does not absorb more than 70% of recurrent revenue if we are to avoid prejudicing our ability to finance our capital works programmes, for capital revenue cannot be expected to finance more than 25% of capital expenditure (and it has a tendency to be erratic anyway) and there are severe limits to the use of loan finance.

Of the increase of $454 million in estimated recurrent expenditure in 1974-75 compared with the revised estimates for 1973-74, $356 million is for departmental expenditure, the main items being $137 million for personal emoluments, $62 million for the Housing Authority for squatter control, clearances and the deficit on Group B Housing Estates, $49 million for public assistance and infirmity and disability allowances, $28 million for payments by the Post Office to other postal administrations for the excess of outward over inward mails, $10 million for increases in the cost of existing beds and new beds in Government hospitals and $9 million is for the Auxiliary Police. The remaining $98 million of the increase is for subventions ($36 million for education, $32 million for medical services and $13 million for social services) and grants to the Universities and the Polytechnic account for another $11 million.

I shall not dwell at any length on departmental heads of expenditure, but would ask honourable Members to read the Memorandum Notes at least on the more important heads. 21 of which account for $2,922 million of expenditure or three quarters of expenditure on recurrent account. It is these 21 heads of expenditure which will dominate the growth rate of recurrent expenditure in future years and must be carefully watched.

No commentary on recurrent expenditure would be complete without a particular reference to the public service, which will start the coming year with an establishment of 112,818 posts which represents an increase of 7,922 posts or 7.5% on the establishment of a year ago. This compares with an average annual increase of 6.7% over the preceding three years and is a reflection of the quickening pace of expansion of Government activities in recent months.

The cost of the public service in 1974-75, after taking the vacancy ratio and the recruitment prospect into account, is estimated at $1,676 million, an increase of $137 million or 8.9% over the revised estimate for this year. This estimate includes $115 million, no less than $115 million, for allowances (the three main items of which are $34 million for overtime allowances, $30 million for cost of living allowances for junior staff and $9 million for additional duty allowances for police officers). The cost of the public service is estimated to be 43% of total recurrent expenditure in 1974-75, compared with 46% over the three years ending 1973-74. One reason for this decline is the rapid increase of such other recurrent expenditure as subventions and expenditure on social security. For an analysis of the increase in the approved establishment of the public service I would refer honourable Members to Appendix XV of the Estimates.

For two reasons the provision in 1974-75 for the salaries and allowances of the public service is only about 84% of the theoretical cost of the public service based on mid-points. First of all, the proportion of vacant posts is presently running at 13% and, secondly, in an expanding service, the system of incremental scales means that the actual annual cost tends to be less anyway than a costing based on the midpoints of the scales.

The estimated increase of 8.9% in the cost of the public service in 1974-75 over the revised estimate for 1973-74 compares with an average annual increase of 19.3% over the three years ending 1973-74, but this is a misleading comparison because the figure for 1974-75 is based on the approved establishment and the salary scales at 1st April whereas the annual increases in previous years take into account new posts and salary revisions approved during the year by supplementary

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provision. So there is no scope for complacency about the steady growth in the cost of the public service; and, at this point, I feel I must mention the urgent need for the Government to implement its declared pay policy consistently. Our pay policy recognises that salaries in the public service must never lead those in the private sector, which are related to profitability. If public service salaries lead, then the effect is inflationary and the ultimate consequence is a loss of external competitiveness.

The total provision of $982 million required for recurrent subventions represents an increase of $98 million, or 11%, over the revised estimate for this year, compared with the average annual increase of 28% over the three years ending 1973-74. But this 28% is distorted by the substantial revision of teachers' salaries in 1973. Discounting this factor, the average annual increase would be about 25% and the increase for 1974-75 over the revised estimate for 1973-74 becomes 20%. Next year, no less than 25% of total recurrent expenditure will go to assist non-Government bodies to provide services of various kinds compared with an average of 24% over the three year ending 1973-74 and 21 % over the three years ending 1970-71. The growing relative dependence on public funds of institutions managed by voluntary agencies in all spheres of activities is a matter of concern to me, given our narrow tax base and low standard rate of earnings and profits tax. This growing dependence is well illustrated by the increase in discretionary medical subventions from two thirds to three quarters of the cost per bed and the automatic calls made upon public funds by deficiency grant organizations to meet increased costs.

At $1,833 million the estimate of capital expenditure for 1974-75 is $460 million or one third higher than the revised estimate for 1973-74. In last year's budget speech I reckoned that we could afford to spend $1,600 million annually in the mid and late 70s on capital expenditure. At 1974 prices this figure becomes $1,800 million. As I estimate that capital revenue will finance 28% of capital expenditure in 1974-75—compared with the 25% I consider to be the minimum which ought to be so financed—I am not too concerned with the fact that the 1974-75 estimate is a little on the high side, provided it is understood that, in the coming years, the rate of growth of capital expenditure will have to be carefully controlled (and I shall show in a moment that it simply will have to be).

The estimate of capital expenditure in 1974-75 includes $1,408 million for Public Works Non-Recurrent expenditure, $50 million for the Development Loan Fund to enable the fund to provide loans to the Housing Authority estimated at $100 million in 1974-75, $118 million for departmental, capital or departmental special expenditure, $121 million for capital subventions to subvented organizations and for grants to the Universities and the Polytechnic and $136 million for miscellaneous purposes.

Sir, in analysing recurrent expenditure, attention must be focussed on the rate at which the public services are expanding year by year and thereby locking the Government into expenditure which could only be cut back at a social (and, possibly, economic) cost, however sound the budgetary reasons might be for doing so. Capital expenditure, by contrast, must be considered in terms of the total commitment at any moment in time; and the phasing of expenditure against this commitment over time.

As can be seen from paragraph 16 of the General Memorandum Note, at 1st April 1974 the outstanding balance on the total approved capital commitment on General Revenue is $6,220 million, of which $1,833 million is required for expenditure in 1974-75. The outstanding commitment on departmental special expenditure is $201 million, of which $118 million will be spent in 1974-75, an increase of 128% on the revised estimate for 1973-74. The outstanding commitment on capital subventions and grants is $307 million, of which $121 million will be required for expenditure in 1974-75, an increase of no less than 13% on the revised estimate for 1973-74 reflecting the growing size of the commitment to expand secondary education via the voluntary agencies. The commitment on such miscellaneous capital expenditure as coinage expenses, purchases of non-departmental quarters and capital expenditure under the Defence Costs Agreement amounts to $239 million of which $186 million will be required in 1974-75.

As can be determined from Appendix XII, the outstanding commitment at 1st April 1974 on approved expenditure for Public Works Non-Recurrent is likely to be $5,473 million of which $1,408 million will be spent in 1974-75. To this commitment on Public Works Non-Recurrent must be added $471 million for public housing projects already being undertaken by the Housing Authority as part of our 10-year housing programme. The Authority plans to spend $138 million in the coming year, $100 million as a charge to public funds through the Development Fund—which, in consequence, will have to be augmented by a transfer of $50 million from General Revenue and this has been allowed for—and $38 million from its own resources.

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With total expenditure of $5,747 million and revenue of only $5,679 million the Estimates as printed show a deficit of $68 million, but this figure has to be adjusted in several ways to arrive at the correct position.

On the one hand, it does not take into account applications for funds on recurrent account amounting to $102 million. These applications are in respect of the recommendations of the University and Polytechnic Grants Committee for the quadrennium starting in July 1974, the operating costs of the desalting plant, further expenditure in respect of the Independent Commission Against Corruption, requests for additional posts now being processed, the increased cost of bought beds in the Grantham Hospital, allowances for technical teachers in training, increased per capita grants for students in selected private schools, a refund of a proportion of the rates payable by the Housing Authority in respect of certain housing estates, and personal radios for the Police. On the other hand, the deficit to be borne by General Revenue in respect of the management of public housing estates might well be some $12 million less in 1974-75 than the provision sought under Head 40 Housing Department as a result of the Housing Authority reconsidering rent levels.

Nor does the deficit, as published, take into account further likely commitments on capital account amounting to $70 million in respect of the recommendations of the University and Polytechnic Grants Committee for the next building programme of the Universities and the Polytechnic, part-built accommodation in licensed areas and the construction of a railway siding at Shatin for oil imports.

If the total cost of these further recurrent and capital commitments, together with an allowance of 1% for contingencies is added to the published deficit it becomes $285 million. However, the provision shown in the Estimates for expenditure by the Public Works Department on the Mass Transit Railway will be recovered eventually from the Mass Transit Fund and so this estimate of the deficit may be reduced by $131 million to a final figure of $154 million.

Sir, before taking a view on the fiscal implications of this estimated deficit of $154 million for 1974-75, 1 fear I must set it in the context of the likely state of the public finances as a whole over the next few years. To this end, we have prepared a forecast of expenditure at 1974 prices for the three years 1975-76 to 1977-78 based on the following assumptions: first, that the present level of services will be maintained;

secondly, that certain services will be expanded and introduced in accordance with approved policies; thirdly, that the capital commitment resulting from the Government's policies as they are developed will be implemented in accordance with the time schedule proposed by the departments involved; and, fourthly, that there will be no constraints of a physical, economic, political or financial nature such as to affect the rate of growth or pattern of expenditure. The forecast is included in Appendices V, VI and IX to the Estimates.

We have also updated and improved the assessment I made last year of the order of cost of projected capital works over a period of ten years, 1974-75 to 1983-84. This is contained in Appendix XI.

I should like to say something in explanation of these two exercises. They are much more comprehensive than anything we have attempted in the past and, in their new format, they have not been published before. As these two exercises must influence my view of the coming year they should be regarded as integral to the Estimates. They show the implications of existing policies and plans, as they now stand, and as they have been approved by this Council.

As I have already said, I am presenting this year's budget at a time of uncertainty due to the oil crisis and when very sharp increases in costs, particularly building costs, in relation to the revenue trend, have occurred. Nevertheless, the adjustments necessary to deal with the 1974-75 budgetary problem are comparatively small. It would have been open to me to leave it at that and, in so far as the Government believed that adjustments were called for in plans for subsequent years, to have these worked out by the Government machine before the 1975-76 estimates season came along. I think this would have been the procedure of minimum exposure that most other Governments would follow. However, in accordance with our policy and practice of open dealing with the public, I must set out the calculations for the period of the three year forecast of expenditure, namely, the period 1975-76 to 1977-78, and for the period of the ten year order of cost of projected capital works, namely, 1974-75 to 1983-84; and I must then sketch out the medium term implications for expenditure and fiscal policy that stem from them. As I shall show, these implications certainly do call for some adjustments to be made in the years ahead. No doubt, as our procedures for planning and forecasting improve, the three year forecast of expenditure and the ten year order of cost of projected capital works as they are rolled forward and amended each year, will tend to approximate more closely to our forecasts of resources and, consequently, will call for only modest

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adjustments annually. Sir, I must ask honourable Members to bear this explanatory foreword in mind when listening to what I am now going to say or they will be quite unnecessarily alarmed.

Recurrent expenditure on General Revenue Account is forecast to increase at 1974 prices by $929 million from $3,914 million in 1974-75 to $4,843 million in 1977-78, an average annual increase of about 7½%, but this does not include any allowance for the further expansion of secondary education. Nor does it make any allowance for the additional cost of the recommendations by the University and Polytechnic Grants Committee for the quadrennium beginning in July this year. Finance Committee will be considering both subjects shortly and it is certainly likely that some extra expenditure will have to be incurred with effect from 1976-77 in respect of secondary education and 1974-75 in respect of university and polytechnic expenditure. However, taking the figures as they are presented in Appendix V, recurrent expenditure is forecast to increase from $3,914 million in 1974-75 to $4,263 million in 1975-76, to $4,531 million in 1976-77 and to $4,843 million in 1977-78; and, for the sake of the argument I shall be developing shortly about the capital account, I am accepting these figures as they stand and shall assume a certain annual surplus on recurrent account.

The real impact on the total bill for recurrent expenditure will be made by the large spending departments. Of the total increase of $929 million over the period, education accounts for $282 million (30%), medical services for $104 million (11%), maintenance of roads and other civil engineering facilities for $81 million (9%), water supply for $64 million (7%), general administration and law and order for $48 million (5%), social welfare for $43 million (4½%), and the Post Office, the KCR and general communications for $31 million (3%).

Thus the functional analysis of recurrent expenditure on Consolidated Account (Appendices IX and X) shows that expenditure at $1,215 million will be dominant three years hence in 1977-78 as it was three years ago in 1970-71, accounting for nearly a quarter of total recurrent expenditure. Expenditure on medical services in 1977-78 at $561 million, or 11% of the total, will continue to be in second place. Law and order at $497 million also retains its position in 1977-78 in third place, but accounting for 10% rather than 12% of the total. The dramatic increases in respect of housing and of public amenities from 4% and 5% of recurrent expenditure in 1970-71 three years ago to 9% and 7% respectively in 1977-78, the end of our three year forecast period, reflect the Government's continuing emphasis on public housing and the formation of the new Urban Council. The other growth area of recurrent expenditure worthy of mention is social welfare which will increase from 2% of the total in 1970-71 to 5% in 1977-78, largely as a result of the changes in the criteria for public assistance and the introduction of non-means tested infirmity and disability allowances.

Honourable Members will recall that, in last year's budget speech, I suggested that the order of cost of projected capital works over the ten years ending 1982-83 at 1973 prices was $19,500 million. I am now able to offer in Appendix XI a much more definitive assessment of what the Government's policies as they are being further developed are likely to involve in terms of capital expenditure over the ten years ending 1983-84 at 1974 prices (though I cannot claim that it is necessarily complete for the long term implications of our policies are not too easy to determine at a given moment of time).

The order of cost is put at $24,945 million and is built up according to spending authority, that is to say: projects already in the Public Works Programme; projects expected to be included in the Public Works Programme in due course, so far as these can be determined; projects in hand and planned by the Housing Authority; miscellaneous Public Works Non-Recurrent projects; capital subventions (including grants to the Universities and the Polytechnic); and finally capital requirements of departments for capital equipment of various kinds and other miscellaneous capital expenditure.

Of the $24,945 million, $1,971 million will be spent in 1974-75 leaving a balance of $22,974 million to be spent from 1975-76 onwards. I mentioned earlier that the estimate of capital expenditure in 1974-75 on General Revenue Account was $1,833 million. This figure may be reconciled with the $1,971 million I have just mentioned by adding in the $138 million to be spent by the Housing Authority on new projects. (And to repeat, of this $138 million, $50 million will have to be provided form General Revenue in 1974-75 in order to top up the Development Loan Fund to the $100 million expected to be drawn by the Authority from the Fund in 1974-75. The remaining $38 million will be found from the Authority's own resources).

Now having built up the total order of cost of our projected capital works to nearly $25,000 million in the way I have just described at 1974 prices it is then analysed in the same appendix (Appendix XI) by major programme areas: housing by the Public Works Programme and the Housing Authority accounts for $4,157 million or 17% of the

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total order of cost (of which $219 million will be spent in 1974-75); new towns development (excluding the housing element, but including all other facilities) accounts for $5,070 million or 20% (of which $96 million will be spent in 1974-75); roads account for $3,478 million or 14% (of which $274 million will be spent in 1974-75); water development accounts for $2,270 million or 9% (of which $363 million will be spent in 1974-75); other public works projects not included in new towns development and a range of miscellaneous projects account for $6,062 million or 24% of the total (of which $407 million will be spent in 1974-75); and, finally, all other capital expenditure (on miscellaneous Public Works Non-Recurrent and other projects, subventions and grants and departmental capital equipment) accounts for $3,908 million or 16% (of which $612 million will be spent in 1974-75).

A detailed functional analysis of expenditure on projects in Category A, in Category A only, of the Public Works Programme (and on Public Works Non-Recurrent: Headquarters) and on projects so far authorised, actually authorised and actually put in hand by the Housing Authority, is at Appendix XII. This shows estimated expenditure in 1974-75 at $1,546 million which may be reconciled with estimated total capital expenditure in 1974-75 of $1,971 million by adding in capital subventions and grants of $121 million and departmental and other miscellaneous capital expenditure of $304 million.

So much for the total order of cost of projected capital works at 1974 prices: there is a difference of some $7,000 million between the figure of $25,000 million and the resources I am prepared to assume will be available at current tax rates, namely, $18,000 million, being ten times the guideline figure of $1,800 million at 1974 prices for annual capital expenditure chargeable to General Revenue.

Now, Sir, two questions must be asked: first, can we expect a surplus on recurrent account annually of the order of $1,350 million, that is to say, $1,800 million less one quarter for capital revenue; and, secondly, can the difference of $7,000 million be reduced or covered by raising additional resources in acceptable ways?

To deal with the first question: on the basis of certain assumptions about the rate of growth of the economy and of recurrent revenue, I estimate that the surplus on recurrent account over the three years in our forecast period at current tax rates could be of the order of $4,300 million. If this is the case, and if capital revenue is of the order of $1,100 million only, then we shall be able to finance capital expenditure of $5,400 million or of $1,800 million annually over the forecast period of three years.

But—and this is a very large "but" as will be seen from Appendix V—the forecast of capital expenditure in each of the three years of the period is $2,765 million in 1975-76, $3,196 million in 1976-77 and $3,443 million in 1977-78, a total of $9,404 million or $4,004 million in excess of the resources I am prepared to assume will be available.

The difference of $4,000 million or so between the forecast of capital expenditure and the resources I am assuming will be available for the three years ending 1977-78 becomes $7,000 million if one does the same exercise for the ten years ending 1983-84. And so I come to the second question I posed: how can the difference of $7,000 million be reduced or covered?

Fortunately, in view of the time span involved, it is neither necessary nor would it be realistic to do so—to consider now how the programmes might be cut back and additional resources raised. The order of cost figure of $25,000 million may prove to be on the high side for various reasons including physical constraints; equally, it may also prove to be on the low side, for other unavoidable projects are bound to come forward (despite our attempt to make a reasonably comprehensive assessment of the implications of our developing policies).

It is also difficult to be definitive about the availability of additional resources over such a time span. For instance, the Housing Authority has a statutory obligation to move towards a situation in which revenue from rents is sufficient to cover both operating costs and capital charges and thereby to reduce steadily its borrowings from the Development Loan Fund (largely, in effect, General Revenue) and later on to generate a net cash flow and steadily to reduce its outstanding indebtedness. Again, development works in the new towns and elsewhere could result eventually in receipts from land sales being such that more than one quarter of capital expenditure is financed by capital revenue. Some might argue, furthermore, that investment in the community's infrastructure should result in a tendency for the rate of growth of revenue to increase more rapidly thereby producing a larger surplus on recurrent account. But I think prudence dictates that we should assume that, if this is the case, it will be offset by the increasing cost of utilizing our growing stock of social capital.

So, for the moment, I do not propose to worry unduly about the position over the ten years as such but—and this is also a very large "but"—the difference of $7,000 million between the order of cost and

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assumed resources must not grow any larger year by year as we roll forward.

However, we must consider and consider now that part of the difference that falls within our three year forecast, namely, some $4,000 million. And I propose to do this in terms of three questions: first, is it in any case practicable to think in terms of an annual rate of expenditure on capital account in excess of $1,800 million (at 1974 prices)? Now we can deduce from Appendix V that commitments in respect of capital subventions and grants and departmental and other miscellaneous capital expenditure will absorb $276 million, say, $280 million of the $1,800 million I am assuming we shall be able to finance in each of the forecas4 years. This leaves $1,520 million.

So the answer to this question depends upon the view that may be taken of the spending capacity of the Public Works Department and the Housing Authority. In 1974-75 these two organizations will be spending $1,408 million and $137 million respectively, a total of $1,545 million. After consulting those concerned, I have concluded they could spend at an annual rate of $2,500 million from 1975-76 if their approved establishments were brought up to strength and consultancy services were freely available to augment their general capability and to provide specialist services; and on certain assumptions as to the rate at which land was cleared and/or acquired. This so-called optimum rate of expenditure makes some allowance for inevitable frictions, that is to say, modifications of policy based on revised ideas and updated information, delays in finalising designs and contract documents and in the delivery of materials and equipment and such frictions leading to short falls in estimated expenditure on actual expenditure are inevitable even in such well managed organizations as the Hong Kong Government.

But a second question must immediately be asked: can capital expenditure of the order of $2,780 million a year be financed that is to say $2,500 million for the Public Works Department and the Housing Authority together and $280 million for other capital expenditure? The short answer is that I do not believe this is possible. The maximum average annual capital expenditure I think we can possibly finance in the forecast period 1975-76 to 1977-78 is $2,480 million (that is to say $2,200 million by the Public Works Department and the Housing Authority and $280 million for other capital expenditure) or in other words $680 million a year over and above the $1,800 million a year I am prepared to assume we can finance at existing tax rates.

Thus the difference of $4,000 million over the forecast period cannot be reduced by more than $2,040 million that is to say three times $680 million leaving a residual difference of $1,960 million.

Having established the figure of $2,480 million as the acceptable annual level of capital expenditure in financial terms over the forecast period, or which $280 million is non-public works and non-housing expenditure, the next step is to indicate—and it is not for me alone to do more than indicate at this stage—the next step is to indicate what will have to be done with the remaining difference of $1,960 million. That is to say, what projects should be postponed and/or the rate of expenditure on them slowed down in order to cut back total capital expenditure envisaged by departments in the forecast period (as set out in Appendix V) so as to reduce the difference to a figure which possibly can be covered by additional resources?

One way of approaching an answer to this question is to look at the trend of the pattern of expenditure in recent years and over the forecast period as a result of our developing policies. The trends from three years before 1974-75 to three years after, as revealed in Appendices IX and X, which analyse expenditure on Consolidated Account by function, are what they would be if there were no constraints other than those exercised as a matter of ordinary budgetary routine in 1974-75.

By 1977-78, housing and the related function, transport, roads and civil engineering, would occupy the first two places in the league table of capital expenditure accounting for $2,835 million or 69% of total capital expenditure. In 1971-72, they also occupied first and second places, but with $273 million only, and they accounted for only 34% of the total. By 1977-78, water, in third place, would account for $296 million or 7% of total capital expenditure, compared with $120 million or 15% in 1971-72, when it also occupied third place. By 1977-78, education, in fourth place, would account for $287 million or 7% of total capital expenditure, compared with $108 million or 13% in 1971-72, when it also occupied fourth place.

The growing domination of the new towns in the pattern of capital expenditure leads to three obvious possibilities, so far as the residual difference of $1,960 million worth of expenditure which we cannot finance is concerned. The first would be to hold back expenditure on the new towns so that it does not unduly damage the pace of development works not connected with the now towns.

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But as the effect of this first possibility would be to delay the achievement of the 1.8 million additional units of public housing which you, Sir, have firmly laid down as a priority target, we must turn to a second possibility, namely, to proceed with the new towns at all costs in terms of development elsewhere.

But I presume that this would not be an acceptable idea and so we must look to a third possibility which is in the nature of a compromise: that is to say, to maintain over the forecast period all capital expenditure except that related to the new towns and to other public housing at the level proposed for 1974-75. An approach along these lines would, I estimate, have the effect of reducing the difference by some $1,420 million to $540 million.

Unless the Housing Authority can generate additional contributions from its own resources towards the cost of public housing, then the only way of eliminating the difference finally would be to defer expenditure amounting to $540 million on the new towns. The estimate for the new towns includes all engineering works, Government buildings and new public housing and the Tsuen Wan By-Pass and the Tuen Mun Road, the estimate for the new towns including all those items is $3,310 million over the three years of the forecast and so to defer $540 million worth of expenditure on the new towns would not be all that serious.

As I shall explain shortly, I believe the economy could bear some extra taxation to help finance the extra $680 million needed to raise the level of annual capital expenditure to $2,480 million and I also believe that we could raise loans to finance a few self-liquidating projects. But the consequential reduction in our reserve of taxability must mean that the limits on the component parts of the $7,440 million worth of expenditure thereby financed and spent, (that is to say three limes $2,480 million annually), the limits on the component parts of that total figure must not be exceeded. On the contrary, projects that make up each part must be planned in such a way that expenditure can be reduced, and quickly, in the event that revenue (and hence the surplus on recurrent account) fails to live up to expectations.

Before suggesting how the additional finance amounting to $680 million a year might be found, I must deal with a third question which is this: would an annual rate of capital expenditure of $2,200 million by the Public Works Department and the Housing Authority lead to inflationary pressures building up as a result of competing demands from the private sector because the capacity of the building and construction industry is necessarily limited; and, further to this question, would the economy as a whole be put under strain in the sense that resources were diverted away from export oriented manufacturing industries? Even if we were to assume that the private sector's call upon the available capacity of the construction industry remained constant and therefore accounted for a declining share of that capacity as it expanded, the calls made upon it by the public sector would be so substantial that I cannot give re-assuring answers to these two questions at this stage (and there is also now, of course, the construction of the Mass Transit Railway in the offing). The main reason for my present inability to answer these questions definitively is that the capacity of the construction industry is a difficult concept to define, and the demands on it are difficult to measure (given the diversity of public works projects); and so I have arranged for a comprehensive study to be undertaken to ascertain the load that the industry and the economy could bear, financing possibilities notwithstanding.

So, Sir, it should be feasible to cut back and phase (on plans, remember, not actual expenditure) in a rational way. The ideas I have just sketched out will have to be developed in detail during 1974 by the Secretariat and departments, but can we be fairly certain of being able to afford an extra $680 million worth of capital expenditure over the forecast years? The answer to this question can only be based on an assumption that the economy will grow at around 7% per annum in real terms over the forecast period, that is to say, that sufficient recurrent revenue at current and revised tax rates will be generated to finance recurrent expenditure and the deficit on capital account, and on a further assumption that capital revenue (as a contributor to capital expenditure) will also come up to expectations: and the answer to this question must also be based on a decision that our available fiscal reserves as they stand just now are not substantial enough to be drawn down even if they were in more liquid (and therefore less profitable) form (though let us not forget that we have set aside the $800 million required for the Government's equity position in the Mass Transit Railway Corporation). The fact is that our available fiscal reserves must be kept in hand in case the rate of growth of recurrent revenue is disappointing (an ever present possibility in these uncertain times).

We have, then, the following possibilities: first, a tightening of financial control to ensure cost-efficiency, modesty of standards, minimum overheads and elimination of waste and extravagance. In our anxiety to get the rate of expenditure up in recent years as the economy

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and revenue yields surged forward after 1967, there has been a tendency to concede applications for supplementary provision regardless of wider budgetary considerations for these have not been of critical significance. We have now reached the point where a new attitude is required by both the Government and the Finance Committee of this Council if our developing policies are not to be seriously prejudiced. We must now look much more carefully at the margin of advantage to the community of each proposal to spend more.

Secondly, we must vigorously update, and keep up to date, our system of fees and charges for those goods and services which are not a fair charge to general tax revenue; and this means ensuring that the full cost of these goods and services is covered. We have a major exercise in hand at the moment as I promised last year. There is no logical reason why the contribution of fees and charges to total recurrent revenue should remain constant; but it has tended to fall in recent years and this tendency must be corrected.

Thirdly, we cannot afford to allow social and political considerations unduly to influence our management of public utility undertakings, namely, the Waterworks, the Post Office, the Airport, and the Kowloon-Canton Railway.

Fourthly, our system of licences must be updated, and kept up to date, not so much on an historical cost basis, but in terms of what the market will bear.

Fifthly, we can no longer afford to surrender rate revenue as a result of postponing revaluations of property; for rate revenue contributes 7½% to total recurrent revenue, even though the yield from 6/15ths of the rate in the urban area has been hypothecated to the Urban Council. Over the past decade as a result of postponements in favour of using staff on rent control measures we surrendered, quite unwarrantably but unavoidably, some $90 million at least.

Sixthly, there is our reserve of taxability. I shall have more to say about indirect taxes shortly in connection with the coming financial year. As regards earnings and profits taxes, there are three ways in which the yields, at any given level of incomes and economic activity, can be raised: by increased efficiency in tax administration, a subject dear to the heart of the Commissioner of Inland Revenue (and dear to my heart, too, for I think the present investigation powers and penalty provisions in Part IX and XIV of the Inland Revenue

Ordinance need strengthening); by rectifying the eroding effect of case law on the width of the profits tax base over the past 25 years; and by raising the standard rate of 15%.

Seventhly, we must continue to nurse with great care our major source of capital revenue, land, the case for occasionally adopting special methods of disposal for special reasons notwithstanding. Much of the development work in the next three years, particularly in the new towns, will produce land for sale to the public. So there is a reasonable possibility that capital revenue will continue to play a significant role in financing capital expenditure although, with the increase in recurrent revenue, on the one hand, and the level of capital expenditure, on the other, there must be some doubt as to whether capital revenue will in fact live up to the guidelines I laid down earlier, namely, 10% of recurrent revenue and 25% of capital expenditure.

Finally, we are virtually a debt free Government. Without wishing to dwell on the blindingly obvious, we are also a highly credit worthy Government, but I am totally opposed, in our economic circumstances, to the use of loan finance for other than directly self-liquidating projects for we must be able to relate debt charges to cash flows generated. Otherwise, we would run the risk of debt charges becoming a burden on general revenue to the detriment of our fiscal policies and thereby put the growth rate of the economy at risk.

I do not anticipate, however, any difficulty in finding directly self-liquidating projects and, in the first instance, I propose that we should invoke our borrowing rights with the Asian Development Bank. I have already been in touch with the President of the Bank and floated the idea that we should negotiate further loans over the forecast period. I shall be pursuing this idea further during the annual meeting of the Board of Governors of the Bank in Kuala Lumpur at the end of April.

To sum up, then: Sir, over the forecast period I am prepared to assume that we can finance $5,400 million worth of capital expenditure at 1974 prices that is to say three times $1,800 million. But departmental plans envisage expenditure of $9,400 million involving a difference of $4,000 million. Only $2,040 million worth of this difference can be covered by additional resources through higher taxation, additional capital revenue and the raising of loans and so there will have to be a re-phasing of $1,960 million worth of expenditure to later years or various adjustments and economies. As total capital expenditure of $7,440 million involves an average annual rate of expenditure of no less than $2,200 million by the Public Works Department and the Housing Authority there can be, I suggest, no

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question of this cut-back on the forecast involving under-utilization of planning, engineering and administrative resources; and, indeed, to achieve such a high rate of expenditure on capital works will require a considerable effort, a very considerable, effort, by all concerned. I might also add, with some regret, that it will require a degree of forbearance by the taxpaying community; but I would further add that the fundamental necessity of our tax system and the rate of growth of public expenditure not damaging the rate of growth of the economy will be my constant preoccupation.

Sir, compared with the budgetary problems facing us in the three year forecast period and thereafter, the problem we face in the coming year, 1974-75, is a relatively minor one.

However, there can be no question of our compounding our future problems by carrying forward a deficit, no matter how small, to the General Revenue Balance. In other words, I am of the view that we should budget for a balance between revenue and expenditure and, because of our uncertain economic prospects in 1974, 1 think we should seek to bring the budget safely into balance. The corollary to this is that, in 1974-75, heads of departments will be expected to keep within the provision in the Estimates. In the past five years applications for supplementary provision put to Finance Committee have risen sharply and have vitiated the annual budgetary exercise. But we can no longer allow actual expenditure to exceed the original estimate as has been the case in the last four years.

Sir, in last year's budget speech, I postulated eight considerations which should dictate fiscal policies, namely: the need for extra revenue to finance essential expenditure which could not otherwise be contemplated; the need for reform of the tax system; the need to widen the base of the tax system; the desirability of affording relief in particular circumstances and/or to particular classes of taxpayers; the desirability of striking a certain balance within the system as between one type of levy and another; the need to achieve certain policy objectives via fiscal measures; and finally the need to avoid general revenue subsidizing those public services, particularly public utility type undertakings, which should be paid for by users and, then again, in buoyant times, the desirability of adding to our fiscal reserves,

I shall deal with my fifteen revenue proposals for 1974-75 under seven of these eight heads—needless to say, the last the desirability of adding to our fiscal reserves hardly arises—but, before honourable

Members recover from their understandable sense of shock, let me hasten to add that several of my revenue proposals are of a minor nature and four involve relief.

To begin with tax increases specifically and solely designed to raise extra revenue. Other increases which I shall be proposing later will be partly for this reason and partly related to other considerations such as the balance of the system and the pursuit of certain policy objectives.

Sir, there is one source of revenue that clearly can be tapped. The rates of duty on intoxicating liquors have remained unchanged since 1963, apart from one small exception to remove an anomaly. Because the rates are specific rather than *ad valorem*, they are now, as a result of the price increase over the last ten years, a much smaller proportion of retail prices than they were when the current rates were fixed. Retail prices for the main brands of imported European-type spirits have risen by 35% on average since 1963. In principle, I consider an increase of at least 25 % on the rates of duty would be fully justifiable, but with higher percentage increases for grape brandies for which the rise in prices has been particularly steep; lower percentage increases on the rates of duty on non-European type spirits and beer which the less well-off sections of the community tend to drink; and no increase for industrial-type ethyl alcohol.

Having regard to our obligation under the General Agreement on Tariffs and Trade not to widen absolute preference margins, the increases in the rates of duty per gallon for intoxicating liquors will be as follows:

Grape brandy..............	$24
Other spirituous liquor including liqueurs, whisky, gin, rum and vodka	$16.50
Sparkling wines..............	$11
Still wines	$5
Cider	60 cents
Imported beer	30 cents
Locally brewed beer..............	20 cents
Non-European-type wines	$3
Non-European-type imported spirits	$1
Non-European-type locally distilled spirits	85 cents

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and there are, of course, other corresponding increases for liquors above specific strength. These increases came into effect at 2.30 p.m. today and I estimate that they will benefit the revenue by some $47 million in 1974-75.

On a standard bottle of brandy the increase will be $4, of whisky $2.75, of sparkling wines $2, of still wine less than $1, and of beer 5 cents. In view of the recent increases in retail prices and the advantages importers have been gaining from fluctuations in exchange rates, I would be surprised (and personally upset) if the trade did not find they could absorb part of this extra duty instead of passing it all on to consumers. Certainly, the price of a tot of spirits in our leading and more expensive hotels should not be increased at all.

Except for technical adjustments, the rates of duty on tobacco were last increased in 1966. I consider they also could now be raised by 25%. Rounding off, and having regard to the need not to widen preference margins, the increases will be $2.00 a pound for unmanufactured tobacco, $2.80 a pound for cigars, $2.70 a pound for cigarettes and $2.20 a pound for other manufactured tobacco, except Chinese prepared tobacco. The duty on Chinese prepared tobacco was reduced in 1962 to deter smuggling and I do not propose to change it now. The increase in terms of a packet of cigarettes will be about 10 cents whether manufactured locally or imported.

These increases will increase the yield from tobacco duties by $37 million in 1974-75 and they also came into effect at 2.30 p.m. today.

As regards the width of the tax base, I have only two proposals for 1974-75. In my 1972 budget speech, I said there was a very strong case for bringing the 11% rate charge for rateable areas in the New Territories up to that applicable in the urban area proper. My argument was based on the rapid development of Tsuen Wan, then the only rateable area in the New Territories. Simultaneously, I proposed that the rate charge for the urban area be reduced from 17% to 15%, a change which was implemented from 1st April 1973. The time has now come to implement the second stage and to raise the rate charge applicable to the New Territories to that payable in the urban area, that is to say, to 15%. But so that the change for newly rateable areas is not too abrupt, I proposed that for the first four years of assessment they should be rated at 11% only. By newly rated areas I mean completely new areas included in the schedule to the Rating Ordinance; I do not include extensions to existing areas. For

1974-75 the effect will be that the rate charge for Area D (Tsuen Wan) which has been subject to rates for 17 years in other words since 1956, will increase to 15% from 1st April 1974. The Commissioner for Rating and Valuation estimates that this proposal will yield a further $12 million in 1974-75. An amendment to the Rating Ordinance by Resolution of this Council will be necessary.

During the current year, action was taken to prepare a new valuation list for Area E (Tsing Yi Island). The list will come into effect on 1st April 1974 and the rate yield from this new area for 1974-75 is estimated at $2 million and this has been included in the estimate for Revenue Head 2—Rates. The rate charge for Tsing Yi will be 11% until 1st April 1978.

My second proposal to widen the tax base will have the effect of removing the present anomaly hereby under proviso (*e*) to section 5(1) of the Inland Revenue Ordinance (and I quote):

> "property tax shall not be charged for any year of assessment in respect of any land or buildings in the New Territories, other than New Kowloon, unless and until the Governor by proclamation in the *Gazette* declares that property tax shall be so charged."

Now that rateable values have been established and properties assessed to rates in certain areas of the New Territories (Areas D and E), I can see no reason why the Commissioner of Inland Revenue should not collect property lax from non-owner occupied properties in such areas in the New Territories, and Your Excellency has agreed, therefore, to make the necessary proclamation which will be published in the *Gazette* on 29th March next. I estimate that the revenue should benefit to the extent of some $11 million in 1974-75 after making due allowance for owner occupied properties and the fact that many properties, particularly on Tsing Yi, are owned and used by corporations which are covered by their assessments to profits tax.

Incidentally, one argument for this move is that the practice of not charging property tax in the rated areas of the New Territories has left the way open for considerable profits tax avoidance by director-controlled companies operating in commercial premises in these areas. Properties are leased to such companies at rents which hive off much of what would otherwise have been part of the companies' assessable profits. Such rental income has then been tax free in the hands of the property owners.

I should mention at this point that the Rating Ordinance 1973 obliges the Commissioner for Rating and Valuation to include in the

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valuation lists rateable values for the former Resettlement Estates, now known as Group B Housing Estates. Hitherto, the Commissioner for Resettlement collected fixed amounts by way of rates for nearly all such premises as an element of the monthly rent. These amounts were then transferred to the rates revenue account. They were determined many years ago and no longer reflect present rateable values.

In accordance with his statutory obligation under the Rating Ordinance, the Collector of Rates will demand the full General and Urban Council Rates from the Housing Authority in respect of Group B Housing Estates in 1974-75. The Commissioner has, therefore, included in his estimate of the yield from rates in 1974-75 the increase resulting from the application of the full General Rate (and, of course, the Urban Council will benefit also to the tune of 6/15ths of about $28 million). But, because the Housing Authority has not yet completed its revision of rents for Group B Housing Estates, I propose that the Government should put the Housing Authority in funds to pay the additional rates for two years. For this purpose, I shall be seeking supplementary provision of $28 million in respect of 1974-75 under Head 40 Housing Department (and I have allowed for this in calculating our extra commitments on recurrent account in 1974-75).

Sir, in last year's budget speech I defined tax reform measures as changes designed *either* to make the burden of the system of taxes and levies more equitable (and I would now add to remove anomalies), *or* to simplify the administration of the laws under which these taxes and levies are raised, *or* to increase the efficiency of their administration in the sense that higher yields are derived from the same rates of charge. This year I have two proposals for reform.

My first proposal concerns property tax on vacant premises. Before 1st April 1973 owners of such vacant property could claim full refunds of property tax. With effect from that date, the Inland Revenue (Amendment) Ordinance 1973 contained a provision to restrict refunds of property tax by reason of vacancy to one-half of the full charge and this was effective for the year of assessment 1973-74 (coincidental with a charge to half-rates under the Rating Ordinance 1973).

However, the Commissioner of Inland Revenue and I now realize that this move was illogical in that property tax is one of our forms of tax on profits and vacant premises are, clearly, not producing profits.

I propose, therefore, to introduce another amending bill straight away to correct this error on our part.

My second reform proposal concerns the surcharge for late payments of earnings and profits taxes and rates which is 5% and was fixed as long ago as 1940 in the case of earnings and profits taxes and 1951 in the case of rates. The Surcharge is levied under section 71(5) of the Inland Revenue Ordinance and section 22(2) of the Rating Ordinance irrespective of the period of default and, with the time it takes to process debt collection through the courts and other channels, its initial deterrent effect is lessened. Thus, once the surcharge has been incurred, it becomes cheaper for defaulters deliberately to delay payment for as long as possible rather than realize assets, or borrow at commercial rates of interest to meet their due liabilities. At current rates of interest the surcharge, in fact, ceases to be effective after, say, six months.

I propose, therefore, that the respective ordinances should be amended to provide that a further surcharge of 10% may be added to any amount due (including the surcharge) in default six months after the due date for payment. I hope this will encourage prompter settlements rather than lead to increased impositions; and I hope also will dampen down a tendency apparent in recent years for outstanding arrears of revenue to rise.

Sir, there are four areas which I think qualify for relief this year (though two of them are of minor importance). The first important area is depreciation allowances for plant and machinery. Overall, the present allowances for depreciation are probably adequate in that, on disposal, or at the end of the life of the assets, balancing charges exceed balancing allowances, that is to say, the allowances have proved to be over-generous and the excess has had to be brought into assessable profits. But this is not true for all industries and, even if it were, I am anxious to offer encouragement to manufacturers to re-equip and upgrade their plant and equipment as the economy faces the challenges of a new and certainly changing world trading environment. I mentioned earlier that expenditure on gross domestic fixed capital formation has been growing rapidly in recent years and so has expenditure on the plant, machinery and equipment component, which now represents about 12% of the gross domestic product. I would like to see this percentage even higher.

I propose, therefore, that the initial allowance laid down in section 37(1) of the Inland Revenue Ordinance should be increased from one

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fifth to one quarter as from the year of assessment 1974-75 at a cost to the revenue of $10 million.

I also propose to invite the Board of Inland Revenue to adopt a new table of rates of depreciation under Rule 2 of the Inland Revenue Rules to be effective for years of assessment commencing on or after 1st April 1974 at a cost to the revenue of not less than $20 million in 1974-75. This is a proposal for relief coupled with reform and I can explain what is intended quite briefly: the present basic rate for plant and machinery, except for specific items, is 10% on reducing values. An increase in the basic rate from 10% to 15%, and a reduction in the number of exceptions, would make for simpler administration and result in a measure of relief for most profits taxpayers. The exceptions to the 15 % will be those where, even on a reducing balance, the 15% would be either too generous or insufficient. Thus the annual rates for tankers and other ships will be raised from 7% and 6% respectively to 10%, but not to 15%, whilst the annual rates for the textiles and plastics industries will be raised to 20%, a rate which is at present enjoyed by the electronics industry.

My second proposal for relief (with a measure of reform in the interests of economy) is in the estate duty field. The exemption limit for estate duty was $50,000 for the four years 1959-62, $100,000 for the seven years 1963-70 and by April of this year the present limit of $200,000 will have been in force for four years.

I think present circumstances warrant an adjustment of this figure to $300,000, involving an amendment to the Tenth Schedule of the Estate Duty Ordinance so as to abolish the first platform attracting duty at 5% at a possible cost to the revenue in 1974-75 of rather more than $1 million. In 1972-73, whilst estates valued between $200,000 and $300,000 contributed only 2.6% to the total duty assessed, they represented over 20% of the number of estates assessed. In anticipation of helpful, but probably expensive, suggestions from some honourable Members, let me say that I do not consider there is any need to do more than raise the exemption limit by $100,000 and I would remind them that there was a considerable reduction in platform rates with effect from 1st April 1972 as a result of the 1972 budget proposal to reduce the maximum rate from 20% to 15%.

During the debate on the Stamp (Amendment) Bill, 1973 on 6th June last, my honourable Friends Mr Q. W. LEE and Mr Roger LOBO suggested that transfers of shares, marketable securities and property by way of outright donations to designated charitable insitutions should be exempt from stamp duty in the same way as bills of exchange which constitute gifts are exempt. I accept the case for doing this and, accordingly, my third proposal for relief involves appropriate amendments to Heads 48 and 53 of the Schedule to the Stamp Ordinance at an unknown, but small, cost to the revenue.

Although I relieved a miscellany of documents from stamp duty last year, I overlooked a special type of case which warrants consideration.

I refer to the instruments involved in documenting interest free loans from public funds to students. The undertakings signed by the students do not now attract a charge, but the accompanying deeds of indemnity remain liable to *ad valorem* stamp duty. The loans are mostly for amounts around $3,000 with duty payable of about $6. The number of students receiving loans in 1973-74 was 3,438 and is estimated to be 7,000 next year. Although I am dealing with this matter as my fourth proposal for tax relief, for that is what it is strictly speaking, I would readily admit that the Collector of Stamp Revenue will be happy to be relieved of collecting very small individual amounts from a very large number of people. There seems to be little point in collecting such duty from this class of person on this type of document and I propose that Head 14 of the Schedule to the Stamp Ordinance be amended accordingly.

At this point, Sir, I should deal with a piece of unfinished business, though I shall not be making a proposal. During the debate on Your Excellency's Address at the beginning of this session of the Council, I undertook to consider a suggestion by my honourable Friend Mr Q. W. LEE that a greater degree of tax relief should be offered for charitable donations. This I have done, but I am afraid I must adhere to the view that 10% is the maximum allowance that should be deducted from the personal assessment, earnings or profits of donors.

I do this for three reasons: first, the Government's ability to finance current and projected expenditure should not be put at any risk by allowing personal decisions as to allocation of profits or income to charities to have more than a very limited effect on the revenue. The 10% limit is as far as I think we should go. Secondly, with our present narrow tax base, a person can have considerable tax free income from dividends and indeed from sources outside Hong Kong. It would be extremely difficult to ensure that non-taxable income bears its due share of donations. Thirdly, my honourable Friend's suggestion—though I certainly know this is not his motive—is in effect a

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proposal to relieve taxpayers rather than to subvent approved charitable organizations. I know of no evidence that increased relief to taxpayers would necessarily bring in increased donations and I do not see any justification for raising the present limit to benefit certain taxpayers at the expense of the revenue.

Furthermore, a proposal to place profits tax assessments on a current year basis with effect from 1975-76, to which I shall be referring later, provides that the 10% limitation will be in reference to the assessable incomes of the year before any reduction by post-change losses.

I now turn to several proposals, all to take effect immediately, unless I state otherwise, designed partly to increase revenue for its own sake and partly to enhance the role of indirect taxes and levies in our fiscal system.

In last year's budget speech, I refrained from putting forward any restraint measures to achieve a better use of road space until honourable Members had had a chance to debate the problem of a viable and acceptable transport policy for the 70s and 80s. As honourable Members know a green paper entitled "Transport in Hong Kong" will be published and laid on the table of this Council in April. Without wishing to pre-empt honourable Members' conclusions in the debate on transport policy, I propose to take the opportunity provided by the need to raise additional revenue to propose some changes to the structure of our system of levies on road users in line with the proposals in the green paper, which have the general support of the Transport Advisory Committee.

To begin with, I propose to make some adjustments to vehicle licence fees, last adjusted to any major extent in 1966.

I propose to raise a further $56 million from licence fees for cars of all classifications and motor cycles. Fees for private cars are at present charged on the basis of six platforms according to engine capacity. As part of the restructuring process, and to make the system simpler to administer, I propose two platforms only with the dividing line at engines of 1,500 cubic centimetres. I consider it would be reasonable to require owners of cars of this capacity and less to pay $400 a year; and those with cars above this capacity to pay $1,000 a year. Although the relative increases may seem fairly steep—licence fees for many of the popular makes of car will be more than doubled—the absolute increases are not unreasonable.

Public cars pay on the same basis as private cars, plus $30 for each seat for a passenger. As virtually all public cars are large cars, to simplify administration I propose to take the higher rate of $1,000 for private cars and to add to it $150 for seating capacity to give a licence fee for public cars or red plate cars of $1,150.

Taxis are charged on a different basis: $10 for the driver and $30 for each seat for a passenger. The Commissioner or Transport and I have considered the possibility of introducing a single rate of $1,000 to bring taxis into line with private cars over 1,500 cubic centimetres. But such an increase might be considered too steep for such a useful means of public transport. So I propose to simplify the charge by introducing a single rate on the assumption that all taxi have five passenger seats and then to double the figure of $160 so derived to give a fee of $320. The effect of this increase on the operating cost of taxis will be quite insignificant.

The four rates for motor cycles and motor tricycles can be brought together at $200 compared with, for example, $70 for motor cycles at present and I so propose.

Secondly, I consider goods vehicles should pay more for using public roads. The present fee is $240 for a goods vehicle not exceeding 20 cwt and $50 for each further 5 cwt up to a maximum of 2,500. To simplify the system and to produce additional revenue, particularly from the middle range of goods vehicles, which the Commissioner for Transport considers are becoming over-plentiful to the detriment of other road users, I propose to introduce four platforms:

20 cwt and under at $300,

over 20 cwt and up to 45 cwt at $600,

over 45 cwt and up to 75 cwt at $900, and

$1,200 for heavy goods vehicles.

The effect will be to increase the licence fee for a 20 cwt van, for example, by 25%, for a 40 cwt truck by 36%, for a 3-ton lorry by 40% and for a 5-ton lorry by 15%. I estimate these charges will raise a further $5 million in a full year (but it could be rather more).

Thirdly, I propose to raise the fee for public light buses from $3,000 to $6,000 to increase the yield in a full year by $12 million. The profitability of these buses is indicated by the price at which licences change hands. I can only conclude quite reasonably that they could well afford to pay an additional $3,000; and the public should not allow themselves to be persuaded that an increase of this size in

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any way provides an excuse for higher fares. I estimate that the additional cost will be less than 4 cents a passenger journey.

The total additional revenue from these several increases in 1974-75 should be, after making due allowance for deterrence, $73 million. The remaining fees, I propose should remain as they are: goods vehicles on construction sites because they do not use roads; and buses because they are a form of transport I am sure honourable Members will wish to encourage, my budgetary problems notwithstanding.

First registration tax was originally introduced in 1961. The tax is at present levied on private cars, on motor cycles and motor tricycles. I propose to raise the rate from 10% to 15% of the value of the vehicle, but to leave the scope of the tax alone for the time being. To meet our GATT obligations on preference margins, I shall have to leave the Commonwealth Preference Tax, which applies to all types of motor vehicle not of Commonwealth origin, at 15%. This proposal should yield a further $10 million in 1974-75 after allowing for some reduction in the number of cars imported.

Last year I predicted an increase of $38 million from increases in the driving licence, fee to bring it up-to-date and in the fees in respect of application forms of driving tests and of provisional licences to dampen down the quite excessive demand. The dampening down effect has been such that the revised estimate for provisional licences and drivers' licences this year is $16 million short of the original estimate. Because all the three year drivers' and provisional licences issued before the fees were raised, have not yet, as it were, worked themselves through the system, I expect the dampening effect to continue into 1974-75. In the circumstances, I propose not to introduce any further increases to the fees at the present time.

But the Commissioner for Transport tells me that there are at present 450,000 licence holders with nearly 700,000 endorsements permitting them to drive various different classes of vehicle. He suspects that licence holders do not in fact use a fair number of these endorsements; and, much more serious, when they do, they have not driven the class of vehicle concerned for many years. As the Commissioner would like to discourage licence holders from maintaining unused endorsements, I propose to apply the fee to each endorsement on a licence. Allowing for a fairly dramatic dampening effect, this measure should raise a further $4 million in 1974-75.

My last set of proposals in this disputatious field is designed to implement the recommendation of the Transport Advisory Committee that charges for multi-storey and temporary car parks should be raised so as to ensure better use of the limited spaces available in the central urban areas by deterring drivers from parking for very long periods. The present charge, other than for weekends and evenings is $1 an hour, with a minimum charge of $2 and a monthly pass of $200.

The Committee has recommended $2 per hour for the first 5 hours, $3 an hour for the sixth to eighth hours and $4 thereafter, with no minimum and no monthly pass. The Committee recommended no change to the cheaper rate and the period to which it applies, but did recommend that the present charge for temporary car parks should be raised from $2.50 a half day to the same level as for multi-storey car parks. As the Commissioner for Transport assures me that there will be no temporary car parks left by the end of next year, it seems to me that the administrative cost of introducing an hourly charge for temporary car parks would not be worthwhile. In the circumstances, and with his agreement, I propose a modification of the Committee's recommendation: a revised half-day charge of $5. I propose that these changes be implemented as soon as practicable after 1st April 1974, to yield a further $4 million provided drivers' parking habits are not affected too drastically.

Duties on motor spirit and diesel oil for road vehicles are a further obvious source of revenue quite apart from being also a means of implementing policy objectives. And there is still the anomalous difference between the rates on the two types of automotive fuels. Nevertheless, although the rates were last raised as long ago as 1966, I propose to introduce no changes this year for, with the increases in the prices of petrol and diesel oil, the cost of actually moving vehicles is going to be increased substantially anyway.

In furtherance of the promise I made last year to pay greater attention to fees and charges, the Finance Branch has now completed the first stage of an exercise to revise them. They cover a multitude of services and of permits, licences, certificates and other official documents. The rates were originally designed either to recover full costs, or to raise revenue or to keep administrative costs within bounds by deterring frivolous applications. With a few exceptions, the most notable perhaps being fees and charges connected with the operation of the harbour, they have not been revised for many years, nearly thirty years in some cases and one hundred years in one other case.

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The first stage of the exercise has been to identify those that can be revised without a complicated costing exercise and to propose new levels consistent with the object of the fee or charge. The Finance Branch has identified forty original documents and a miscellany of duplicates, copies and extracts for which higher rates can be introduced virtually straight away in 1974-75 or when the necessary amending legislation is passed. The revised rates should yield a further $7 million in 1974-75, of which $2 million has already been allowed for in the published Revenue Estimates, and about $5 million will result from a doubling of business registration fees.

I should make a special mention of rail fares: when the additional locomotive and 12 carriages and the 28 carriages to replace existing carriages are delivered and paid for later this year, I shall be taking a close look at the profitability of the Kowloon-Canton Railway. The indications are that present fares are too low and will have to be raised when the new train set and carriages come into use, yielding an extra $3 million in the latter half of 1974-75.

In order to safeguard the revenue, four of these proposals have to be implemented immediately. Accordingly, Your Excellency this morning signed the necessary orders under the Public Revenue Protection Ordinance bringing the increased rates of duty for liquors and tobacco, the increased fees for vehicle licences and the increased rate for first registration tax into effect from 2.30 p.m. today. This means that the outturn for the current year will be affected by one month's additional revenue from these sources which I have taken into account in my prediction of a surplus of $200 million, net of the $300 million to be transferred to the Mass Transit Fund.

All my revenue proposals added together, then, should yield net a further $175 million to turn the deficit of $154 million into a small surplus of $21 million. This is the equivalent of 0.3% of estimated revenue for the year of $5,854 million. It must be considered in the context of a fairly bold view of the growth of revenue which, in turn, must be viewed against a background of uncertainty created by the oil crisis. If I have slightly under-estimated the effect of this crisis on the economy, the surplus could easily become a deficit. And I must remind honourable Members that a more significant contributor to the surplus than my tax proposals were the cuts of $205 million for budgetary reasons in the level of total expenditure the Finance Branch considered reasonable. Clearly, if revenue does prove more buoyant than I have anticipated, our priority must be to restore these cuts. In the circumstances, as I have already said, I shall expect heads of departments to keep expenditure firmly within the amounts voted in the heads for which they are accountable and the Finance Branch, in consequence, to take an austere view of requests for supplementary provision.

That completes, Sir, my presentation of the budget for 1974-75. Before giving honourable Members the undoubted pleasure of seeing me sit down, I feel obliged to mention certain specific revenue proposals I have in mind for 1975-76, the first year of the three year forecast.

To begin with, the Finance Branch will undertake the second stage of the revision of fees and charges to which I have already referred. The fees and charges concerned are generally those designed to recover costs, but for which a complicated costing of the relevant activities of the departments concerned is required before they can be reviewed. They will be revised as soon as the necessary preparatory work is completed, but the additional revenue is unlikely to be too significant until 1975-76. The ultimate result should be at least another $11 million annually at 1974 prices. And with the longer term in mind, the Finance Branch has been carrying out all the revisions in such a way that the rates can be reviewed regularly and adjusted as soon as they begin to be significantly out of date.

My second proposal for next year is in the nature of a warning that water charges may have to be raised next year, two years earlier than the year my predecessor predicted for a further revision. This is because there are several disturbing features developing in the water accounts. First, although the Waterworks accounts for the year ending 31st March 1973 showed a surplus, the deficit brought down from previous years is being eliminated far too slowly. Secondly, the capital cost of the High Island Scheme is proving about 50% higher than was allowed for in calculating present water charges. Thirdly, the cost of fuel oil has already trebled since the charges were determined with the result that the unit cost of desalted water will increase by about the same factor. Fourthly, the Water Authority is still operating the salt waiter supply at a loss. Fifthly, the Director of Water Supplies reports abuse of the free allowance of 2,000 gallons to domestic consumers. In the New Territories, apparently, villagers are using up to the limit of the free allowance and then drawing their remaining requirements free from public standpipes (*laughter*). Sixthly, he also reports a growing number of illegal connections to free standpipes in licensed areas.

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The consequence of all this is that the cost of water looks as if it is going to be appreciably higher than my predecessor anticipated when he determined the present charges. And as I said earlier, we simply cannot afford to subsidize our public utility undertakings from General Revenue.

Next, I must return to the point I made earlier about the financial sacrifices involved in the postponement of revaluations. I have had to agree to postpone the revaluation due this year (1974) until next year (1975), effective from 1976-77, owing to the work involved in administering the system of rent controls provided for in the Landlord and Tenant (Consolidation) Ordinance 1973. The cost to General Rate revenue will be, on present indications, about $115 million. So I now give notice of my intention to propose that this be offset by raising the General Rate from 9% to a rate which will yield a roughly equivalent sum—it will be round about 12%, I think. Following the revaluation, the rate will be adjusted back to 9% or to whatever rate is necessary to raise the revenue required from the revalued properties. If honourable Members think this proposal is a little on the harsh side, may I remind them that the revised terms for renewing renewable Crown Leases (3% of rateable values) will yield about $8 million a year only whereas, under the previous proposal (5% of market values), we expected to collect $300 million in 1974-75, and $1,200 million over the three years of the forecast period.

In my 1972 budget speech I said I had in mind to start bringing Tsing Yi Island, Yuen Long, Tai Po and the Clearwater Bay area into rating. With Tsing Yi Island now rated, the Commissioner of Rating and Valuation will be able to turn his attention to Yuen Long and Tai Po and I sincerely trust his staff position will enable him to complete valuations during 1974. And so, in addition to adjusting the general rate for 1975-76, properties in these two areas will be rated; and, of course, the properties concerned will be charged to property tax as from that year.

Before dealing with our profits tax base (and then our reserve of direct tax taxability), I must refer back to an idea I floated in last year's budget speech in response to pleas from various quarters that our interest withholding tax was inhibiting the development of Hong Kong as a financial centre. Briefly the argument ran that foreign currencies held by residents and non-residents were unlikely to be deposited in Hong Kong so long as they attracted interest tax when they could be deposited elsewhere (in London or Singapore) and not attract tax. Accordingly, I floated an idea for the establishment of special departments of banks and finance houses which would borrow and lend foreign currencies. These special departments would have to observe certain minimum capital and liquidity requirements and would only be permitted to accept deposits of a stipulated minimum size. Although profits arising from these transactions would be specifically deemed by an appropriate amendment to the Inland Revenue Ordinance to be exigible to Hong Kong profits tax, interest payable on deposits would be exempted from withholding tax.

Subsequently, I arranged for three colleagues of mine collectively to take soundings on this idea and, if they were favourable, to work up drafting instructions for legislation to amend the Banking Ordinance (to provide for the licensing of the special departments) and the Inland Revenue Ordinance (to exempt deposits received by these licensed departments from interest withholding tax and to deem profits to be exigible to Hong Kong profits tax). Discussions were held with upwards of 100 representatives of various organizations. Without exception all expressed a wish to receive foreign currency deposits *in* Hong Kong and engage in lending operations *from* Hong Kong, passing all entries through the books of their offices or branches *in* Hong Kong. Except for one large bank, however, all were of the opinion that the business would be of real advantage to them only if the transactions could be conducted free of all taxes.

The minority view was that licensed special departments operating a so-called "official" market (that is with dealings "across the counter") would be more attractive to depositors than the present unregulated operations, even if some banks and finance companies continued to offer more advantageous deposit rates because their operating profits were not subject to Hong Kong profits tax. The bank expressing this view also argued that, with Hong Kong charging interest tax on foreign currency deposits, there was an incentive for Hong Kong dollar deposits to be taken out and a disincentive for foreign currencies to be sold on the Hong Kong foreign exchange market and the Hong Kong dollar proceeds placed on deposit here. Consequently, there was a risk that the Hong Kong dollar deposit base would shrink to an unworkable level. This has not been the experience in the past. But this argument also ignores the fact that, in the absence of exchange controls, funds will flow into foreign currency deposits or into Hong Kong dollar deposits for a variety of reasons, apart from relative interest rate levels.

It is true that, until a year or so ago, our interest rate structure was influenced more by internal than by external factors. Funds

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surplus to banks' requirements were normally remitted overseas; but so long as the demand for Hong Kong dollars remained stable, so did interest rates. But two developments forced the banks to defend the Hong Kong dollar deposit base by raising interest rates: the first was the establishment of a large number of finance companies in the Colony in 1972-73 prepared to offer higher deposit rates and take a smaller turn; and the second was a tendency for Hong Kong based companies, whenever possible, to borrow cheaply in Hong Kong and then switch these Hong Kong dollars into foreign currency deposits at higher rates of interest and this was done on quite a large scale. There is no logical reason why the exemption from interest tax on foreign currency deposits in Hong Kong should influence interest rates in Hong Kong and prevent the erosion of the Hong Kong dollar deposit base. Bank deposits will rise whenever depositors take the view that the Hong Kong dollar is a more stable currency than another or they can receive the same rates of interest from the licensed banks as they can earn elsewhere, that is, when the difference between domestic rates and Euro/Asian dollar rates (after allowing for interest tax) is reduced to a level where it is not worthwhile accepting an exchange risk. This may well result in a relatively higher interest rate structure in Hong Kong than in the past and it may also mean narrower margins than the banks have been accustomed to in the past, but these have to be weighed against the advantages of freedom from exchange controls.

But to return to the majority view that the proposals in the 1973 budget speech would not be advantageous: obviously, the banks concerned would prefer to operate an official market here, but only if they were exempt from interest tax and tax on the profits derived from these borrowing and lending transactions. But the use of what is known as the memorandum account method means that neither the deposits nor the loans come within the territorial source criterion of the Inland Revenue Ordinance and so both interest tax and profits tax are avoided. There is no doubt that if legislation was drawn up for the establishment of special departments many banks and finance houses would apply for licences, but, in my view, many would continue to transact offshore borrowing and lending transactions under existing procedures.

So I have concluded that the establishment of a so called "official" international currencies market would not result in an extra facility being provided by financial institutions in Hong Kong, but would only mean that an existing facility would be provided somewhat more simply. The consequential deeming of profits on these transactions to be Hong Kong profits was regarded by the financial community as an unattractive price to pay for this scheme, since on such profits, most banks and finance companies are not now liable to Hong Kong profits tax. In other words, banks and finance companies currently undertake business in the international currencies market in such a way as to avoid interest withholding tax on deposits and a charge to profits tax on their lending transactions outside Hong Kong.

I should like just to interject here that there is a school of thought that interest tax should be abolished altogether. I gave a number of reasons last year why I was not prepared to consider this proposal. At this point I would just like to reiterate two: first, we cannot afford really the loss of revenue from his source, which was $66 million in 1973-74 and is estimated to be about the same in 1974-75. And, secondly, this is a point I would like to stress, if the restraint provided by interest tax were removed, there is a risk of the Hong Kong dollar becoming subject to pressures exerted by banks and companies moving large sums to and from the Colony for speculative gains and thereby creating difficult conditions for our exporters; and I am not prepared to expose our economy to this kind of risk, especially at this time.

So much for the case for not proceeding with the idea I floated in the 1973 budget speech. I must now consider the question of the liability to tax of profits derived from offshore borrowing and lending transactions in the general context of the ambit of the profits tax charge (and this question must now be considered, since banks and finance houses are paying no Hong Kong taxes on these transactions whereas my 1973 intention was to exempt them from interest tax in return, as it were, for deeming their profits to be Hong Kong profits).

In fact, in last year's budget speech, I gave notice that, in the interests of increasing the efficiency of the tax system and simplifying its administration, I hoped to introduce an amending bill which would redefine chargeable profits so as to encompass income derived by a business carried on in Hong Kong where that income arose from no conduct of business outside Hong Kong. Whilst I would not consider that a modest increase, a modest increase, in the standard rate would damage Hong Kong's image as a territory with a low tax structure, I would be very reluctant to take even this step while there were gaps in the existing system which might be plugged to produce more revenue.

I intend, therefore, to seek Your Excellency in Council's permission to introduce a bill into this Council to amend the Inland Revenue Ordinance with effect from the year of assessment 1975-76 along the

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following lines. To begin with, there is the type of case which has been the subject of adverse court decisions (from the revenue point of view). In essence, this type of case involves a business conducted by a person having a permanent establishment in Hong Kong which then proceeds to earn profits which cannot possibly be said to be attributable to any permanent establishment anywhere else and which, in all probability, have not been declared for profits tax anywhere else. This can be done by means of "back to back" arrangements, that is to say, by reinvoicing, agency agreements, servicing agreements and a host of other similar devices. I can see no reason at all why these persons, making use as they do of the Hong Kong infrastructure, should not make some contribution to the cost of maintaining that infrastructure. Profits which are clearly attributable to the operation of a business by a permanent establishment outside Hong Kong or from immovable property outside Hong Kong would continue to be outside the scope of the Hong Kong profits tax charge.

In addition to the general proposition I have just outlined, there are two industries which call for special consideration, namely, shipping and banking. The operations of these two industries do not fall into neat geographical areas. In recent years, and particularly since the 1971 amendments to the Inland Revenue Ordinance introduced a somewhat narrow definition of charter hire, it has become apparent that resident shipping companies are deriving what are, even in these days when margins are under pressure because of rising costs, substantial profits from charter hire which are not exigible to tax either in Hong Kong or elsewhere. I shall be looking at means of bringing these profits to charge. I hasten to add that it is not my intention to extend the charge to non-resident shipping companies.

In the case of banking and similar financial institutions, the Commissioner of Inland Revenue has, from time to time, drawn my attention to the fact that Hong Kong based concerns enjoy a particularly privileged position. Whilst in the broader sense (though not in the narrow technical sense) all, or almost all, their profits arise from business carried on by a permanent establishment in Hong Kong, a large part is not subject to Hong Kong tax, or indeed to tax anywhere. This can quite simply be achieved by placing surplus funds in centres which, for various reasons, do not tax non-residents on interest earnings. The net result is that these institutions are paying nothing like 15 % of their profits by way of tax. Furthermore, I have reason to believe that, with the development of the international currencies market, the proportion of tax-free profits is likely to increase and I can no longer ignore this as a source of revenue. I feel there is justification for such an approach in that the dominant source of all such profits must surely be recognized to be the conduct of banking business in Hong Kong. Although I have mentioned Hong Kong based concerns in particular it would be wrong, in principle and in practice, to distinguish between these concerns and overseas banks operating in Hong Kong through branches. To the extent that the funds of these branches are borrowed locally and lent abroad, I think I should look for tax on the "turn" notwithstanding the probability that these concerns will ultimately pay tax in their country of residence. This burden, will, however, be mitigated by the unilateral relief from double taxation available in their home countries.

At this point, it is opportune for me to clear the air on the matter of Hong Kong and its tax haven image. The Australian Government has announced that it proposes to clamp down on the movement of currencies to various countries which it lists as tax havens and, to my very great regret Hong Kong has been listed officially as a tax haven. Apparently to invest in any areas listed as tax havens it will be necessary lo apply to the Australian Commissioner of Taxation for his approval, but the basis of the tests to be applied by the Commissioner is at present unknown.

I object strongly to Hong Kong being listed as a tax haven and thereby having our low tax structure equated with the no-tax structures of the real tax havens. Hong Kong, as a financial centre, requires all the infrastructure of a modem city to support it and it is only right and proper that those operating here—all those operating here should make a due contribution to the revenue through the tax system. In Hong Kong, we rely on our low tax structure and free movements across the exchanges to encourage investment and not on the usual gimmicks of tax holidays and quick writes-off found in tax havens. Given our future commitments, we simply cannot afford to be a tax haven and, at the same time, damage our image.

I turn now, Sir, to our reserve of direct tax taxability. I do not wish to take a firm public view on this just now. But, clearly, as I have proposed an attack on our reserve of indirect tax taxability in 1974-75 (and thereby made a contribution to the extra revenue required in the three year forecast period) and as the yield from our earnings and profits taxes contributes about one third to total recurrent revenue, I shall have to contemplate raising the standard rate in 1975-76, *contemplate* raising the standard rate. 1975-76, however, will be the first

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year of the forecast period and, therefore a year which we shall have to examine with great care but as it happens it will be 10 years after the rate was last raised by 2½ percentage points to 15% and that's quite a long time ago. But I would like to assure honourable Members that I shall not allow fiscal considerations to override economic realities.

Finally, there is one piece of outstanding business I have not mentioned: in last year's budget speech I suggested hopefully that legislation would be introduced in 1973, effective from 1st April 1974, to change the basis for the assessment of profits tax to a current year basis. The restudy of the various proposals and comments has taken time and the drawing up of drafting instructions has required a great deal of attention to detail, especially in relation to the transitional proposals, so it has not been possible to meet that target date.

The restudy has confirmed that the 1966 Inland Revenue Ordinance Review Committee's full proposals were unduly complicated and, recently, Your Excellency in Council advised that a bill be now drafted to incorporate simpler proposals for effecting this change from 1st April 1975. As I shall be explaining the main features of these revised proposals when introducing the bill into this Council I shall say no more than this: the revised proposals will bring profits tax into line with property tax, interest tax and salaries tax in that the profits finally assessed for any one year of assessment will be those current to that year of assessment.

Sir, if this budget speech and the Estimates of Revenue and Expenditure for 1974-75 are characterised as being cautious I, for one, will not be upset, for cautious I think we must be, having regard to our immediate circumstances and the financial implications of our developing policies over the next few years. And I would remind honourable Members that, in the Year of the Tiger, we are enjoined by the Book of Fate to exercise caution in all fields of activities, though I think we should do so as imaginatively as possible; and let us not fail to take comfort in the undoubted facts of our economic and social progress in past years.

Debate adjourned pursuant to standing Order 54(2).

Valedictory to Mr Lloyd

HIS EXCELLENCY THE PRESIDENT: —Honourable Members before we meet again, Mr LLOYD will have left us on transfer, and I am sure we would all like to thank him for the contribution he has made to our proceedings while he has been here. Mr LLOYD is taking up an appointment as Deputy Governor of Bermuda. For Mrs LLOYD, at least, going to Bermuda is going home, and I am sure we all wish the LLOYDS all happiness and success in their new posting.

MR P. C. WOO: —Sir, on behalf of the Unofficial Members may I associate myself with your tribute to Mr LLOYD. In the relative short period of time of his service in Hong Kong, first as the Defence Secretary, then as the Secretary for Security, Mr LLOYD has made his mark as a very able administrator.

I think I have more contact with Mr LLOYD than any of my Unofficial colleagues. As Commissioner of Civil Aid, I have found Mr LLOYD most considerate in dealing with me in connection with affairs of the Civil Aid Services, particularly in the selection of permanent camps for my Civil Aid cadets and youth organizations.

I am happy to know that we are not saying good-bye to Mr LLOYD today, as you say, Sir, he is seconded to Bermuda as the Deputy Governor and I earnestly hope will have Mr LLOYD again in the very near future. In the meantime, may I on behalf of my Unofficial colleagues wish him every success in his new assignment.

Adjournment and next sitting

HIS EXCELLENCY THE PRESIDENT: —In accordance with Standing Orders I now adjourn the Council until 2.30 p.m. on Wednesday the 13th of March.

Adjourned accordingly at half past five o'clock.

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