

**CONTENTS**

**SECTION I – FORECASTING ASSUMPTIONS AND BUDGETARY CRITERIA**

**SECTION II – THE MRF FOR 2004-05 TO 2009-10**

**SECTION III – RELATIONSHIP BETWEEN GOVERNMENT EXPENDITURE,  
PUBLIC EXPENDITURE AND GDP IN THE MRF**

**SECTION IV – ESTIMATES OF CONTINGENT LIABILITIES**

## SECTION I - FORECASTING ASSUMPTIONS AND BUDGETARY CRITERIA

1 A number of computer-based models are used to derive the Medium Range Forecast (MRF). These models reflect a wide range of assumptions about the factors determining each of the components of Government's revenue and expenditure. Some are economic in nature (the general economic assumptions) while others deal with specific areas of Government's activities (the detailed assumptions). These are supported by studies of historical and anticipated trends.

### General Economic Assumptions

#### *Real Gross Domestic Product (real GDP)*

2 GDP is forecast to increase by 4.5% to 5.5% in real terms in 2005. For planning purposes, over the ensuing four-year period 2006 to 2009, the trend growth rate of the economy in real terms is assumed at 4% per annum. We have made reference to the mid-point of the range forecast of GDP growth rate for 2005 in deriving the MRF.

#### *Price change*

3 The GDP deflator, measuring overall price change in the economy, is forecast to decline by 1% in 2005. For the four-year period 2006 to 2009, the GDP deflator is assumed to increase at a trend rate of 1.5% per annum. The Composite Consumer Price Index, measuring inflation in the consumer domain, is forecast to increase by 1.5% in 2005. The trend rate of increase for the ensuing period 2006 to 2009 is assumed to be 3.0% per annum.

#### *Nominal Gross Domestic Product (nominal GDP)*

4 Taking the assumptions on the rates of change in the real GDP and the GDP deflator together, the growth rate of GDP in nominal terms is forecast at 3.5% to 4.5% in 2005, and the trend growth rate in nominal terms for the period 2006 to 2009 is assumed at 5.5% per annum.

### Detailed Assumptions

5 The MRF incorporates a wide range of detailed assumptions on expenditure and revenue patterns over the forecast period, taking the following, amongst other factors, into account—

- estimated cash flow of capital projects,
- forecast completion dates of these capital projects and their related recurrent consequences in terms of staffing and running costs,
- estimated cash flow arising from new commitments resulting from policy initiatives,
- the expected pattern of demand for individual services,
- the trend in yield from individual revenue sources, and
- new revenue/expenditure measures in the 2005 Budget.

### Budgetary Criteria

6 In addition to the above forecasting assumptions, there are a number of criteria against which the results of forecasts are tested for overall acceptability in terms of budgetary policy.

7 The following covers the more important budgetary criteria—

#### *Budget surplus/deficit*

The Government aims to achieve balance in consolidated and operating accounts by 2008–09. In the longer term, the Government needs to achieve an operating surplus to partially finance capital expenditure.

#### *Operating expenditure*

The Government aims to bring operating expenditure down to \$200 billion by 2008–09.

#### *Capital expenditure*

By its nature, some fluctuations in the level of capital expenditure are to be expected. However, over a period the aim is to contain capital expenditure within expenditure guidelines.

#### *Total expenditure*

The general principle is that, over time, expenditure growth should not exceed the growth of the economy, taking into account both real and nominal terms. The Government aims to keep public expenditure at or below 20% of GDP by 2008–09.

#### *Revenue policy*

Account is taken of the need to maintain over time the real yield from revenue.

#### *Fiscal reserves*

The Government in the long run aims to maintain the level of reserves at around 12 months of total government expenditure.

## SECTION II - THE MRF FOR 2004–05 TO 2009–10

8 The current MRF (*Note a*) is summarised in the following table which indicates the forecast financial position of the Government—

Table 1

(\$ million)	Original Estimate*	Revised Estimate	Forecast				
	2004–05	2004–05	2005–06	2006–07	2007–08	2008–09	2009–10
<b>Operating Account</b>							
Operating revenue ( <i>Note b</i> )	155,593	175,640	181,388	184,111	189,929	197,939	207,804
Operating expenditure ( <i>Note c</i> )	212,200	201,241	208,000	207,080	203,540	200,000	202,500
<b>Surplus/(deficit) before investment income</b>	<b>(56,607)</b>	<b>(25,601)</b>	<b>(26,612)</b>	<b>(22,969)</b>	<b>(13,611)</b>	<b>(2,061)</b>	<b>5,304</b>
Investment income ( <i>Note b</i> )	10,039	11,453	11,161	10,878	11,360	12,367	13,405
<b>Operating surplus/(deficit) after investment income</b>	<b>(46,568)</b>	<b>(14,148)</b>	<b>(15,451)</b>	<b>(12,091)</b>	<b>(2,251)</b>	<b>10,306</b>	<b>18,709</b>
<b>Capital Financing Statement</b>							
Capital revenue ( <i>Note d</i> )	18,624	39,839	42,159	40,619	41,687	43,458	44,110
Asset sales ( <i>Note d</i> )	11,000	6,177	5,401	18,126	24,770	14,225	6,226
Capital spending ( <i>Note e</i> )	29,624	46,016	47,560	58,745	66,457	57,683	50,336
	53,418	48,058	44,741	47,403	43,613	42,791	42,734
Surplus/(deficit) before investment income/interest expenses	(23,794)	(2,042)	2,819	11,342	22,844	14,892	7,602
Investment income ( <i>Note d</i> )	2,215	3,192	2,940	2,930	2,987	3,173	3,397
Interest expenses ( <i>Note e &amp; f</i> )	500	442	853	826	799	754	642
<b>Surplus/(deficit) after investment income/interest expenses</b>	<b>(22,079)</b>	<b>708</b>	<b>4,906</b>	<b>13,446</b>	<b>25,032</b>	<b>17,311</b>	<b>10,357</b>
Net proceeds from issuance of bonds and notes ( <i>Note d &amp; f</i> )							
– Toll Revenue Bond	6,000	5,522	-	-	-	-	-
– Other government bonds and notes	20,000	19,871	-	-	-	-	-
Repayment of bonds and notes ( <i>Note e &amp; f</i> )	-	-	-	2,550	-	2,700	3,500
<b>Capital financing surplus/(deficit) after bond issuance/repayment</b>	<b>3,921</b>	<b>26,101</b>	<b>4,906</b>	<b>10,896</b>	<b>25,032</b>	<b>14,611</b>	<b>6,857</b>
<b>Consolidated Account</b>							
<b>Fiscal reserves at 1 April</b>	<b>266,448</b>	<b>275,343</b>	<b>287,296</b>	<b>276,751</b>	<b>275,556</b>	<b>298,337</b>	<b>323,254</b>
Operating surplus/(deficit)	(46,568)	(14,148)	(15,451)	(12,091)	(2,251)	10,306	18,709
Capital financing surplus/(deficit) before bond issuance/repayment	(22,079)	708	4,906	13,446	25,032	17,311	10,357
<b>Consolidated surplus/(deficit)</b>	<b>(68,647)</b>	<b>(13,440)</b>	<b>(10,545)</b>	<b>1,355</b>	<b>22,781</b>	<b>27,617</b>	<b>29,066</b>
Net proceeds from issuance of bonds and notes							
– Toll Revenue Bond	6,000	5,522	-	-	-	-	-
– Other government bonds and notes	20,000	19,871	-	-	-	-	-
Repayment of bonds and notes	-	-	-	2,550	-	2,700	3,500
<b>Consolidated surplus/(deficit) after bond issuance/repayment</b>	<b>(42,647)</b>	<b>11,953</b>	<b>(10,545)</b>	<b>(1,195)</b>	<b>22,781</b>	<b>24,917</b>	<b>25,566</b>
<b>Fiscal reserves at 31 March</b>	<b>223,801</b>	<b>287,296</b>	<b>276,751</b>	<b>275,556</b>	<b>298,337</b>	<b>323,254</b>	<b>348,820</b>
As number of months of government expenditure	10	14	13	13	14	16	17
Outstanding debt at 31 March ( <i>Note f</i> )							
– Toll Revenue Bond	6,000	5,667	4,877	4,538	3,319	2,979	1,840
– Other government bonds and notes	20,000	20,000	20,000	17,450	17,450	14,750	11,250

\* We have reclassified the net proceeds of Toll Revenue Bond and the interest expenses of bonds. The consolidated deficit before bond issuance for the 2004-05 Original Estimate becomes \$68,647 million (vs \$62,147 million in the 2004 Budget), while the consolidated deficit after bond issuance remains unchanged at \$42,647 million.

## Notes—

## (a) Accounting policies

- (i) The MRF is prepared on a cash basis and reflects forecast receipts and payments, whether or not they relate to operating or capital transactions.
- (ii) The MRF includes the General Revenue Account and the Funds (Capital Investment Fund, Capital Works Reserve Fund, Civil Service Pension Reserve Fund, Disaster Relief Fund, Innovation and Technology Fund, Land Fund, Loan Fund, and Lotteries Fund).

## (b) Operating revenue

- (i) The operating revenue has taken into account the revenue-concession measures proposed in the 2005 Budget, and is made up of –

(\$ million)	2004–05	2005–06	2006–07	2007–08	2008–09	2009–10
Operating revenue before investment income	175,640	181,388	184,111	189,929	197,939	207,804
Investment income	11,453	11,161	10,878	11,360	12,367	13,405
Total	<u>187,093</u>	<u>192,549</u>	<u>194,989</u>	<u>201,289</u>	<u>210,306</u>	<u>221,209</u>

- (ii) For the purpose of the MRF, investment income under the Operating Account includes the investment income of the General Revenue Account which are credited to revenue head Properties and Investments and the investment income of the Land Fund. The rate of investment return is assumed at 5% per annum throughout the MRF period.

## (c) Operating expenditure

- (i) The operating expenditure in 2004–05 and 2005–06 includes forecast expenditure of \$4 billion and \$0.4 billion respectively for the Voluntary Retirement Schemes. The one-off expenditure under these schemes comprises commuted pensions and compensation for takers of the schemes.
- (ii) The level of operating expenditure in 2004–05 to 2009–10 has taken into account the two-phased payout on 1 January 2004 and 1 January 2005.

## (d) Capital revenue

- (i) The breakdown of capital revenue is –

(\$ million)	2004–05	2005–06	2006–07	2007–08	2008–09	2009–10
General Revenue Account	3,652	5,008	3,193	2,183	2,104	762
Capital Works Reserve Fund	31,368	32,161	33,753	35,620	37,591	39,671
Capital Investment Fund	2,389	2,432	2,009	1,938	1,488	871
Innovation and Technology Fund	14	—	—	—	—	—
Loan Fund	1,412	1,527	584	816	1,075	1,551
Lotteries Fund	1,004	1,031	1,080	1,130	1,200	1,255
Capital revenue before asset sales, investment income and net proceeds from bond issuance	<u>39,839</u>	<u>42,159</u>	<u>40,619</u>	<u>41,687</u>	<u>43,458</u>	<u>44,110</u>
Asset sales	6,177	5,401	18,126	24,770	14,225	6,226
Investment income	3,192	2,940	2,930	2,987	3,173	3,397
Net proceeds from issuance of bonds and notes	25,393	—	—	—	—	—
Total	<u>74,601</u>	<u>50,500</u>	<u>61,675</u>	<u>69,444</u>	<u>60,856</u>	<u>53,733</u>

- (ii) For the purpose of the MRF, the annual land premia included under the Capital Works Reserve Fund are assumed at 2.4% of GDP throughout the MRF period.
- (iii) For the purpose of the MRF, investment income under the Capital Financing Statement includes investment income of the Funds except Land Fund (i.e. Capital Investment Fund, Capital Works Reserve Fund, Civil Service Pension Reserve Fund, Disaster Relief Fund, Innovation and Technology Fund, Loan Fund and Lotteries Fund).

(e) *Capital spending*

The breakdown of capital spending is –

	2004–05	2005–06	2006–07	2007–08	2008–09	2009–10
(\$ million)						
General Revenue Account	1,790	1,628	4,015	4,060	4,105	4,152
Capital Works Reserve Fund	34,858	32,035	33,581	33,669	33,665	33,999
Capital Investment Fund	6,767	5,802	3,956	503	284	250
Disaster Relief Fund	36	—	—	—	—	—
Innovation and Technology Fund	470	809	809	809	809	809
Loan Fund	2,973	3,259	4,052	4,019	3,518	3,363
Lotteries Fund	1,164	1,208	990	553	410	161
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>
Capital spending before interest on and repayment of government bonds and notes	48,058	44,741	47,403	43,613	42,791	42,734
Interest expenses	442	853	826	799	754	642
Repayment of bonds and notes	—	—	2,550	—	2,700	3,500
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>
Total	48,500	45,594	50,779	44,412	46,245	46,876

(f) *Government bonds and notes*

- (i) For 2004-05, two bond programmes were launched, viz. a Toll Revenue Bond of \$6 billion in April 2004 and a global bond issue totalling \$20 billion in July 2004. The net proceeds of the two bond programmes were credited to the Capital Works Reserve Fund.
- (ii) Interest expenses and repayment of bonds and notes are only in respect of the global bond issue and not the Toll Revenue Bond. The interest expenses and repayment of the Toll Revenue Bond are charged directly against the net toll revenue of concerned tunnels and bridges. The toll revenue thus foregone has been taken into account in forecasting Government's operating revenue.

### SECTION III - RELATIONSHIP BETWEEN GOVERNMENT EXPENDITURE, PUBLIC EXPENDITURE AND GDP IN THE MRF

9 For monitoring purposes, the Government's own expenditure is consolidated with the expenditure of the Housing Authority and the Trading Funds (collectively referred to as "other public bodies") in order to compare total public expenditure with Gross Domestic Product.

**Government Expenditure and Public Expenditure in the Context of the Economy** *Table 2*

(\$ million)	Original Estimate	Revised Estimate	Forecast				
	2004-05	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Operating expenditure	212,200	201,241	208,000	207,080	203,540	200,000	202,500
Capital expenditure	46,539	41,733	39,792	44,273	43,909	43,261	43,126
<b>Total government expenditure</b>	<b>258,739</b>	<b>242,974</b>	<b>247,792</b>	<b>251,353</b>	<b>247,449</b>	<b>243,261</b>	<b>245,626</b>
Other public bodies	27,235	22,285	20,798	18,835	18,968	18,333	18,327
<b>Total public expenditure (Note a)</b>	<b>285,974</b>	<b>265,259</b>	<b>268,590</b>	<b>270,188</b>	<b>266,417</b>	<b>261,594</b>	<b>263,953</b>
<b>Gross Domestic Product (calendar year)</b>	<b>1,269,744</b>	<b>1,281,999</b>	<b>1,332,877</b>	<b>1,406,722</b>	<b>1,484,658</b>	<b>1,566,913</b>	<b>1,653,724</b>
<b>Growth in GDP (Note b)</b>							
Money terms		5.1%	4.0%	5.5%	5.5%	5.5%	5.5%
Real terms		8.1%	5.0%	4.0%	4.0%	4.0%	4.0%
<b>Growth in government expenditure (Note c)</b>							
Money terms		-0.1%	2.0%	1.4%	-1.6%	-1.7%	1.0%
Real terms		1.7%	2.7%	0.5%	-2.5%	-2.7%	-0.2%
<b>Growth in public expenditure (Note c)</b>							
Money terms		-2.2%	1.3%	0.6%	-1.4%	-1.8%	0.9%
Real terms		-0.5%	1.9%	-0.3%	-2.3%	-2.8%	-0.2%
<b>Public expenditure as a percentage of GDP</b>	<b>22.5%</b>	<b>20.7%</b>	<b>20.2%</b>	<b>19.2%</b>	<b>17.9%</b>	<b>16.7%</b>	<b>16.0%</b>

Notes—

- (a) Public expenditure comprises government expenditure (i.e. all expenditure charged to the General Revenue Account and financed by the Government's statutory funds excluding Capital Investment Fund), and expenditure by the Trading Funds and the Housing Authority. But *not* included is expenditure by those organisations, including statutory organisations, in which the Government has only an equity position, such as the Airport Authority, the MTR Corporation Limited and the Kowloon-Canton Railway Corporation. Similarly, advances and equity investments from the Capital Investment Fund as well as repayment of government bonds and notes are excluded as they do not reflect the actual consumption of resources by the Government.
- (b) For 2005-06, the GDP growth in money terms of 4.0% represents the mid-point of the range forecast of nominal GDP growth at 3.5% to 4.5% for the calendar year 2005. Similarly, the growth in real terms of 5.0% represents the mid-point of the range forecast of real GDP growth at 4.5% to 5.5% for 2005.
- (c) The growth rates refer to year-on-year change. For example, the rates for 2004-05 refer to the change between revised estimate for 2004-05 and actual expenditure in 2003-04. The rates for 2005-06 refer to the change between the 2005-06 forecast and the 2004-05 revised estimate, and so forth.

10 Table 3 shows the relationship amongst the sum to be appropriated in the 2005 Budget, government expenditure and public expenditure. It also shows the effect of the Budget revenue measures on the overall surplus/deficit position for 2005–06.

**Relationship between Government Expenditure  
and Public Expenditure in 2005–06**

(\$ million)

Table 3

Components of expenditure and revenue	Appropriation	Government expenditure and revenue			Public expenditure
		Operating	Capital	Total	
<b>Expenditure</b>					
General Revenue Account					
Operating					
Recurrent	199,117	199,117	—	199,117	199,117
Non-recurrent	8,883	8,883	—	8,883	8,883
Capital					
Plant, equipment and works	824	—	824	824	824
Subventions	804	—	804	804	804
	209,628	208,000	1,628	209,628	209,628
Transfer to Funds	5,028	—	—	—	—
Capital Works Reserve Fund	—	—	32,888	32,888	32,888
Innovation and Technology Fund	—	—	809	809	809
Loan Fund	—	—	3,259	3,259	3,259
Lotteries Fund	—	—	1,208	1,208	1,208
Trading Funds	—	—	—	—	3,109
Housing Authority	—	—	—	—	17,689
	214,656	208,000	39,792	247,792	268,590
<b>Revenue (before Budget revenue measures)</b>					
General Revenue Account					
Taxation		155,028	1,510	156,538	
Other revenue		31,905	3,998	35,903	
Land Fund		186,933	5,508	192,441	
		6,376	—	6,376	
		193,309	5,508	198,817	
Capital Works Reserve Fund		—	33,820	33,820	
Capital Investment Fund		—	2,482	2,482	
Civil Service Pension Reserve Fund		—	784	784	
Disaster Relief Fund		—	2	2	
Innovation and Technology Fund		—	208	208	
Loan Fund		—	1,547	1,547	
Lotteries Fund		—	1,248	1,248	
Asset sales		—	5,401	5,401	
		193,309	51,000	244,309	
<b>Surplus/(deficit) before Budget revenue measures</b>		(14,691)	11,208	(3,483)	
<i>Less:</i> Effect of Budget revenue measures		760	500	1,260	
<b>Surplus/(deficit) after Budget revenue measures</b>		(15,451)	10,708	(4,743)	
<i>Less:</i> Advances and equity investments from the Capital Investment Fund		—	5,802	5,802	
<b>Consolidated surplus/(deficit)</b>		(15,451)	4,906	(10,545)	

**SECTION IV - ESTIMATES OF CONTINGENT LIABILITIES**

**11** The Government's contingent liabilities as at 31 March 2004, and estimates of these should they remain unsettled as at 31 March 2005 or 31 March 2006, are provided below as supplementary information to the MRF—

(at 31 March)	2004 \$m	2005 \$m	2006 \$m
Guarantee to the Hong Kong Export Credit Insurance Corporation for liabilities under contracts of insurance	9,499	9,983	10,383
Litigation			
- the Government's appeals arising from judicial reviews challenging the lawfulness of the two pieces of pay reduction legislation giving effect to the civil service pay adjustments in October 2002, January 2004 and January 2005	-	5,400	9,600
- others	113	119	124
Possible capital subscriptions to the Asian Development Bank	2,069	2,069	2,069
Guarantees provided under loan guarantee schemes for small and medium enterprises, the Film Guarantee Fund and the Loan Guarantee Scheme for Severe Acute Respiratory Syndrome Impacted Industries	3,680	4,092	3,850
Total	15,361	21,663	26,026