The 2005-06 Budget

Information Pack for

The Financial Secretary's Consultations

November 2004

Introduction

In preparation for the 2005-06 Budget, the Financial Secretary will be kicking-off a series of consultations with Members of the Legislative Council and representatives from various sectors in the coming few months.

We have prepared this pack, already uploaded on the budget website (**www.budget.gov.hk**), to facilitate discussion.

We welcome and value advice on the Budget, whether tendered through the consultations sessions, the website or written submissions.

Chart 1

Contents

I. Economic Positioning and Prospects (Charts 2 to 7)

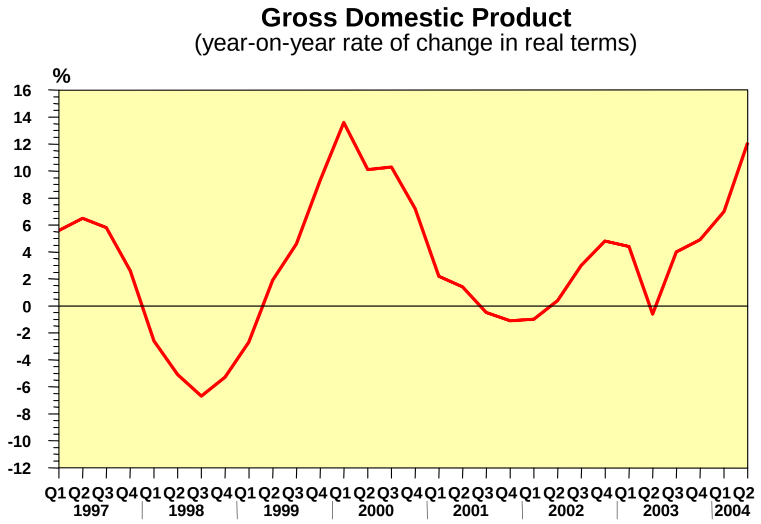
II. Management of Public Finance (Charts 8 to 21)

Economic Positioning

- Leveraging on the Mainland, engaging ourselves globally
- Market leads, Government facilitates
- Building on Hong Kong's strengths, enhancing competitiveness of our key industries
- Capitalizing on CEPA, strengthening our two-way business platform
- Developing our human resources, promoting job opportunities
- Maintaining a robust market structure, ensuring the consistency of our policies

Chart 3

Economy on a broad-based upturn



- The recovery of the Hong Kong economy broadened to a full-fledged upturn in the second quarter of 2004, with Gross Domestic Product (GDP) soaring by 12.1% in real terms against an exceptionally low base of comparison caused by SARS a year earlier. This was significantly up from the 7.0% growth in the first quarter, and was also the fastest growth in four years.

I. Economic Positioning and Prospects

Chart 4

Latest economic indicators

Gross Domestic Product	2nd Quarter	+12.1%
Unemployment rate	July to September	6.8% (down from peak of 8.6%)
Volume of exports of goods	First 8 months	+16.7% (August +19.4%)
Volume of exports of services	2nd Quarter	+31.3%
Outbound container cargoes	First 7 months	+7.4% (July +8.2%)
Outbound air cargoes	First 9 months	+23.0% (September +22.3%)
Incoming visitors	First 8 months	+58.4% (August +25.6%)
Volume of retail sales	First 8 months	+10.0% (August +4.2%)
Investment expenditure	2nd Quarter	+13.2%

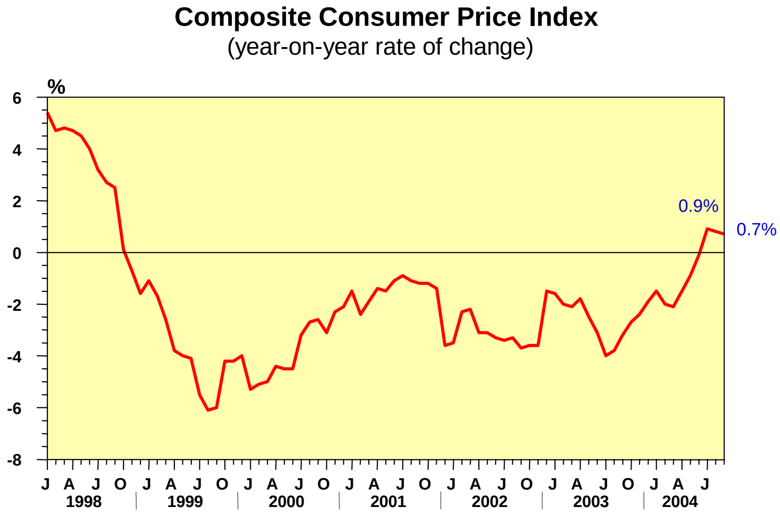
Except for unemployment rate, the above percentages represent year-on-year changes.

- The economy is now on a broad-based upturn, as evident in many economic indicators.

- Looking ahead, the economy maintains a generally positive tone. Merchandise exports are expected to continue to fare well in the months ahead, even though growth may not be as rapid as in early 2004. Exports of services are also expected to maintain strong growth momentum in the rest of the year, as inbound tourism is likely to remain vibrant, supported on the one hand by the Individual Visit Scheme for Mainland visitors and on the other hand by a further rebound in visitors from the other major sources. Offshore trade should continue on an uptrend, reflecting the positive external environment and strong trade flows in the region.

Chart 5

End of 68-month long deflation



- In July 2004, the Composite Consumer Price Index (CCPI) reverted to a 0.9% increase over a year earlier, signifying the end of a 68-month long deflation. It rose further by 0.8% and 0.7% respectively in August and September over a year earlier.

- The generally improved economic conditions, revived consumer demand and higher import prices have prompted many retailers to reduce the earlier price discounts or raise prices for some consumer items.

- Another contributory factor was the low base of comparison brought about by the rates concession in the third quarter of 2003 and the waiver of water and sewage charges in August-November 2003.

Updated forecasts for the Hong Kong economy

	Forecast for 2004	
GDP real growth	7.5%	(vs 6% in March forecast)
CCPI	0%	(vs -1% in March forecast)

- With the outturn so far this year well exceeding earlier expectations, and with both external and local demand likely to hold up well throughout the rest of the year, GDP for 2004 as a whole is now forecast to grow by 7.5%, 1.5 percentage points up from 6% in the 2004 Budget.

- The forecast CCPI for 2004 as a whole is revised upwards from -1% to zero change.

Uncertainties

External

- Surging oil prices
- Rising US interest rates
- Macroeconomic adjustment measures in the Mainland

Domestic

- Asset market developments
- Pace of job creation

- In spite of the robust economic outlook, there are uncertainties.

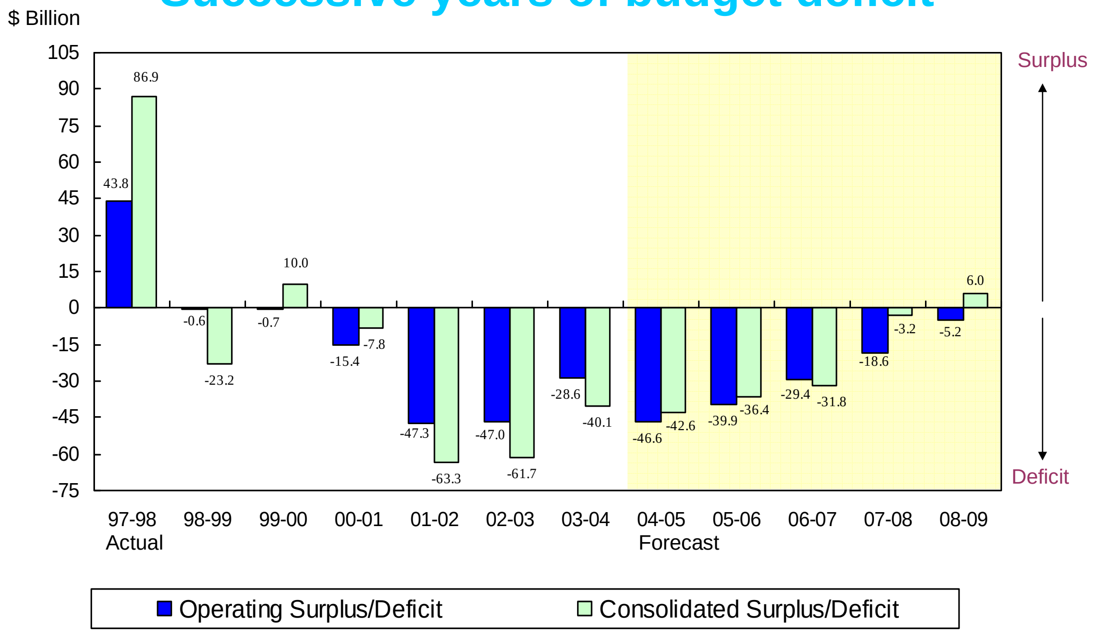
- The external environment is still overshadowed by surging oil prices, rising US interest rates, and the macroeconomic adjustment measures in the Mainland. Yet so far, these risk factors have not reversed or severely dampened the global growth momentum. The Mainland economy stays strong as trade surges ahead, notwithstanding the concurrent slow-down in overall investment. Demand in the industrialised economies also remains firm with industrial production rising and exports staying buoyant. The decline in oil dependency over the years should have rendered these economies less vulnerable to the oil price hike. Moreover, the overall monetary stance in the US remains largely accommodative, despite recent rises in US interest rates.

- In the domestic sector, there are also uncertainties in the pace of job creation and asset market developments.

II. Management of Public Finance

Chart 8

Successive years of budget deficit



- Since 1998-99, there have been six successive years of operating deficit, and five years of consolidated deficit.

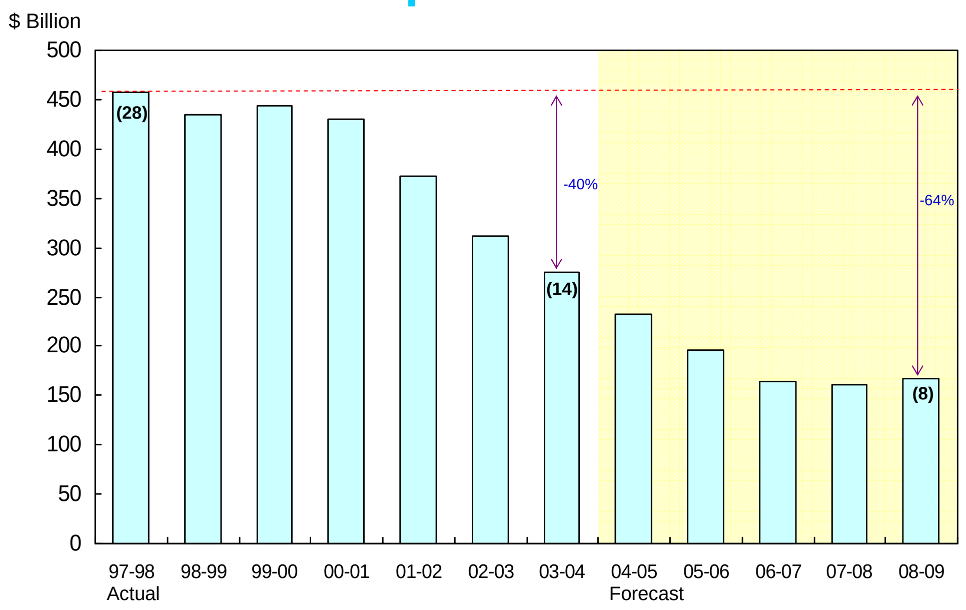
- In 2003-04, the consolidated deficit was $40.1 billion, equivalent to 3.3% of GDP; whereas the operating deficit was $28.6 billion, 2.3% of GDP.

- In the 2004 Budget, we forecast that the consolidated deficit would gradually decline, and a surplus of $6 billion would be recorded in 2008-09, equivalent to 0.4% of GDP. However, the operating account for that year would still record a deficit.

II. Management of Public Finance

Chart 9

Continual depletion of fiscal reserves



Figures in ( ) represent the equivalent months of government expenditure.

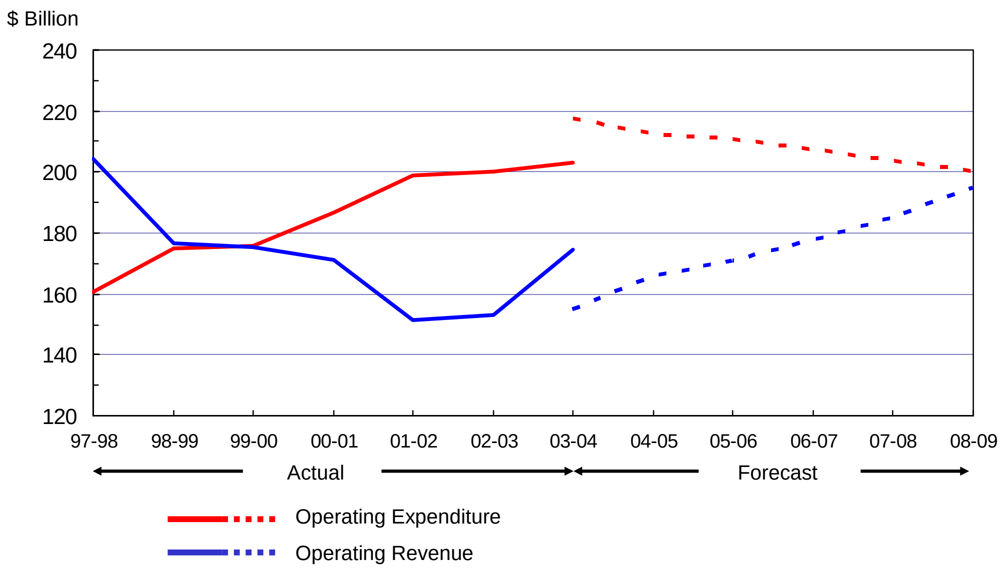
- Fiscal reserves have been depleted by 40% over the past six years, from $457.5 billion at 31 March 1998, equivalent to 28 months of the then government expenditure, to $275.3 billion at 31 March 2004, equivalent to 14 months of government expenditure.

- Based on current forecasts, fiscal reserves would run down by a further 24% of the March 1998 level, or 39% of the March 2004 level, in the coming five years to 2008-09. What remains at 31 March 2009 would be about $167.3 billion, equivalent to only eight months of government expenditure.

II. Management of Public Finance

Chart 10

Mismatch in operating account



- Despite a promising rate of economic recovery, operating revenue still falls short of matching in full the operating expenditure.

- Windfall from non-recurrent revenue, such as land premium, cannot be relied upon to solve the mismatch between operating expenditure and operating revenue.

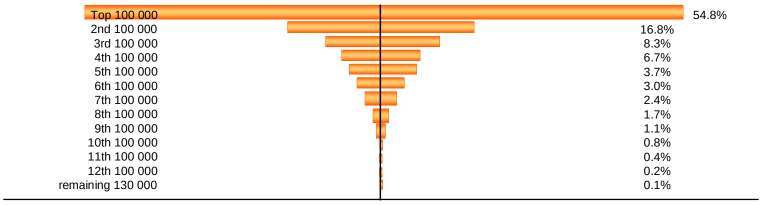
II. Management of Public Finance

Chart 11

Increasing reliance on a small group of taxpayers

1997-98 (Actual revenue)

Taxpaying population (Total: 1 330 000) **% of Total Tax Yield**

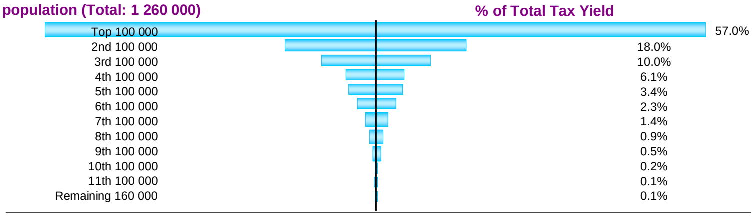


Working population which does not pay any salaries tax (Total : 1 830 000) 0%

* **2% of the working population pay at the standard tax rate of 15% and contribute about 43.9% of total salaries tax receipts**

2004-05 (Provisional Assessment)

Estimated Taxpaying population (Total: 1 260 000) **% of Total Tax Yield**



Estimated Working population which does not pay any salaries tax (Total : 2 040 000) 0%

* **1.27% of the estimated working population pay at the standard tax rate of 16% and contribute 35.8% of total salaries tax receipts**

- The taxpaying population has dropped from 1.33 million in 1997-98 to 1.16 million in 2002-03 although the working population has increased from 3.16 million to 3.2 million during the same period.

- After the implementation of the various changes to the salaries tax in 2003-04 and 2004-05, the taxpaying population is estimated to increase to 1.21 million in 2003-04 and 1.26 million in 2004-05.

- These charts also arrange salaries taxpayers in 1997-98 and 2004-05 in steps of 100 000 each according to their salaries tax bills, and measure their respective contributions to the salaries tax yield.

- The top 100 000 taxpayers contributed 54.8% of the total revenue from salaries tax in 1997-98. The corresponding share rose to 61.1% in 2002-03, signifying an increasing reliance on high-income earners in the years between.

- The reliance has moderated starting from 2003-04 after implementation of the various changes to salaries tax. The share of revenue contributed by these top 100 000 taxpayers is estimated to drop to 59.2% in 2003-04 and further to 57% in 2004-05.

II. Management of Public Finance

Chart 12

Commitment to restore fiscal health

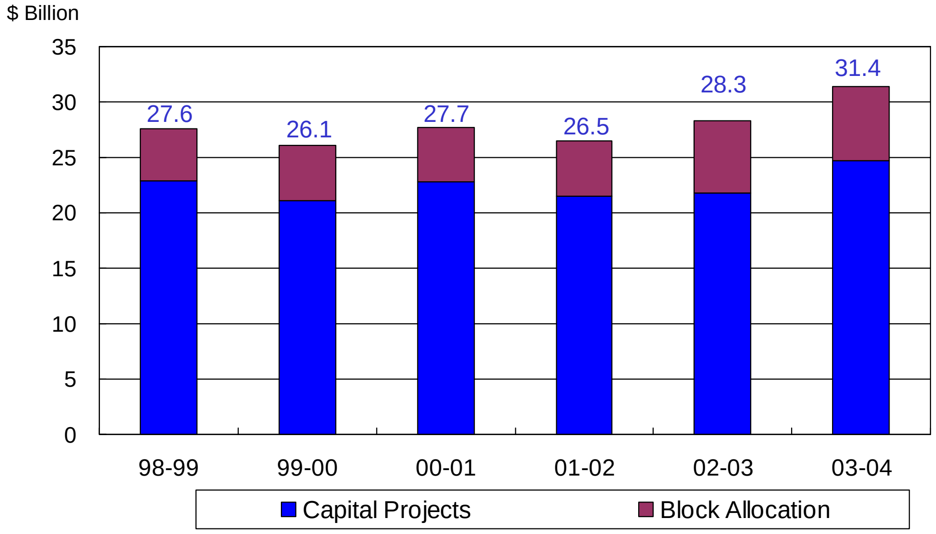
- Restoring fiscal balance in the Operating and Consolidated Accounts by 2008-09
- Bringing public expenditure down to 20% of GDP or below
- Reducing operating expenditure to $210.6 billion in 2005-06, and $200 billion by 2008-09

- In the 2004 Budget, we undertook—
  - to strive to restore fiscal balance in the Operating and Consolidated Accounts by 2008-09;
  - in line with the principle of "big market, small government", to bring public expenditure down to 20% of GDP or below; and
  - to reduce operating expenditure to $210.6 billion in 2005-06 with a longer term goal of reaching $200 billion by 2008-09.

II. Management of Public Finance

Chart 13

Investing in essential infrastructure



- During the past few years, the average actual capital works expenditure was around $28 billion a year.

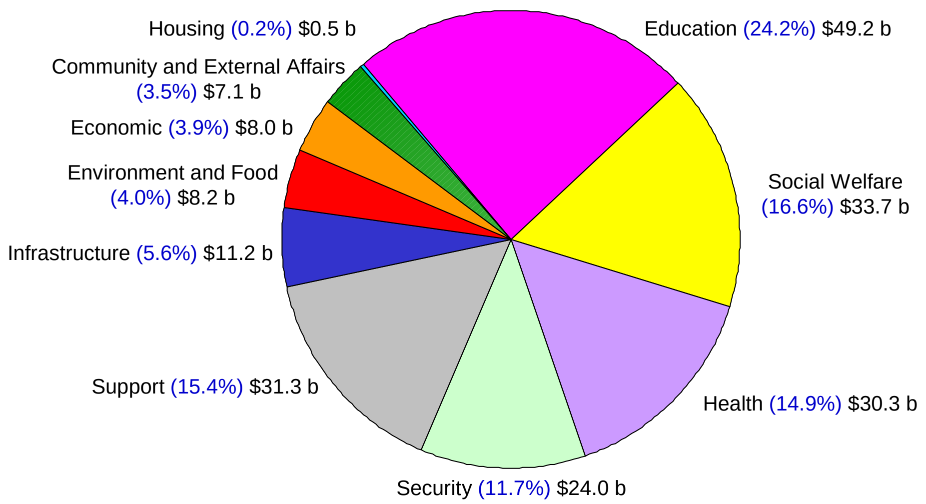
- In the 2004 Budget, we said that we would allocate an average of around $29 billion a year on capital works expenditure for the period up to 2008-09. This remains our planning basis.

- Actual capital works expenditure in 2003-04 amounted to $31.4 billion, while the position in the 2004-05 Original Estimates is $32.9 billion.

II. Management of Public Finance

Chart 14

Aligning spending priorities with policy objectives Snapshot in 2004-05



Recurrent Government Expenditure

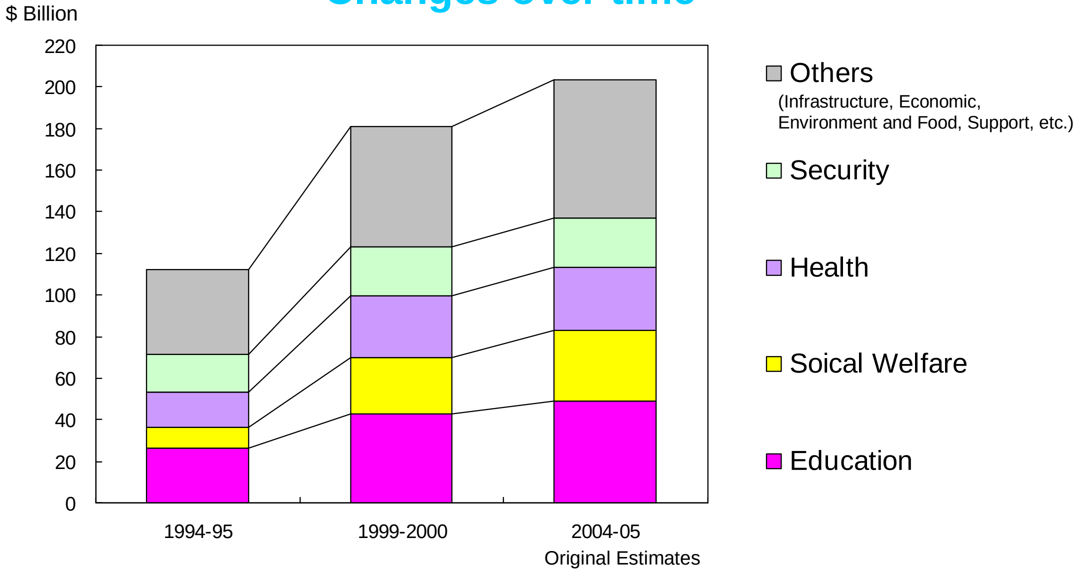
Total : $203.5 billion

- This chart sets out the Government's estimated recurrent expenditure in 2004-05 by policy areas. Education (24.2%), Social Welfare (16.6%) and Health (14.9%) together account for nearly 55.7% of the total government recurrent spending.

II. Management of Public Finance

Chart 15

Aligning spending priorities with policy objectives
Changes over time



Recurrent Government Expenditure

- Total recurrent expenditure increased by some $91.5 billion or 82% over the past ten years.

- Recurrent spending in Education and Social Welfare has outpaced other policy areas in terms of growth—

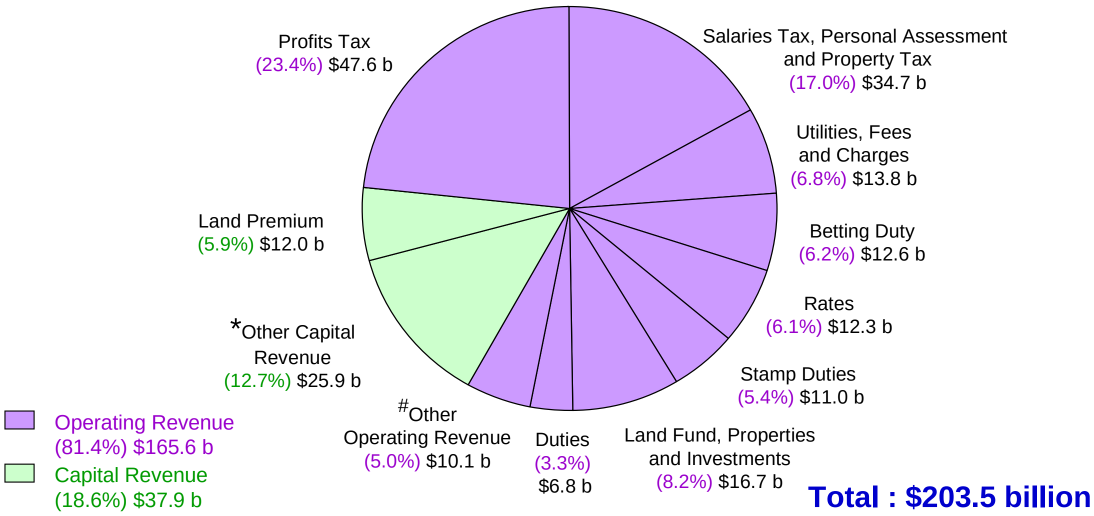
  - Education +88%

  - Social Welfare +236%

II. Management of Public Finance

Chart 16

Sustaining our revenue streams
Snapshot in 2004-05



Total Government Revenue (excluding proceeds from government bonds)

- This chart gives an overview of Government's operating and capital revenue sources based on the 2004-05 Original Estimates.

- Income tax on companies and businesses (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 2004-05. They account for some 40.4% of Government's total revenue.

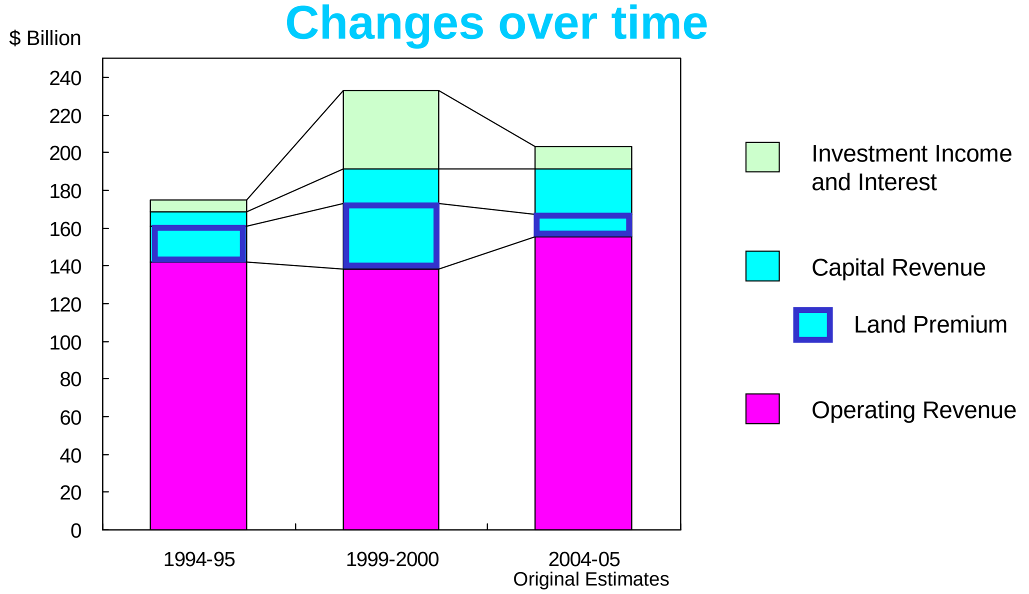
- Other operating revenue(#) comprises—
  - Loans, Reimbursements and Others ($2.8 b)
  - Motor Vehicles First Registration Tax ($2.9 b)
  - Royalties and Concessions ($0.6 b)
  - Fines, Forfeitures and Penalties ($0.9 b)
  - Air Passenger Departure Tax ($1.4 b)
  - Hotel Accommodation Tax ($0.2 b)
  - Returns on equity investments ($1.3 b)

- Other capital revenue(*) comprises—
  - Loan Fund ($6.4 b)
  - Capital Investment Fund ($8.2 b)
  - Recovery from Housing Authority ($0.1 b)
  - Estate Duty ($1.5 b)
  - Repayment of loans and advances ($0.2 b)
  - Capital Works Reserve Fund ($7.1 b)
  - Civil Service Pension Reserve Fund and Disaster Relief Fund ($0.8 b)
  - Lotteries Fund ($1.1 b)
  - Innovation and Technology Fund, taxi concessions and other receipts ($0.5 b)

II. Management of Public Finance

Chart 17

Sustaining our revenue streams
Changes over time



Total Government Revenue (excluding proceeds from government bonds)

- Total operating revenue, covering taxes, stamp duties and over 4 000 government fees and charges items, increased by only $13.4 billion or 9.4% over the past ten years.

- On the other hand, capital revenue, with land premium being a key component, and investment income, fluctuated a lot over the period.

- Land premium's share of the total revenue was 10.9% in 1994-95, 14.9% in 1999-2000 and a lower 2.6% in 2003-04 (or 5.9% as originally forecast for 2004-05).

- Investment income's share of total revenue was 3.8% in 1994-95, 18% in 1999-2000 and 12.5% in 2003-04 (or 6% as originally forecast for 2004-05).

- Capital revenue and investment income **cannot** be relied upon to solve the operating deficit.

II. Management of Public Finance

Chart 18

Broadening our tax base

Goods and Services Tax?

- Should this be introduced?
- If so, should it be as all embracing as possible?
- Exemptions to be contemplated?
- Need for relief/offset package
  - to low-income families,
  - to the business sector, and
  - to the community at large?
- Time frame for introduction?

Capital Gains Tax? World-wide Tax?

Green Taxes?

- Tax on plastic bags/vehicle tyres?

- The Government requires a broader, sizeable and steady income source to underpin its revenue and meet its expenditure requirements. A broad-based Goods and Services Tax (GST) is a reasonable and equitable way to smooth out bumps in revenue stream and secure fiscal stability for the future.

- An internal committee is carrying out a detailed and comprehensive study on the implementation of a GST in Hong Kong. It will draw on the practical experience of other places and come up with a proposed GST framework suitable for Hong Kong. The committee will submit a report to the Financial Secretary by the end of this year. We will then announce what will be done next.

- The Government will strive to build a consensus with the community on how best to implement the GST and will launch a consultation on GST in 2005.

- We need to consider how Hong Kong should seek to improve the stability of revenues. Scope for Capital Gains Tax and World-wide Tax?

II. Management of Public Finance

Chart 19

Reviewing existing taxes

- Estate Duty
- Duty on alcoholic beverages

- Estate duty is estimated to bring $1.5 billion in revenue for 2004-05. The consultation on estate duty has just closed. Views received are divergent with some contending that estate duty is a tax on the rich and helps redistribute income between the rich and the poor, but many others advocating abolition given its susceptibility to abuse and inequitable nature; and the need to help Hong Kong develop into the premier asset management centre in the region. We will further study and consider the views received.

- There are views in the community that the duty on alcoholic beverages should be abolished to facilitate tourism and Hong Kong's development as a regional hub for wine products. On the other hand, the duty is commonly regarded as a tax on non-necessity item and generates stable recurrent revenue. It is estimated to bring $761 million in revenue for 2004-05.

Chart 20

Bonds

- Issuance provides flexibility in the management of Government's liquidity and helps promote development of Hong Kong's capital market
- $20 billion notes and bonds issued to institutional and retail investors in July 2004

- The issuance of bonds provides greater flexibility in the management of Government's liquidity and helps promote the development of Hong Kong's capital market.

- In July 2004, we issued notes and bonds totalling $20 billion to institutional and retail investors. These include institutional notes of US$1.25 billion (equivalent to HK$9.75 billion) denominated in US dollars, and $10.25 billion of institutional notes and retail bonds denominated in HK dollars.

- As well as being the first of its kind, the bond offering has set a number of records, involving—

  - the largest dual currency offering in the region available to both retail and institutional investors;

  - the largest subscription and issue amounts for a retail bond offering; and

  - the largest network ever used for retail bonds, involving more than 1 100 branches of 23 local banks and hundreds of securities brokers.

Chart 21

Views are welcome

www.budget.gov.hk

- The Government welcomes advice and suggestions on how to reposition the Hong Kong economy and restore its fiscal health. Views on the 2005-06 Budget can be presented to the Financial Secretary through consultation sessions, written submissions or the dedicated website. We will take all advice into account when drawing up the 2005-06 Budget.