The 2004-05 Budget

Information Pack for

The Financial Secretary's Consultations

October 2003

Introduction

The Financial Secretary will hold a series of consultations with Members of the Legislative Council in November/December 2003 in preparation for the 2004-05 Budget. The attached charts are prepared to facilitate discussion. Members are invited to send in written submissions before or after these consultation sessions.

Chart 1

Contents

Chart 2

The Basic Law

Article 107

The Hong Kong Special Administrative Region shall follow the principle of keeping expenditure within the limits of revenues in drawing up its budget, and strive to achieve a fiscal balance, avoid deficits and keep the budget commensurate with the growth rate of its gross domestic product.

- The Basic Law (Article 107) requires the government to “follow the principle of keeping expenditure within the limits of revenues in drawing up its budget, and strive to achieve a fiscal balance, avoid deficits and keep the budget commensurate with the growth rate of its gross domestic product.”

- These constitutional provisions for financial prudence are integral to maintaining the confidence of the international financial community, as well as local and overseas investors, in Hong Kong.

- We will also adhere to a low and simple tax regime and will maintain the stability and integrity of the monetary system.

I. Budget Principles

Chart 3

Budget Targets by 2008-09

- Attain a balanced Operating Account
- Restore balance in the Consolidated Account
- Reduce public expenditure to 20% of GDP or below

- The slowdown in economic activities caused by the outbreak of SARS earlier this year has made it unrealistic to stick to the original targets by 2006-07.
- The community also favours giving the economy some more room to breathe in the next year or two.
- Accordingly, the Financial Secretary has decided to adjust the timeline for achieving these budget targets by 2008-09:
    - attain a balanced Operating Account;
    - restore balance in the Consolidated Account; and
    - reduce public expenditure to 20% of GDP or below.

II. Medium Range Forecast

Chart 4

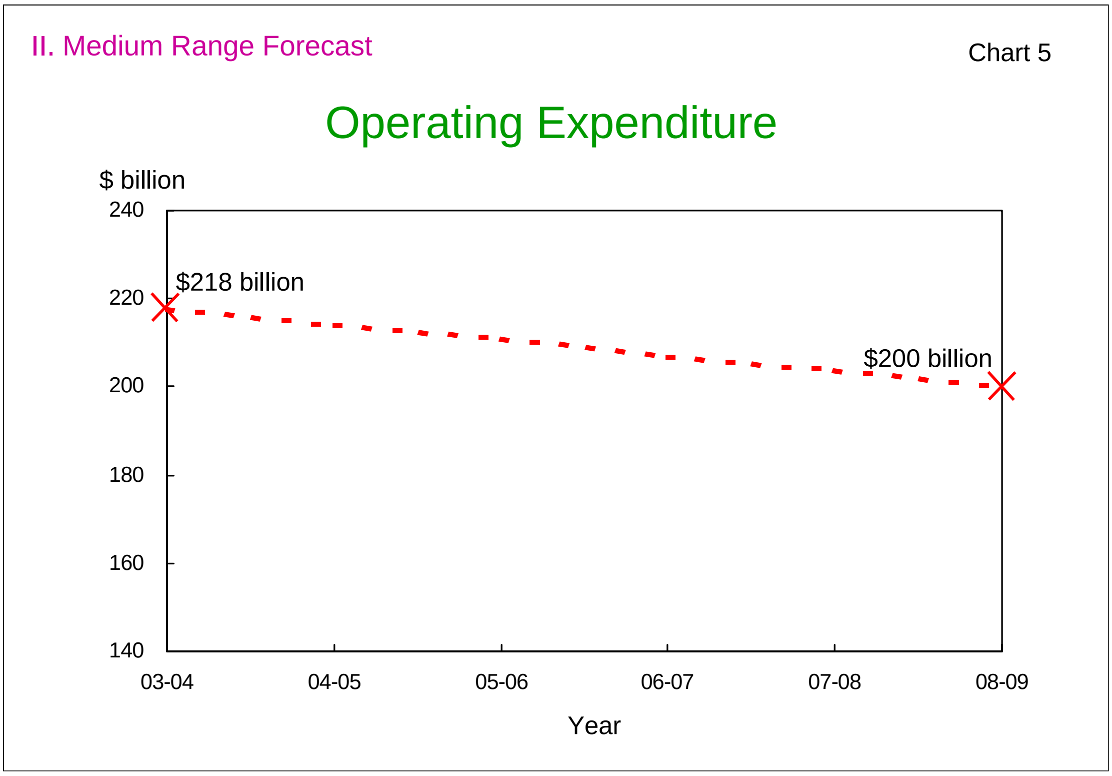
Updated GDP Figures

	Current Forecast	
GDP real growth for 2003	3%	(vs 2% in August forecast)
GDP trend growth in real terms for the medium term	3.5%	(vs 3% in March forecast)

- Following the outbreak of SARS, we adjusted in August 2003 the forecast for GDP real growth in 2003 downward from 3% to 2%.

- Since then, there has been a visible upswing in economic activity and sentiment over the past month or two. With the current pace of upturn, the economy could attain a better performance for this year than the August forecast. Our latest forecast is for the economy to grow by around 3% for 2003.

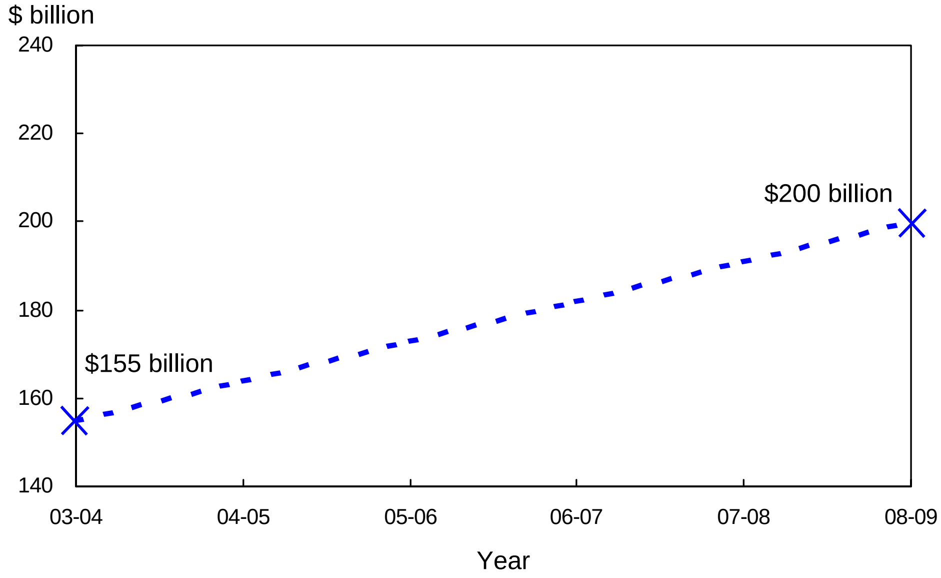
- As Hong Kong’s economic relations develop with the Mainland and other Asian economies, and with growing signs of renewed recovery in the global economy, we now forecast the trend growth rate of GDP to be half a percentage point higher at 3.5% for the medium term.



- We are determined to control government operating expenditure and to bring it down to $200 billion by 2008-09.

Chart 6

Operating Revenue



- To reach a balanced Operating Account by 2008-09, our aim is to attain $200 billion on the operating revenue side by the same year.

II. Medium Range Forecast

Chart 7

Forecast 2003-04 Fiscal Outturn

- Taking into account
  - SARS relief and support package
  - SARS adverse impact
  - Positive signs emerging over past few months
- Current Forecast
  - $78 billion deficit, plus or minus $5 billion

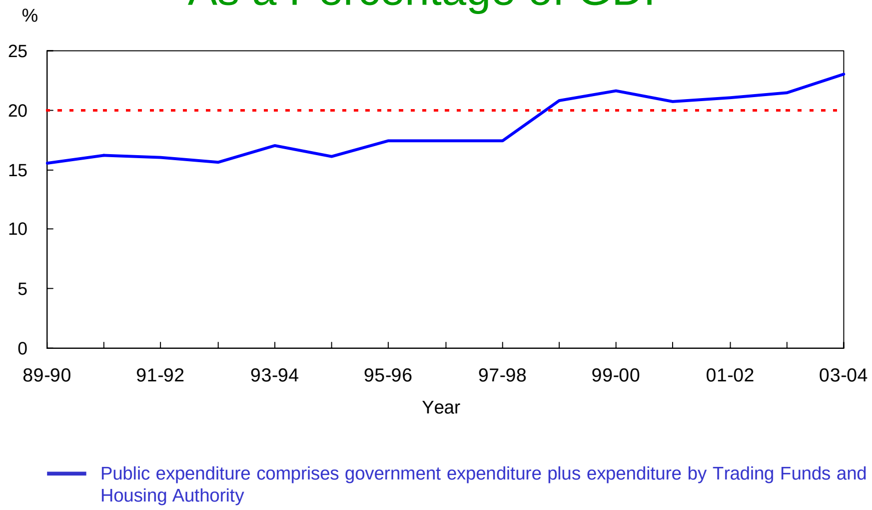
- In the 2003 Budget, we forecast a fiscal deficit of $68 billion for 2003-04.

- Current forecast of outturn deficit is $78 billion, plus or minus $5 billion. This takes into consideration the SARS relief and support measures of $12.6 billion, the negative impact of SARS and the more positive economic signs emerging over the past couple of months.

III. Expenditure

Chart 8

Public Expenditure As a Percentage of GDP



- In line with the principle of "big market, small government", we need to keep public expenditure in the economy at an appropriate level.

- In the 1980s and early 1990s, the public expenditure to GDP ratio averaged about 16%. It now stands at 23%.

- We remain committed to bringing public expenditure to 20% of the GDP or below.

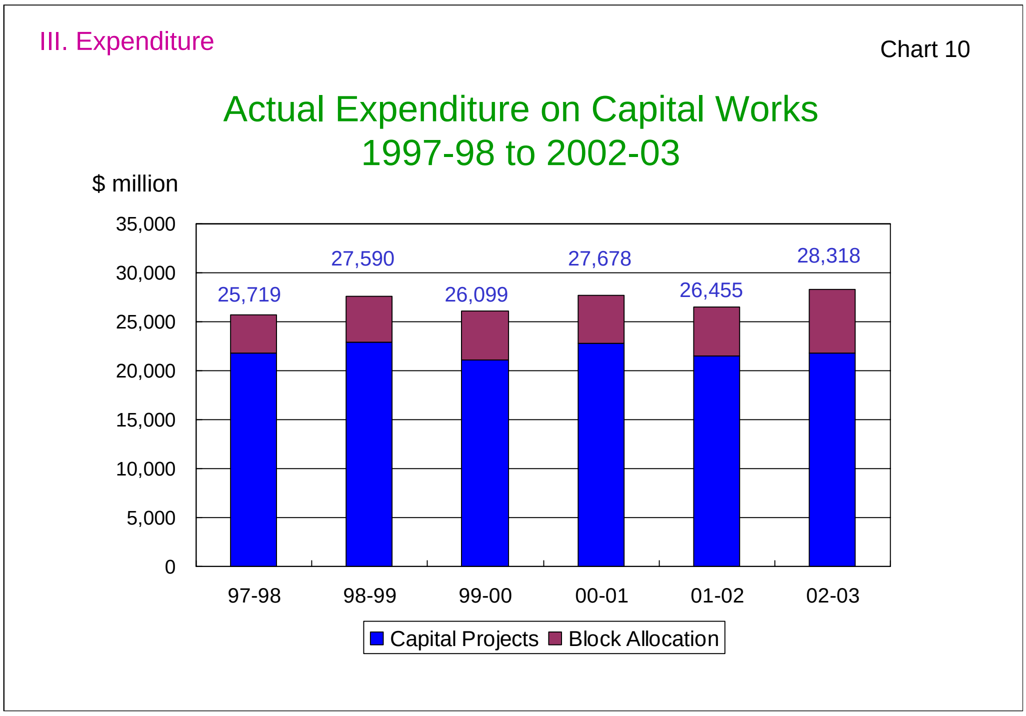
III. Expenditure

Chart 9

Rigidity of Government Expenditure

Major Operating Expenditure Components	2002-03 % of Operating Expenditure	 % of Total Expenditure
Personal Emoluments	25.44	21.57
Personnel Related Expenses (e.g. pension)	8.46	7.16
Subventions (Staff related)	32.99	27.97
Social Security	10.69	9.06
Total	77.58	65.76

- This chart shows that 78% of government's operating expenditure or 66% of total expenditure covers personnel or social security-related expenditure items which are inelastic to downward adjustment in both real and nominal terms.

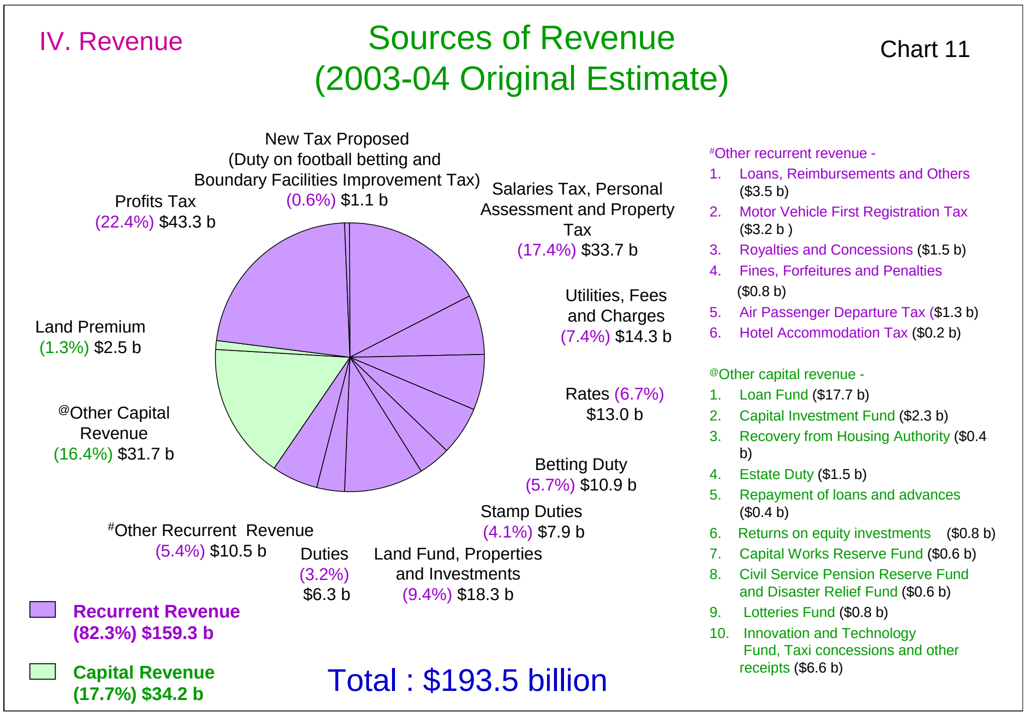


- During the past few years, the average actual capital works expenditure was around $27 billion per year.

- Over the next few years, we have made provision for an average of around $29 billion a year on capital works expenditure.

- Scaling back infrastructure projects or deferring some capital works would have a knock-on effect on other economic sectors. The pace of our economic growth, and our attraction as an international trade, transport and communications hub, might also be adversely affected if our physical infrastructure does not anticipate, or at least match the demands of the market.

- We will need to upgrade our infrastructure continually if we are to live up to our positioning as Asia's world city.



- This chart gives an overview of government's recurrent and capital revenue sources based on the 2003-04 Original Estimate.

- Income tax on companies (i.e. profits tax) and income tax on individuals (i.e. salaries tax, personal assessment and property tax) are the two most important sources of revenue for 2003-04. Together they contribute 39.8% of total government revenue.

- The above figures have not taken into account the $5.3 billion revenue concession on rates, water and sewage charges, licensing fees, rents and salaries tax rebates as part of the SARS relief measures.

- All major revenue-raising measures proposed in the 2003 Budget including adjustments to salaries tax, profits tax and property tax have already been successfully implemented. As a result, we have already secured nearly $13 billion of the $14 billion revenue-raising package proposed.

- The only outstanding measure is the Boundary Facilities Improvement Tax, which is estimated to bring in an annual revenue of $1 billion. We still believe there is a valid principle behind this proposal, that is to expect all departing passengers to contribute to the provision of better boundary facilities and services, regardless of mode of transportation. However, as the public is not yet ready to accept this tax, we have decided not to proceed further with it at the current juncture.

IV. Revenue

Chart 12

Major Recurrent Revenue Sources As Percentages of Total Recurrent Expenditure Declining

Government Revenue	1997-98		2003-04 (Original Estimate)	
	$ Billion	(%)	$ Billion	(%)
Profits Tax	55.3	(37.0%)	43.3	(20.9%)
Salaries Tax, Personal Assessment and Property Tax	36.2	(24.2%)	33.7	(16.3%)
Utilities, Fees and Charges	18.0	(12.0%)	14.3	(6.9%)
Rates	6.3	(4.2%)	13.0	(6.3%)
Investment Income on Fiscal Reserves	17.9	(12.0%)	12.1	(5.8%)
Betting Duty	13.5	(9.0%)	10.9	(5.3%)
Stamp Duties	29.1	(19.5%)	7.9	(3.8%)
Excise Duties	8.5	(5.7%)	6.3	(3.1%)
Total	184.8	(123.6%)	141.5	(68.4%)

* Figures in brackets represent the % out of total recurrent expenditure

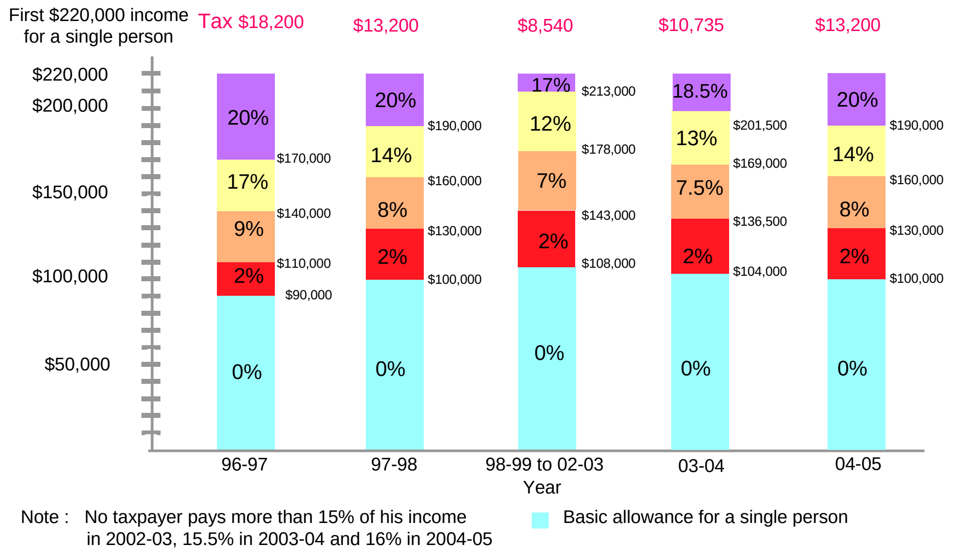
- Revenue from the major recurrent revenue sources (including profits tax, salaries tax, personal assessment and property tax, utilities, fees and charges, investment income on fiscal reserves, stamp duties as well as excise duties) have declined during the past seven years.

- Income from these recurrent revenue sources is increasingly less adequate in funding recurrent expenditure. Income from these sources was 123.6% of total government recurrent expenditure in 1997-98. Under the Original Estimate for 2003-04, it is estimated that these recurrent revenue sources would drop to 68.4% of total recurrent expenditure.

IV. Revenue

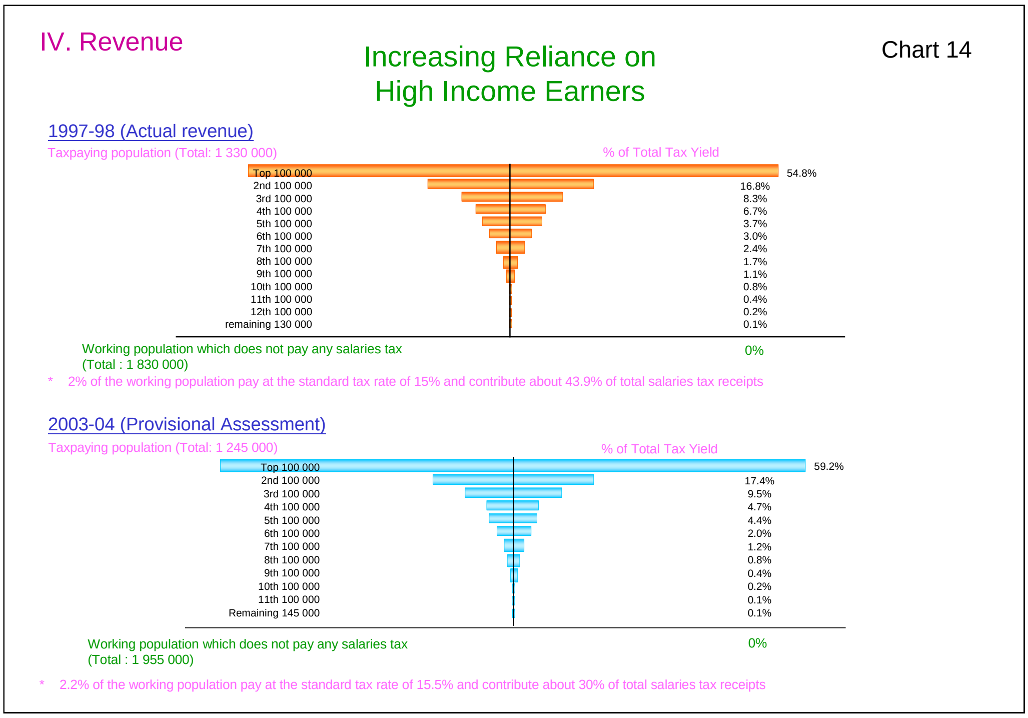
Chart 13

Marginal Rates of Salaries Tax



- This chart shows the changes in tax bands and marginal tax rates since 1996-97.

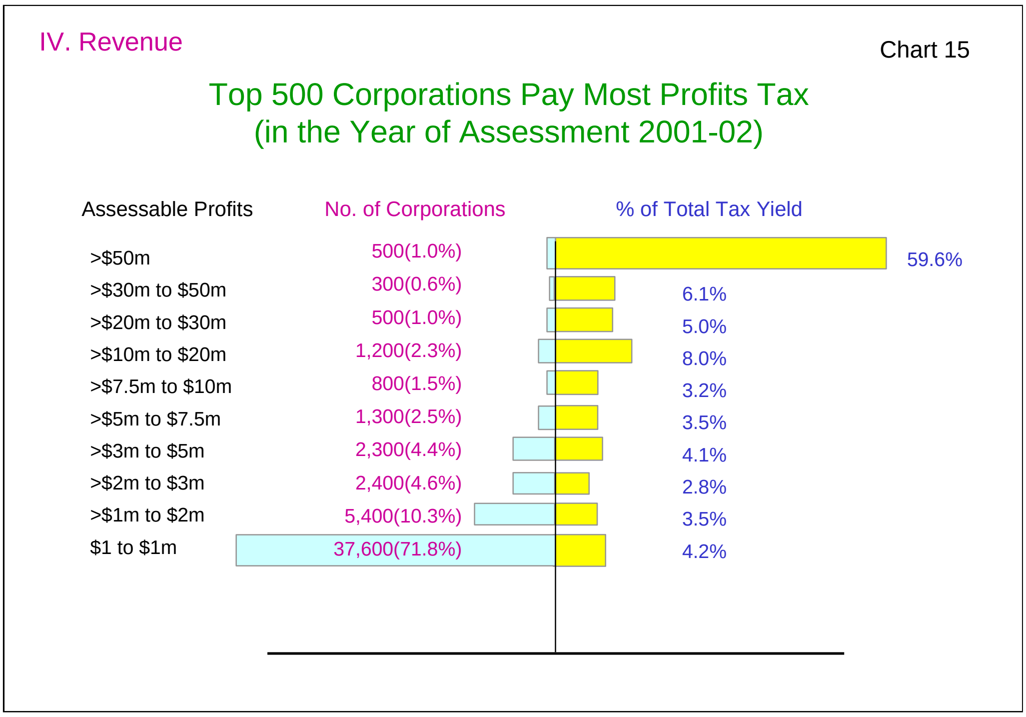
- The 2003-04 Budget measures revert the salaries tax marginal rates and bands to levels before the concessions made in 1998-99 in order to raise revenue and broaden the tax base. The changes are being implemented in two equal phases in 2003-04 and 2004-05.



- These charts arrange salaries taxpayers in 1997-98 and 2003-04 in steps of 100,000 each according to their salaries tax bills, and measure their respective contributions to the salaries tax yield.

- In 1997-98, the top 100,000 taxpayers contributed 54.8% of the total revenue from salaries tax. The share of revenue contributed by them increased to 62.1% in 2002-03, signifying an increasing reliance on high-income earners. With the various changes to salaries tax introduced in the 2003 Budget, the share of revenue contributed by these top 100,000 taxpayers is estimated to drop to 59.2% in 2003-04.

- In 1997-98, there were 1.33 million taxpayers. In 2002-03, taxpaying population decreased to 1.2 million, despite a growth in the number of employees from 3.16 million to 3.2 million over the same period. The number of taxpayers will increase again to 1.25 million in 2003-04 after implementation of the various changes to salaries tax.



- This chart shows the distribution of our profits tax burden among the corporate taxpaying population in the Year of Assessment 2001-02.

- 60% of our profits tax was contributed by the top 500 taxpaying corporations out of more than 50,000 corporations. Most small businesses pay little or no tax.

IV. Revenue

Chart 16

Fees and Charges

Types of Fees & Charges

- Full-cost fees (e.g. Fees for certificates of no criminal conviction)
- Subsidized fees (e.g. School fees)
- Tax-loaded fees (e.g. Business registration fees)
- Utilities fees (e.g. Government tunnel tolls)
- Market-related fees (e.g. Gazette advertisement fees)

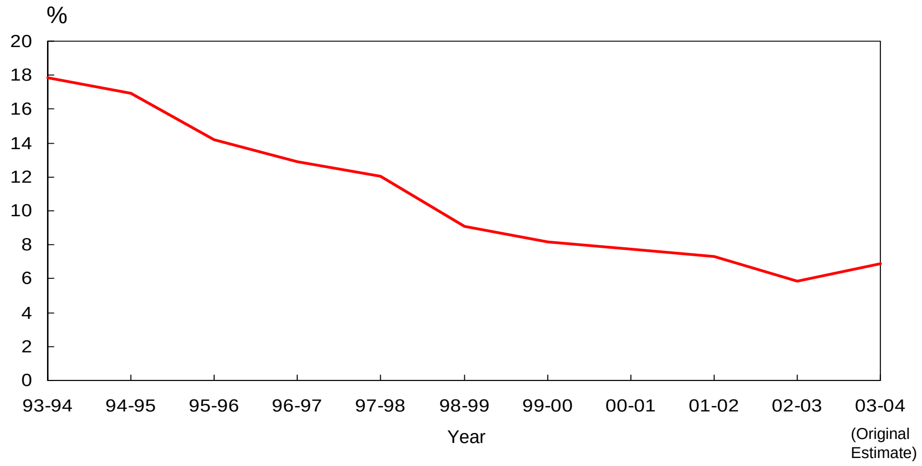
- It is a well-established policy of the government to apply the “user pays” and “full cost recovery” principle for setting the fees and charges for services where government subsidy is not justified.

- The rationale is to ensure that those who benefit from the services should pay for them, so that the costs of the services do not fall on the general taxpayers. This underpins our low tax policy and is an important tool in striving to achieve fiscal balance.

IV. Revenue

Chart 17

Utilities and Fees & Charges As Percentage of
Total Government Recurrent Expenditure Declining



- In 1993-94, revenue from fees and charges and utilities constituted 18% of total government recurrent expenditure. This percentage is estimated to drop significantly to 7% in 2003-04.

- The government has frozen most fees and charges since 1998 as an exceptional measure to ease the burden on the community at a time of economic setback. In view of the steady recovery of the economy in 2000-01, the government has revised some of the fees and charges that do not affect people's livelihood or general business activities, but only an insignificant amount of additional revenue has been generated.

- In the package of SARS relief measures announced in April 2003, the government has provided some one-off concessions by reducing water and sewage charges and trade effluent surcharge for a four-month billing period and waiving certain licensing fees for one year. In addition, the government undertook not to propose any further upward adjustment to fees and charges until the end of October 2003.

- We need to consider when the appropriate time is to restore the "user pays" and "full cost recovery" principles, taking into account the affordability of the people and the impact on the overall economy.

Other Funding Sources

- Goods and Services Tax?
- Bonds?

- We require a broader, sizeable and steady income source to underpin our revenue and meet our expenditure requirements. A broad-based Goods and Services Tax (GST) is a reasonable and equitable way to smooth out bumps in revenue stream.

- However, we would not contemplate the introduction of a GST during deflationary environment. It would only be levied against the backdrop of a healthy and growing economy. We will strive to build a consensus with the community on how best to implement such a tax.

- Issuance of bonds is a possible source of funding for capital projects that would bring long term economic benefits to Hong Kong.

- It will also help promote the development of our capital markets, as well as offering an additional investment avenue for members of the community.

V. Others

Chart 19

Some economic indicators since early 2003

Gross Domestic Product	2nd Quarter	-0.5%
Unemployment rate	July to September	8.3% (peak is 8.7%)
Volume of exports of goods	First 8 months	Around 15% (August around 10%)
Volume of exports of services	2nd Quarter	-14.7%
Outbound container cargoes	First 7 months	+7.8% (July –4.5%)
Outbound air cargoes	First 9 months	+8.3%(September +10.3%)
Incoming visitors	First 8 months	-14.4% (August +9.6%)
Volume of retail sales	First 8 months	-2.8% (August +3.0%)
Consumer price	First 9 months	-2.7% (September -3.2%)
Investment expenditure	2nd Quarter	-5.3%

The Way Forward

- Revitalise the economy
- Collectively promote sustained economic growth and create jobs
- Manage public finances prudently
- Reduce Government operating expenditure to $200 billion by 2008-09
- Restore fiscal balance by the year 2008-09
- Keep public expenditure to 20% of GDP or below