



The 2007-08 Budget

Information Pack for the Financial Secretary's Consultations

November 2006

Introduction

The Financial Secretary will soon be consulting Members of the Legislative Council and representatives from various sectors on the 2007-08 Budget. We have prepared this pack, available also on the budget website (www.budget.gov.hk), to facilitate discussion.

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

Chart 1

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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.

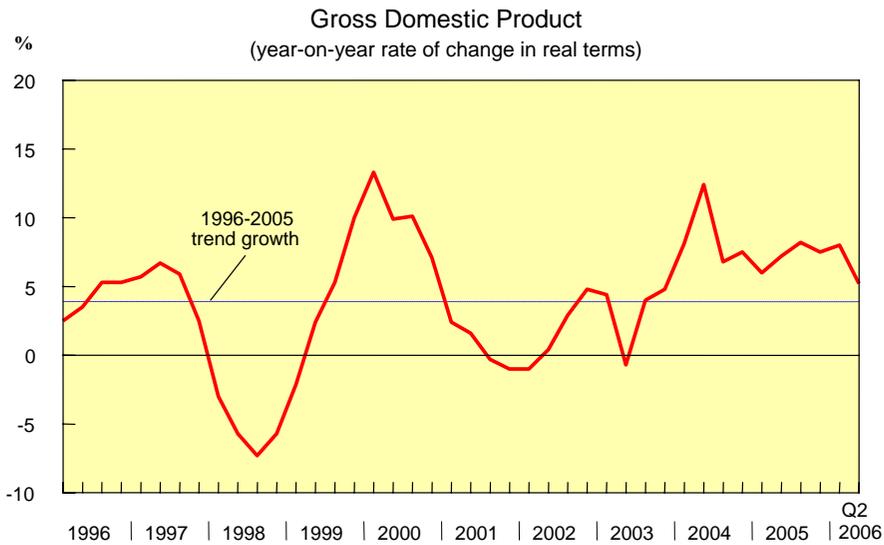
- The Basic Law (Article 107) requires the Government to “follow the principle of keeping expenditure within the limits of revenues in drawing up its budget, and strive to achieve a fiscal balance, avoid deficits and keep the budget commensurate with the growth rate of its gross domestic product.”
- These constitutional provisions for financial prudence are integral to maintaining the confidence of the international financial community as well as that of the local and overseas investors in Hong Kong.
- We also adhere to a low and simple tax regime and always work towards maintaining the stability and integrity of the monetary system.

Economic positioning

- Developing high value-adding activities and a knowledge-based economy
- Continuing economic co-operation with the Mainland
- Strengthening financial services
- Developing tourism and logistics
- Improving business environment
- Pooling of talent

- Hong Kong is highly regarded as the freest economy in the world (ranked by The Heritage Foundation and The Fraser Institute) and an important hub promoting the flow of capital, people, goods and information worldwide. Much of the 6.6% GDP growth in the first half of 2006 came from the expansion of such activities as financial services, trade, logistics and tourism.
- The Mainland continues to be the key growth driver in our economy, accounting for 47% of exports, 55% of tourist arrivals, over 40% of stock market capitalisation and almost 60% of stock market turnover. Through the implementation of CEPA and Pan-Pearl River Delta Regional Co-operation Framework Agreement, Hong Kong will continue to leverage on the opportunities generated from increasing integration with the Mainland.
- To maintain our position as an international financial centre and a trade, logistics and shipping centre, we will continue to enhance our regulatory framework and corporate governance and invest in infrastructure.
- Economies which can attract the best talent will be the most successful in this globalised era. We will continue to attract Mainland and overseas talents and professionals to work and live in Hong Kong.

Economy expanding solidly



- The Hong Kong economy, after an exceptionally strong growth of 8% in the first quarter, grew by 5.2% in the second quarter, giving a 6.6% growth for the first half of 2006 as a whole. This also marked the eleventh consecutive quarter that GDP growth notably exceeded the trend growth of 3.9% over the past ten years.

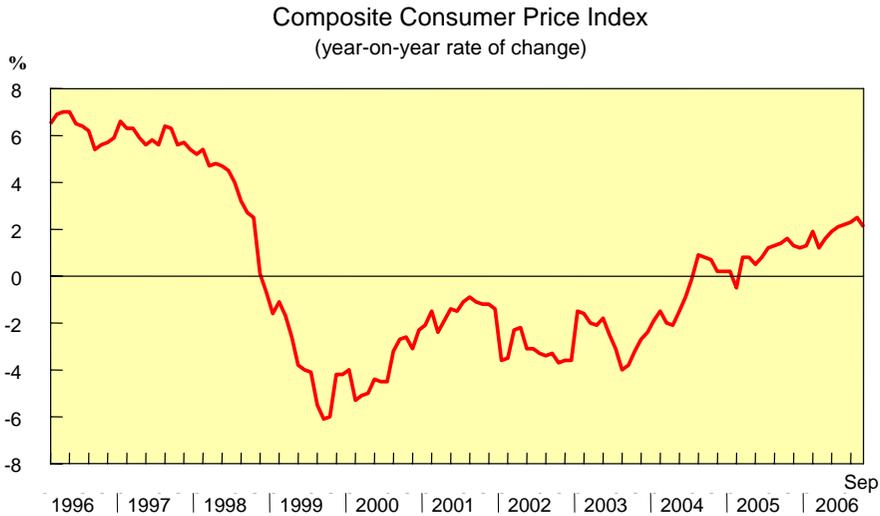
Latest 2006 economic indicators

Gross Domestic Product	First half	+6.6% (Second quarter +5.2%)
Unemployment rate	Third quarter	4.7% (62-month low, down from peak of 8.6%)
Volume of exports of goods	First 8 months	+10.4% (August +10.2%)
Volume of exports of services	First half	+8.8% (Second quarter +8.6%)
Outbound container cargoes	First 7 months	+5.4% (July +8.7%)
Outbound air cargoes	First 9 months	+5.9% (September +6.2%)
Incoming visitors	First 9 months	+9.5% (September +2.4%)
Volume of retail sales	First 9 months	+5.6% (September +5.8%)
Investment expenditure	First half	+5.9% (Second quarter +4.3%)

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

- The economic upturn continued at a solid pace, as evident in many economic indicators. The labour market also improved notably along with the economic upturn.
- Merchandise exports showed some moderation in the second quarter, yet resumed double-digit growth in July and August – thanks to the vibrant Mainland economy and its thriving trade flows. Service exports still maintained notable growth momentum, thanks to continued distinct growth in offshore trade and inbound tourism.
- Meanwhile, domestic demand continued to hold up well, and has become the key driver of economic growth in the second quarter. Consumer demand remained resilient, alongside better employment conditions. Investment spending grew further, with investment in machinery and equipment surging further amidst strong investor confidence. However, the building and construction sector remains a laggard.

Inflation remains benign amidst sustained economic expansion



- Consumer price inflation remained benign, though notching up further in recent months along with the sustained rise in private housing rentals and a slight pick-up in food prices. Rising productivity and relatively soft import prices of consumer goods have helped to contain overall inflationary pressure at a moderate level. The Composite Consumer Price Index (CCPI) rose by 2.1% in September over a year earlier. For the first nine months of 2006 as a whole, consumer price inflation averaged at 2%.
- Looking ahead, overall inflationary pressures are likely to stay rather moderate in the rest of 2006, being kept down by rising productivity and capacity expansion from hefty business investment.

External uncertainties

Short-term

- High and volatile oil prices
- Possibly slower US economic growth and weaker external demand
- Movements of Renminbi
- Movements of interest rates in US, EU and Japan

- After 11 quarters of above-trend growth, the economic outlook for the rest of the year is for a further expansion at a solid pace.
- The run-up of oil prices, coupled with higher interest rates, has led to slower consumer demand growth in some overseas markets, thereby affecting our export performance. International oil prices, though easing lately, are likely to stay high and volatile in the period ahead.
- How the US economy would fare is of crucial significance to the external environment. Currently, the market believes that the US economy would only taper slightly in growth. But if the US economic growth were to show a sharper-than-expected downturn, this could have repercussions on global and regional economic growth.
- The future pace and scale of the Renminbi exchange rate reform would affect the price competitiveness of Hong Kong's exports.
- Despite the recent pause in the US interest rate up-cycle, interest rates in the EU and Japan continue to face upward pressures. This could affect the economic performance of these major overseas markets going forward.

External uncertainties

Beyond the short-term

- Persistent current account deficit in US and on-going trade tension with Mainland
- Sustainability of Japan's and Europe's economic recovery if US economic growth were to slow
- Success in steering a soft-landing in Mainland economy

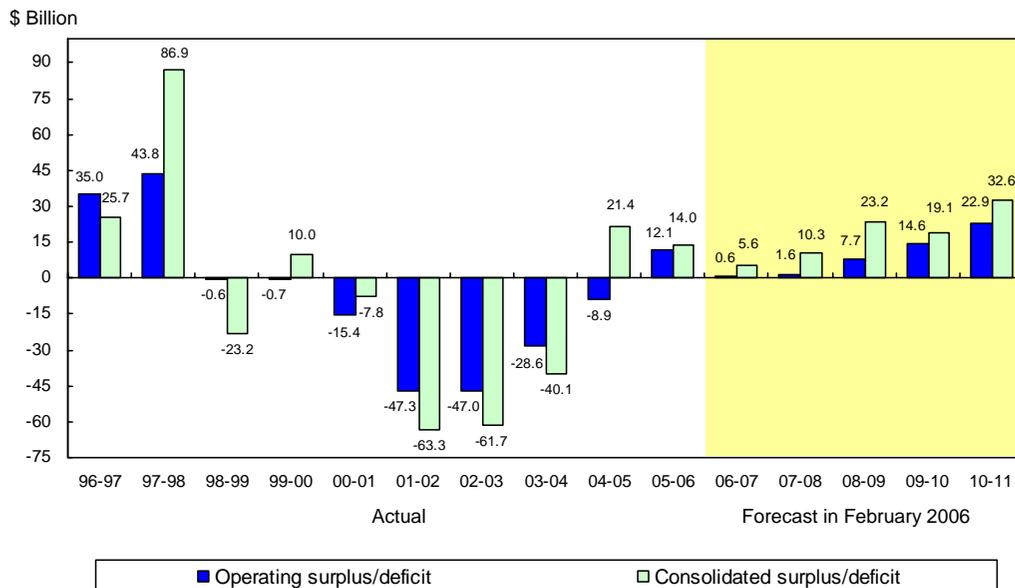
- The persistent global imbalance, as manifested by the huge current account deficit in the US and on-going trade tension with the Mainland, is to a large extent the results of the low saving rate and over-indebtedness of American consumers. If left unresolved, this may result in abrupt adjustments in the exchange rate of the US dollar, US asset prices and economic growth. There could be significant repercussions on the rest of the world.
- The economic upturn currently enjoyed by the EU and Japan would be derailed if the US economic growth were to slow sharply. Also, the central banks in both EU and Japan are facing the same delicate task of returning interest rates to more normal levels without triggering economic slow-down.
- The success of the Mainland economy in containing over-investment and balancing growth pattern is crucial to its long-term stability, and hence also important to the Hong Kong economy over the longer term.

Forecast for 2006

GDP real growth	4% - 5%	(August 2006 forecast, same as Budget round forecast)
CCPI	2%	(August 2006 forecast, with technical adjustment to the Budget round forecast of 2.3%)

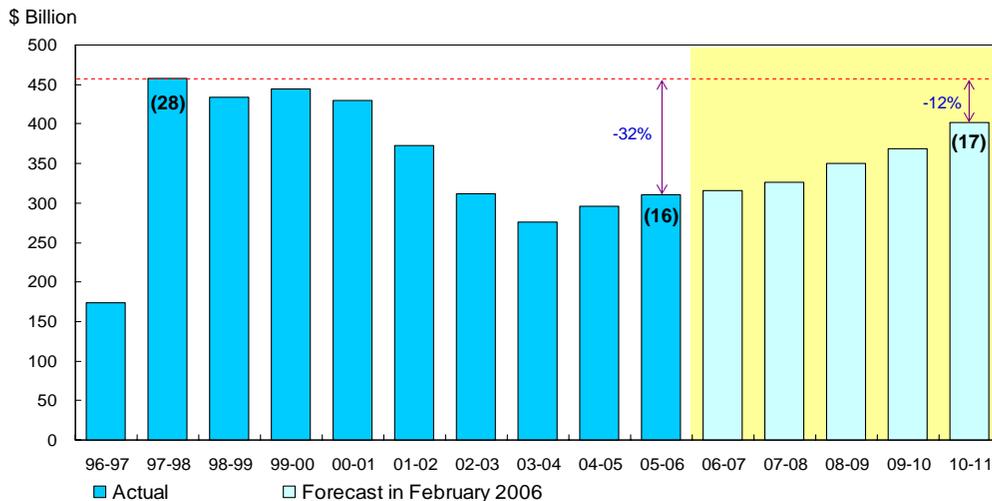
- With the resilience in domestic demand and with external trade resuming strength lately, the economic outlook for the rest of the year is for a further expansion at a solid pace. Given the outturn so far and with the expected further solid expansion in the second half, for 2006 as a whole, the Hong Kong economy should easily attain 5% growth, the upper end of the growth range of 4% to 5%. Indeed, if the Mainland economic growth continues to exceed expectation and if the US economy were to maintain reasonably strong momentum in the rest of the year, and barring any external shocks, there should be upside to GDP growth for 2006.
- The forecast rate of change in the CCPI for 2006 is 2%, a still moderate level when viewed in conjunction with the robust pace of GDP expansion over the past two years.

Fiscal health



- Following the strong economic growth in 2004 and 2005 with GDP growth at 8.6% and 7.3% respectively, Hong Kong has regained its strength and vitality.
- For the first time since 1997-98, both the Operating and Consolidated Accounts recorded a surplus in 2005-06. The consolidated surplus for the year amounted to \$14 billion, equivalent to 1% of GDP.
- Premised on an economic growth forecast of around 4% a year, we anticipate that we would continue to achieve surplus in the Operating and Consolidated Accounts for the coming five years to 2010-11.

Fiscal reserves

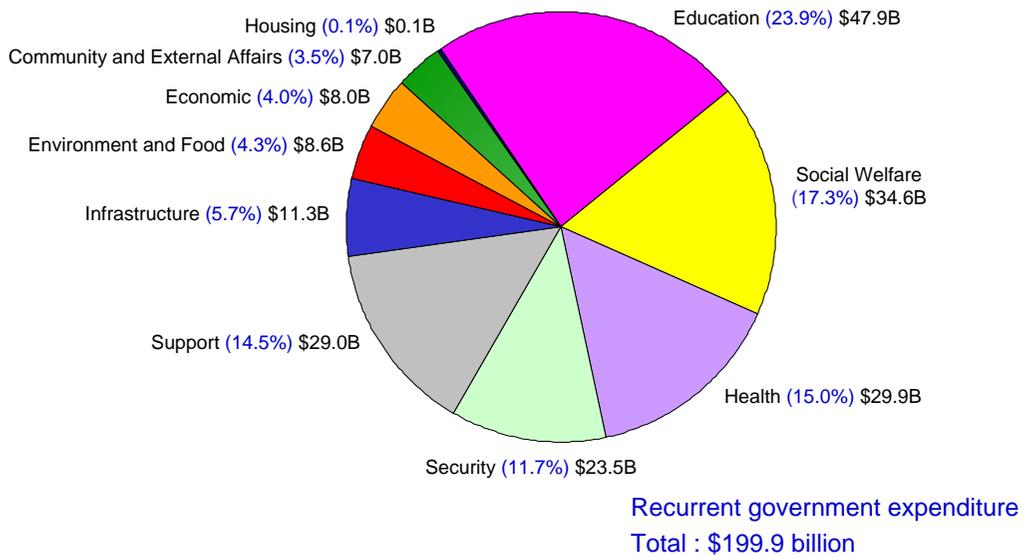


Figures in brackets represent the equivalent number of months of government expenditure.

Starting from 1 July 1997, the fiscal reserves include the net assets transferred from the former HKSARG Land Fund.

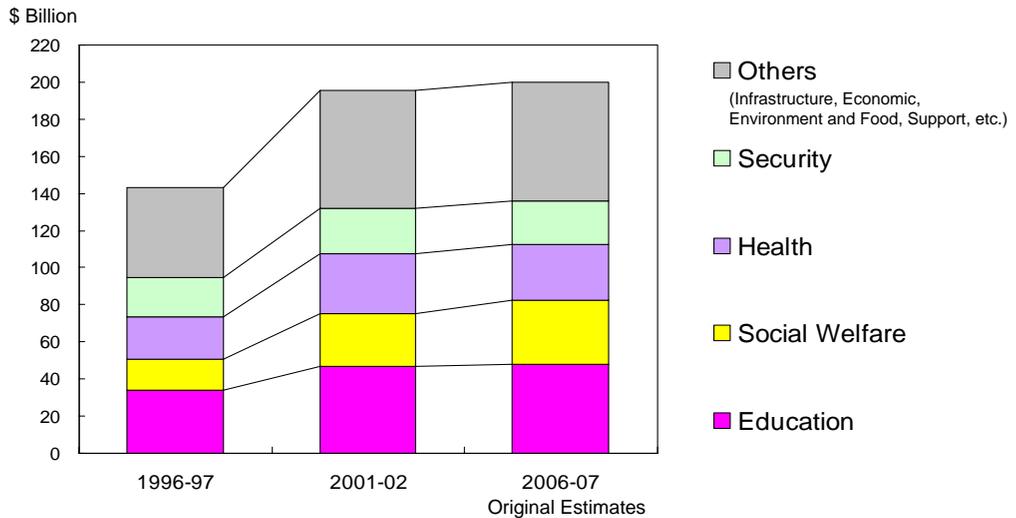
- Discounting the proceeds from the issuance of government bonds in 2004, fiscal reserves have shrunk from \$457.5 billion as at end-March 1998 by \$190.3 billion over the seven years to end-March 2005. The \$14 billion surplus in 2005-06 replenished the fiscal reserves by less than 10% of the shrinkage.
- Taking into account the actual results for 2005-06 and the forecast in February 2006, fiscal reserves by end-March 2007 would be \$316.3 billion, equivalent to 15 months of government expenditure, and rise gradually to \$401.5 billion by end-March 2011, equivalent to 17 months of government expenditure.

Expenditure profile in 2006-07



- This chart shows the Government's recurrent expenditure by policy area as set out in the 2006-07 Original Estimates. Education (23.9%), Social Welfare (17.3%), Health (15%) and Security (11.7%) together account for about 67.9% of the total recurrent government expenditure.

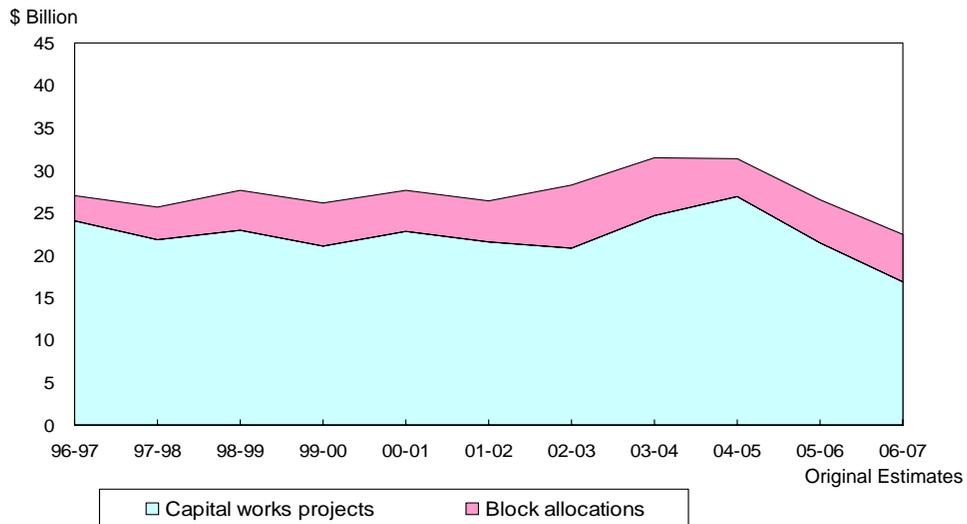
Expenditure profile in past ten years



Recurrent government expenditure

- Total recurrent expenditure increased by some \$56.7 billion or 39.6% over the past ten years.
- Education and Social Welfare have outpaced other policy areas in terms of growth in recurrent spending —
 - Education +40.5%
 - Social Welfare +109.7%

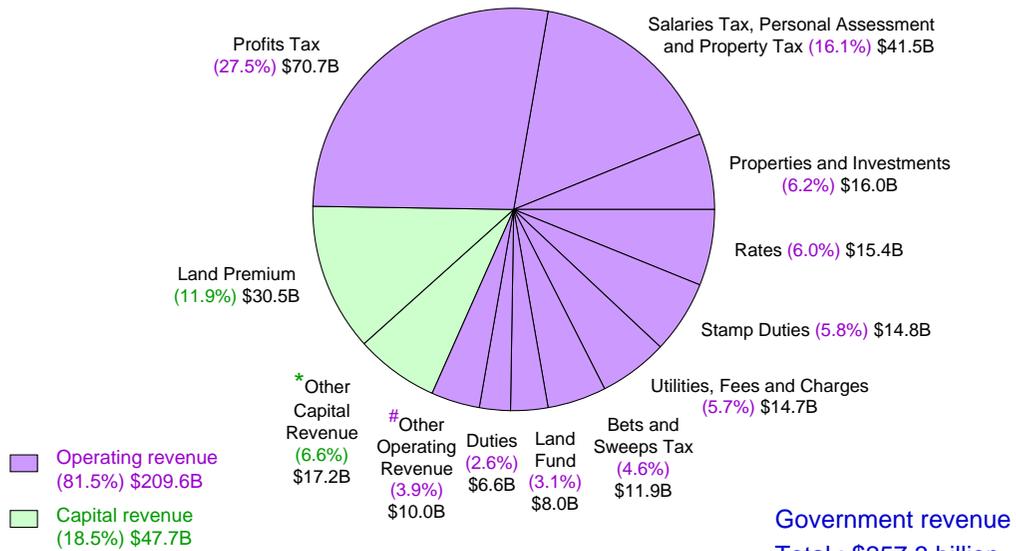
Essential infrastructure



Capital works expenditure

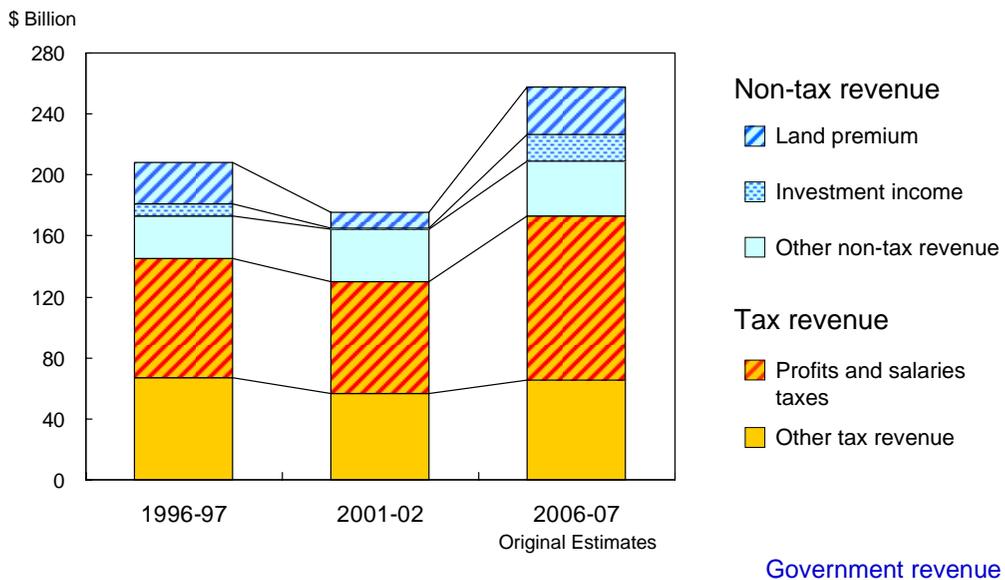
- The Government remains committed to taking forward projects necessary for the future economic development of Hong Kong. We will also do our utmost to expedite the project delivering process.
- We will continue to earmark an average of about \$29 billion a year for spending on public works projects.
- The peak spending period in 2003-04 and 2004-05 coincided with the construction phase of several mega projects like Deep Bay Link, Shenzhen Western Corridor, Hong Kong Disneyland, School Improvement Programme, etc. With the gradual completion of these projects in the past two years and the next batch of mega projects (such as Kai Tak Development, Central-Wanchai Bypass, reclamation in Central and Wanchai, and improvement of Tuen Mun Road) held up by longer than expected public debates, the spending in 2005-06 and 2006-07 has eased off as compared with the peak spending of \$31.4 billion a year.

Revenue profile in 2006-07



- This chart gives an overview of Government's operating and capital revenue sources based on the 2006-07 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 2006-07. They account for some 43.6% of Government's total revenue.
- Other operating revenue (#) comprises —
 - Motor Vehicles First Registration Tax (\$4B)
 - Loans, Reimbursements and Others (\$2.6B)
 - Air Passenger Departure Tax (\$1.5B)
 - Fines, Forfeitures and Penalties (\$1B)
 - Royalties and Concessions (\$0.6B)
 - Hotel Accommodation Tax (\$0.3B)
- Other capital revenue (*) comprises —
 - Loan Fund (\$6.1B)
 - Repayment of Loans and Others (\$3.7B)
 - Capital Works Reserve Fund (\$2.3B)
 - Capital Investment Fund (\$2.2B)
 - Lotteries Fund (\$1.4B)
 - Civil Service Pension Reserve Fund (\$1B)
 - Innovation and Technology Fund (\$0.2B)
 - Estate Duty (\$0.2B)
 - Recovery from Housing Authority (\$0.1B)

Revenue profile in past ten years



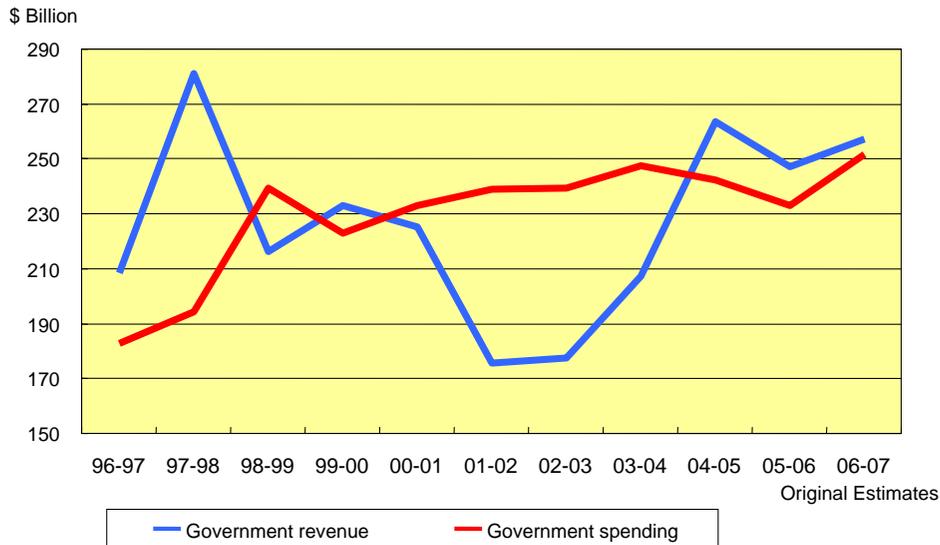
- Profits and salaries taxes together account for about 45% of government revenue. Such reliance on the income taxes would highly expose Hong Kong's public finances to variation in global economic cycles and external shocks.
- Non-tax revenue is primarily derived from land premium and earnings from the fiscal reserves. As a share of government revenue over the past ten years, the former has fluctuated between 3% and 28%, and the latter between 0.5% and 18%.
- With such volatility, these non-tax revenues clearly cannot be relied upon to help Hong Kong get over the tax base deficiency.

Maintaining a robust and sustainable fiscal system

- Continuing to maintain fiscal balance
- Divergent views of the community
 - Maintain Hong Kong's fundamental economic strengths
 - Save for the rainy days
 - Increase government spending
 - Help the poor and address their needs
 - Reduce taxes and give the middle class a respite
- Ageing population

- With the continuous economic expansion and Government's efforts to rein in expenditure, we have restored fiscal balance in 2005-06.
- A robust and sustainable public finance system is one of Hong Kong's fundamental economic strengths. We must observe strict fiscal discipline and avoid substantially increasing expenditure and reducing taxes just because of the good results in one or two years.
- On the other hand, the Government should respond promptly to the reasonable calls of the community and prepare to meet the challenges ahead.

Living within our means



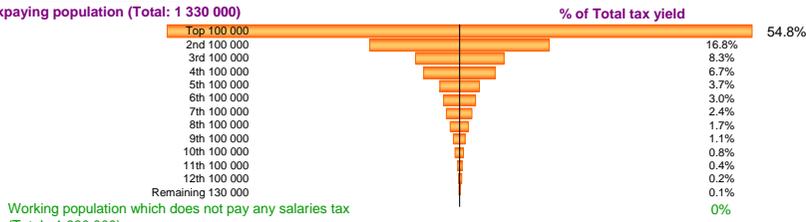
- The extent to which Government can increase spending in future years depends, inter alia, on how much revenue Government can generate.
- Over the past ten years, government revenue oscillated around \$170 billion to \$280 billion.
- On the other hand, there is a degree of rigidity in government spending. The decrease in government spending in the past two years from \$247.5 billion in 2003-04 to \$242.2 billion in 2004-05, then to \$233.1 billion in 2005-06 has not come easily.

Too few taxpayers

Salaries tax

1997-98 (Actual revenue)

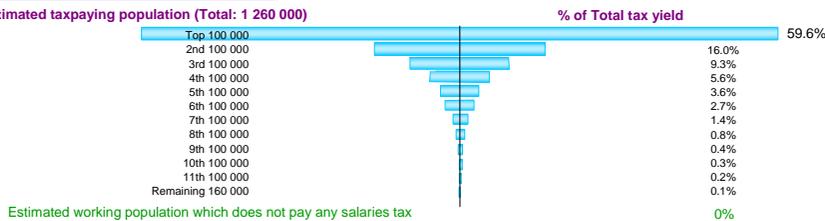
Taxpaying population (Total: 1 330 000)



* 2% of the working population pays at the standard tax rate of 15% and contributes about 43.9% of total salaries tax receipts.

2006-07 (Provisional assessment)

Estimated taxpaying population (Total: 1 260 000)



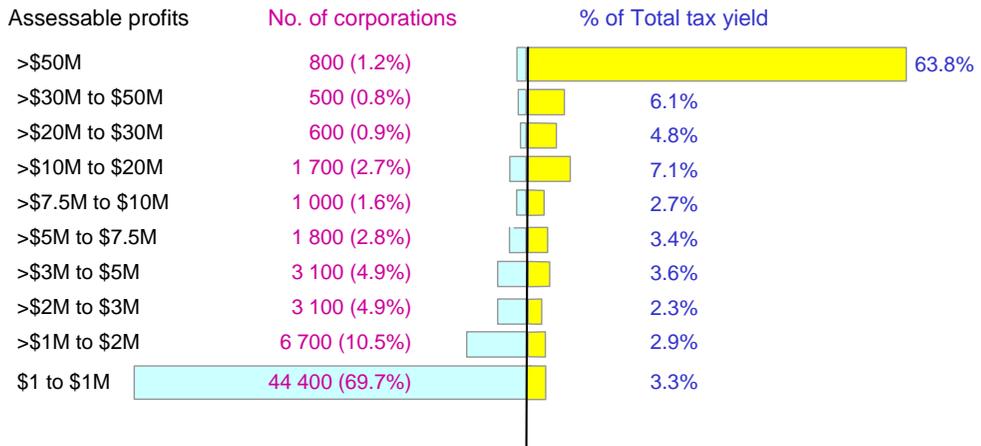
* 1% of the estimated working population pays at the standard tax rate of 16% and contributes 35.8% of total salaries tax receipts.

- The taxpaying population is expected to drop from 1.33 million in 1997-98 to 1.26 million in 2006-07 although the working population has increased from 3.16 million to 3.5 million over the same period.
- This chart also arranges salaries taxpayers in 1997-98 and 2006-07 in steps of 100 000 each according to their salaries tax bills, and measures 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 share contributed by this group was 59.6% in 2004-05 and is expected to stay at 59.6% in 2006-07.

Too few taxpayers

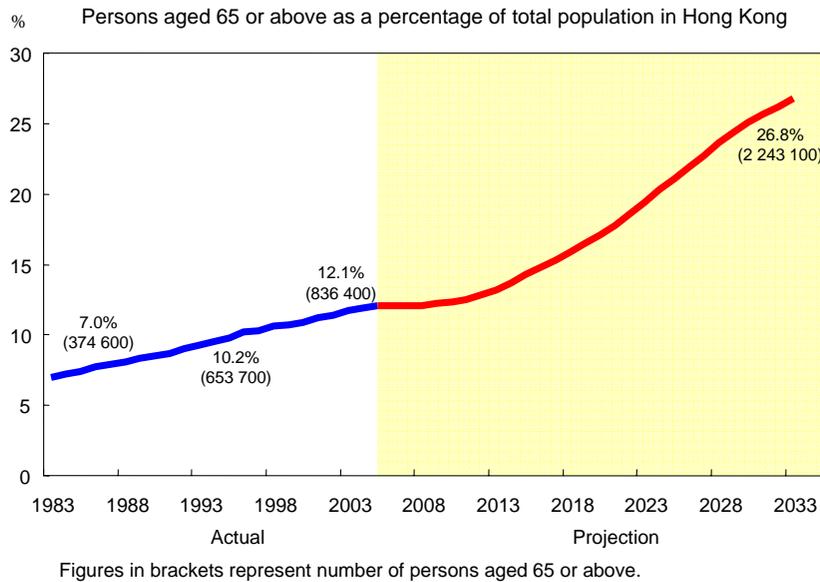
Profits tax

2004-05 (Actual revenue)



- This chart shows the distribution of our profits tax burden among the corporate taxpaying population in the year of assessment 2004-05.
- Some 60% of our profits tax is contributed by the top 800 taxpaying corporations out of more than 63 000 corporations. Most small businesses pay little or no tax.

Ageing population



- The percentage of persons aged 65 or above increased from 10.2% of Hong Kong's total population in 1996 to 12.1% in 2005. This percentage is forecast to rise to 26.8% by 2033.
- The rapid ageing of our population will lead to an increase in health care and social welfare expenditure for the elderly and a decrease, in relative terms, in revenue from salaries tax. These will hamper the sustainability of our public finances.

Three questions to be addressed in the tax reform

- Is our current tax base too narrow? Is there a need to broaden the tax base?
- What are the options to broaden the tax base? Is Goods and Services Tax (GST) an appropriate option?
- What are the key features that these options should have?

- There are three inter-related questions, which are the core of the current tax reform discussions.
- Our government revenue relies on a few direct taxes. Profits tax and salaries tax account for about 45% of the total income. Among other income, investment and property-related income (e.g. land premium, property tax, rates, government rents as well as stamp duties on property transactions) together account for almost 30%, which is a high proportion. Government revenue is therefore unstable.
- What are the options to broaden the tax base? Is GST a suitable option?
- What are the key features that these options should have?
- We welcome views from the community and encourage discussions on the subject.

Principles of tax reform

- **Taxpayers' perspective:** should be fair, comply with the “ability-to-pay” principle and not widen the wealth gap
- **Social perspective:** can produce stable and substantial revenue to respond to our future needs
- **Economic perspective:** should maintain Hong Kong's simple and low tax regime and international competitiveness

- When considering appropriate tax reform options for Hong Kong, we should take into account the following –
 - Fairness and the “ability-to-pay” principle. The design and accompanying measures should ensure that those with higher capacity to pay would shoulder greater tax burden and not widen the wealth gap;
 - Generation of stable and substantial revenue to provide resources to meet the social challenges and increasing needs of the community. The arrangements should remain effective even when there are changes in the economic environment and population structure; and
 - Transparency, predictability and maintenance of Hong Kong's simple and low tax regime. The arrangements should not undermine our international competitiveness.
- When examining GST, we have taken into consideration the above principles. We welcome views from the community on other viable tax reform options. We have an open mind to various options and will engage the public in discussing these options having regard to the above principles.

Sale and securitisation of government assets

- Principle of “Market Leads, Government Facilitates”
- Main focus is on proceeding with the merger of MTRCL and KCRC

- The Government will, in accordance with the principle of “Market Leads, Government Facilitates”, continue to identify suitable assets for sale or securitisation in order to reduce the share of the public sector in the economy and give more scope for the private sector to develop.
- In the process, we shall endeavour to ensure that the interests of the stakeholders will not be adversely affected.
- Programmes being pursued include merger of the two railway corporations.

Views are welcome

www.budget.gov.hk

- The Government welcomes advice and suggestions on how to reposition the Hong Kong economy and continue to maintain fiscal balance. Views on the 2007-08 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 2007-08 Budget.