# The 2012-13 Budget

## (Consultation on Revenue)

21 November 2011

# Content

# Latest 2011 economic indicators

| | | |
|---|---|---|
| GDP real growth | January to September | 5.6% (Third quarter 4.3%) |
| Unemployment rate | August to October | 3.3% (July to September 3.2%) |
| Consumer price inflation | January to September | 5.1% (September 5.8%) |

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

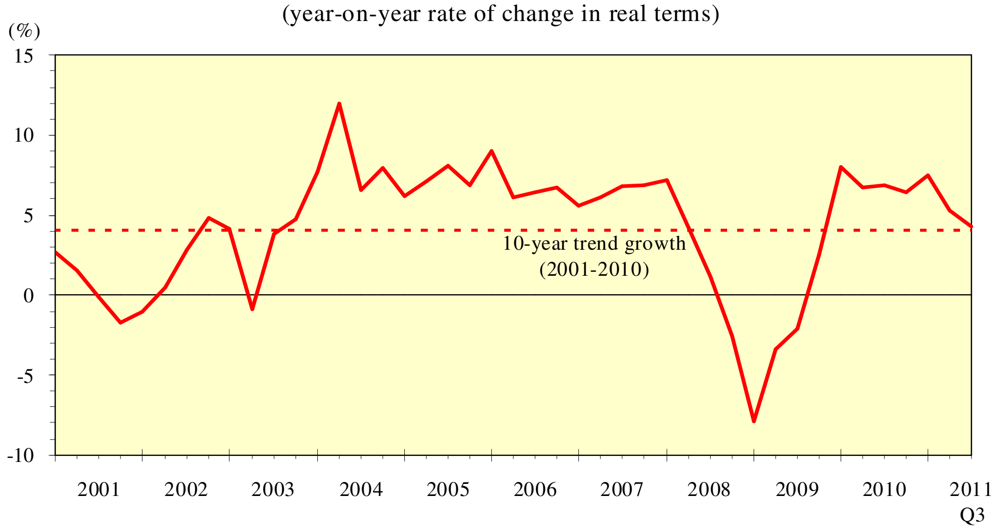
- Amid an increasingly difficult external environment, Hong Kong's economic growth slowed further to 4.3% in real terms in the third quarter of 2011 over a year earlier.

- The seasonally adjusted unemployment rate rose back slightly to 3.3% of late, though still at a low level. Inflation went up over the past year or so, reflecting the progressive feed-through of elevated import prices and rising local costs.

- The external environment has however worsened significantly of late, due to mounting concerns over the eurozone sovereign debt crisis and shaky recovery in the advanced economies. Hiring sentiment has also turned more cautious. As a small and open economy, the Hong Kong economy will inevitably be affected, with growth set to moderate further in the period ahead. We need to stay alert to the external developments and get prepared to cope with potentially big external shocks in 2012.

## Economy moderating after very rapid growth in the past year or so

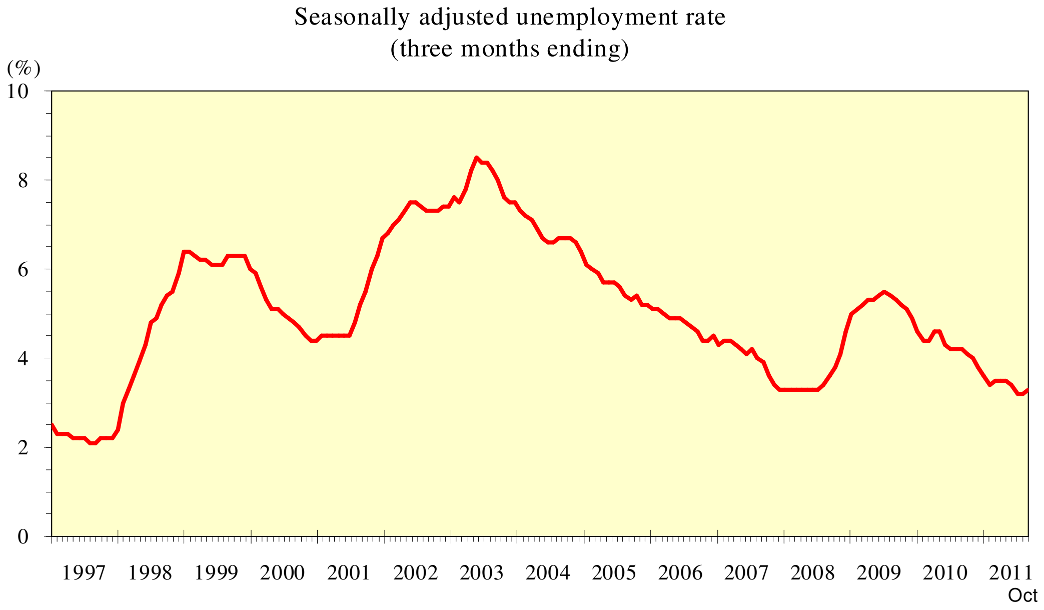
Gross Domestic Product
(year-on-year rate of change in real terms)




- After five consecutive quarters of distinctly above-trend growth, the Hong Kong economy has slowed visibly after the first quarter, and is poised for only a moderate growth in the fourth quarter. The near-term outlook is clouded by the austere global economic situation, characterised by subdued growth momentum in the advanced economies and heightened uncertainties over the eurozone sovereign debt crisis. Indeed, Hong Kong's merchandise exports have slackened markedly in recent months, and even the relatively resilient Asian region has seen signs of moderation.

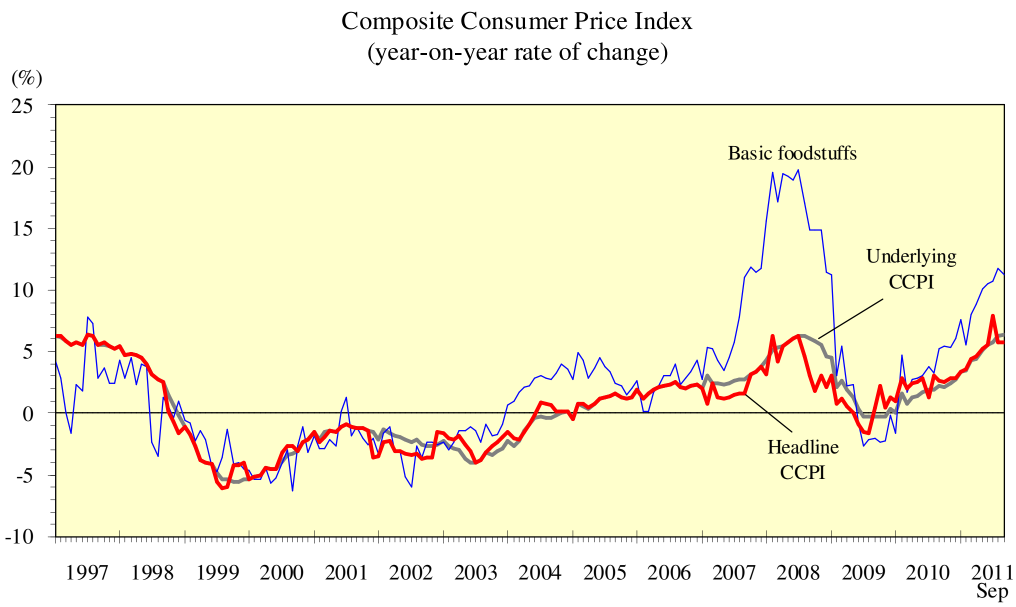
- At the same time, monetary stance in the advanced economies will likely stay loose for an extended period of time, given their sluggish economic performance and weak fundamentals. We also need to stay vigilant to the risks brought about by the persistent global liquidity glut and any potential disruption due to capital flow reversals.

## Labour market still close to full employment




- On the back of buoyant domestic sector, the unemployment rate fell to 3.3% in August-October 2011 from the peak of 5.5% in mid-2009. Total employment, at 3.64 million in the latest period, was generally on a strong uptrend over the past year. Meanwhile, wages and incomes showed accelerated increases across almost all segments of the workforce.

# Inflation up progressively

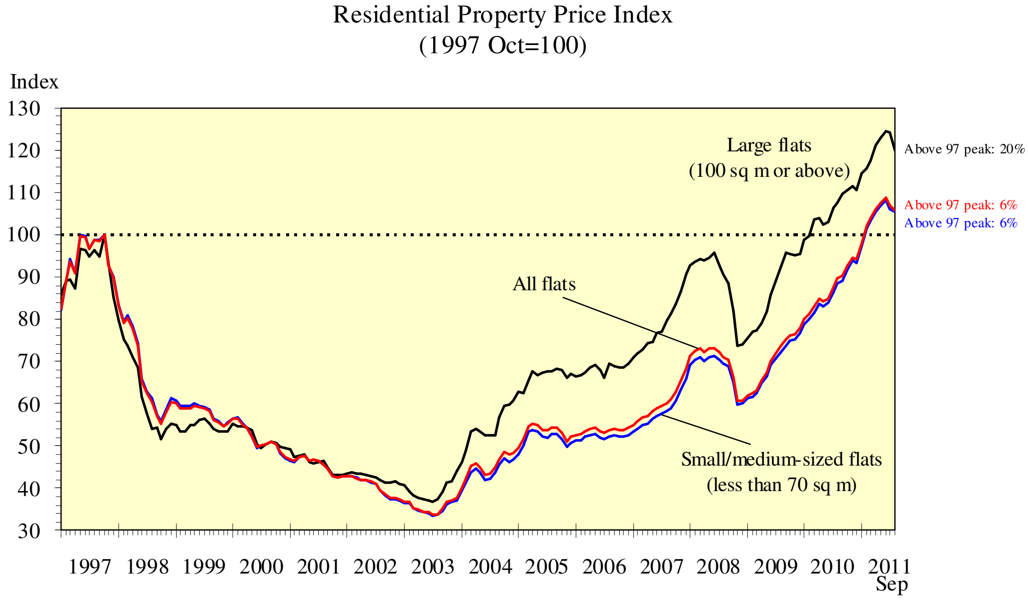



- Inflation climbed progressively over the course of 2011, driven by the stronger local cost pressures amid a buoyant domestic sector, as well as notable imported inflation due to the lagged effects from the surge in international food and commodity prices.

- The pace of rising inflation has nevertheless shown some initial signs of moderation of late, thanks to some ease-back in global food and commodity prices in recent months.

- We will stay vigilant to developments on the inflation front and closely monitor its impact on the lower-income people.

# Continued vigilance to property market bubble risk




- Following an almost uninterrupted boom since early 2009, residential property prices have retreated somewhat during the third quarter. Yet there was still a cumulative increase of 13% in the first nine months of the year. Flat prices in September 2011 were 6% higher than the 1997 peak, with prices of large flats exceeding the peak by a sharp 20%.

- Given the surge in flat prices since early 2009, home purchase affordability as indicated by the ratio of mortgage payment to median household income rose from 32% in the fourth quarter of 2008 to 46% in the third quarter of 2011, and would have exceeded the long-term average of 51% over 1990-2009 should interest rates return to a more normal level.

- To ensure a stable and healthy development of the market, since February 2010 the Government has introduced successive packages of measures along four directions, viz. raise flat supply through increasing land supply, curb speculative activities, prevent excessive growth of mortgage lending and increase transparency of the property market. The Chief Executive has also introduced in the 2011-12 Policy Address new housing measures. Notwithstanding the recent consolidation, the Government will stay mindful of the property market bubble risk, and will closely monitor the property market situation.

## Latest forecast for 2011

| | |
|---|---|
| GDP real growth | 5% |
| Consumer price inflation | |
| Underlying | 5.3% |
| Headline | 5.2% |

- The near-term export outlook is bleak given the fragile conditions in the advanced economies and slowing regional trade flows of late. The domestic sector has held up well so far, and has provided a strong cushion against the setback in external trade.

- Given the actual outturn in the first three quarters and in view of the expected further moderation in the rest of the year, the economy is projected to grow by 5% for 2011 as a whole.

- On inflation outlook, a more positive development has been the continued ease-back of global food and commodity prices in recent months, which in time should help alleviate imported inflation. Judging from the latest trends, inflation is likely to peak out during the fourth quarter of 2011. Headline and underlying consumer price inflation rates for 2011 as a whole are forecast at 5.2% and 5.3% respectively.

## Economic uncertainties

- Eurozone sovereign debt crisis
- Risk of a significant global downturn
- Resurgence of protectionist sentiment
- Gyrations in exchange rates and financial market volatility

- As a small and open economy, Hong Kong is inevitably susceptible to external shocks. In face of greater downside risks to our economy next year, we must brace ourselves and stay vigilant to external developments. We also need to stay competitive and maintain our economic vibrancy to cope with changes in the global economy.

- The centre of global economic gravity has been shifting towards the East, especially after the financial tsunami in 2008. Hong Kong is in the best position to reap benefits from the vibrant Asia. Given our sound fundamentals, as long as we keep seizing new development opportunities around the globe and leverage our unique advantages to complement the national development, Hong Kong's economic prospects over the medium- to long-term remain bright.

## Key New Expenditure Initiatives

### Education

- New International Cuisine College
- New Youth College
- Injection into the Research Endowment Fund
- Injection into the Start-up Loan Scheme
- Extension of school-based educational psychology service

The Chief Executive announced a number of new initiatives in his 2011-12 Policy Address. On education, these include –

- setting up an International Cuisine College under the Vocational Training Council (VTC) to provide training for people aspiring to become professional chefs;
- establishing one more youth college under VTC to provide specialised support for non-Chinese speaking students and those with special educational needs, as well as alternative progression pathways for young people;
- injecting $5 billion into the Research Endowment Fund. Of that, $3 billion is for self-financing tertiary institutions. Investment income of the remaining $2 billion will replace the existing recurrent research grants to University Grants Committee-funded institutions;
- extending the ambit of the Start-up Loan Scheme to support the development of student hostels by self-financing degree awarding institutions and increasing the total commitment of the Scheme by $2 billion; and
- extending the school-based educational psychology service from the existing 55% progressively to all public sector schools by the 2016/17 school year.

# Key New Expenditure Initiatives

## Health

- Voluntary Health Protection Scheme
- Enhancing health services
- Elderly Health Care Voucher
- Healthcare Personnel Training

New initiatives in relation to public health include –

- preparing for the implementation of a government-regulated voluntary Health Protection Scheme;
- enhancing public health care services such as cataract removal, haemodialysis, joint replacement, mental health services, magnetic resonance imaging and computerised tomography scanning services, coverage of the Drug Formulary, and long term care services for frail elderly people;
- extending the Elderly Health Care Voucher Pilot Scheme and doubling the voucher value; and
- increasing the number of first-year first-degree places in medicine, nursing and allied health professions.

## Key New Expenditure Initiatives

### Social Welfare

- Public transport concessionary fare
- New supplement for elders and disabled persons on CSSA
- Guangdong Old Age Allowance Scheme
- More residential care places for elders
- More jobs for disabled persons

New social welfare initiatives include –

- $2 concessionary fare to elderly aged 65 or above and eligible people with disabilities to travel on the general MTR lines, franchised buses and ferries;
- new supplement for elders and disabled persons on Comprehensive Social Security Assistance living in non-subsidised homes;
- new Guangdong Scheme to provide Old Age Allowance for eligible Hong Kong elderly people residing in Guangdong;
- more residential care places for elders under the Enhanced Bought Place Scheme and more subvented nursing home and long-term care places; and
- injecting $100 million into "Enhancing Employment of People with Disabilities through Small Enterprises" Project to create more jobs for disabled persons.

## Key New Expenditure Initiatives

### Others

- Dedicated fund to help Hong Kong enterprises tap the Mainland market
- Electric buses
- Taxi and light bus catalytic converters
- Enhancing building safety

New initiatives for other policy area groups include –

- setting up a 5-year dedicated fund of $1 billion to support Hong Kong enterprises in developing their brands, promoting domestic sales and upgrading and restructuring their operation in the Mainland, so as to help them capture the opportunities arising from the National 12th Five-Year Plan;

- earmarking $180 million to fund the purchase of 36 electric buses for trial by franchised bus companies;

- setting aside $150 million for a one-off subsidy to help owners of liquefied petroleum gas taxis and light buses to replace catalytic converters; and

- enhancing building safety through new legislation and stepping up enforcement against unauthorised building works.

## Key New Expenditure Initiatives

### Capital Works

- Ten Major Infrastructure Projects
- Increase land supply
- Waste management facilities
- Various community facilities including hospitals, schools, sports centres, etc.

On capital works, we will –

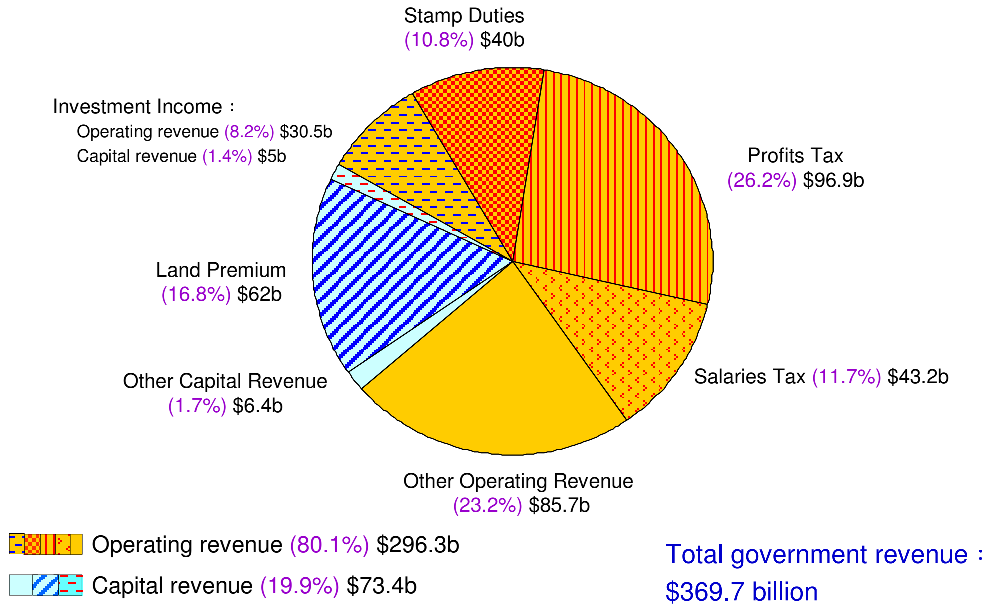
- continue to press ahead with the ten major infrastructure projects. Specifically, we will seek funding for the Hong Kong – Zhuhai – Macao Bridge, Shatin to Central Link, and advance works for Tuen Mun – Chek Lap Kok Link in the current legislative session;

- continue to implement infrastructural works to facilitate land production. We will also actively seek out innovative ways to expand land resources by exploring the use of rock caverns to reprovision existing public facilities and release such sites for housing and other uses;

- take forward the projects for advanced waste management facilities and extension to existing landfills to ensure solid waste can continue to be properly managed in an environmentally acceptable manner; and

- construct various facilities at the district level, including hospitals, schools and sports centres, to meet public needs and community aspirations.

# Revenue for 2011-12

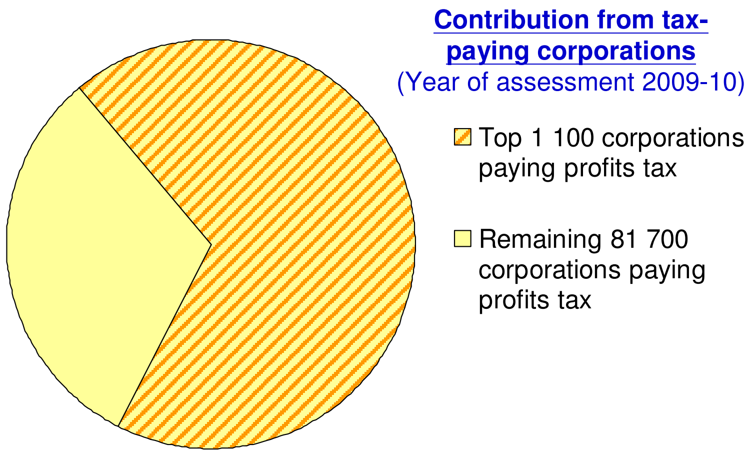



- The five major revenue items are profits tax (26.2%), salaries tax (11.7%), stamp duties (10.8%), investment return from fiscal reserves (mainly from placement of the fiscal reserves with the Exchange Fund) (9.6%) and land premium (16.8%). Together they account for 75.1% of total government revenue. Other than the investment return from fiscal reserves, the other four items are sensitive to economic fluctuations.

# Profits Tax

**Actual Revenue 2009-10**

Profits Tax :
$76.6 billion (24% of total government revenue)




- Only 83 000 or 12% of the 688 000 registered corporations paid profits tax. Nearly 90% of the corporations do not pay any tax. 1 100 corporations (0.16% of registered corporations) contributed 69% of the corporate profits tax revenue.

## Profits Tax for Year of Assessment 2009-10

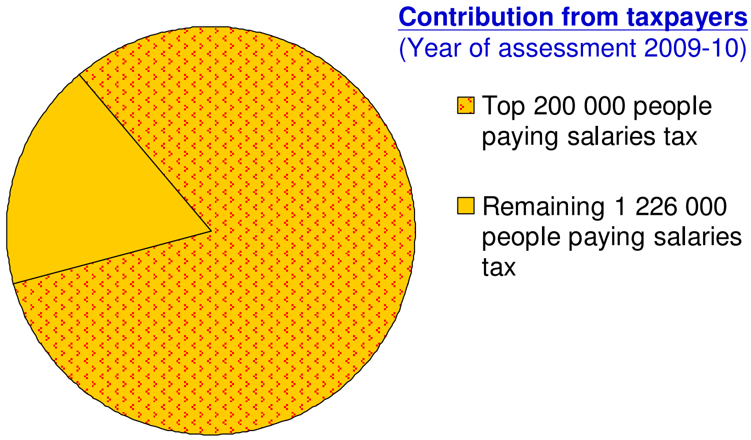
| Net Assessable Profits | No. of Registered Corporations | Average Tax |
|---|---|---|
| ($) | | ($) |
| 1 – 500,000 | 49 200 | 24,390 |
| 500,001 – 1,000,000 | 9 900 | 121,210 |
| 1,000,001 – 2,000,000 | 8 100 | 234,570 |
| 2,000,001 – 3,000,000 | 3 700 | 405,410 |
| 3,000,001 – 5,000,000 | 3 700 | 648,650 |
| 5,000,001 – 7,500,000 | 2 200 | 1,045,460 |
| 7,500,001 – 10,000,000 | 1 300 | 1,384,620 |
| 10,000,001 – 20,000,000 | 2 100 | 2,285,710 |
| 20,000,001 – 30,000,000 | 800 | 3,875,000 |
| 30,000,001 – 50,000,000 | 700 | 6,571,430 |
| 50,000,001 – 100,000,000 | 500 | 12,000,000 |
| Over 100,000,000 | 600 | 80,166,670 |
| **Total** | **82 800** | **952,900** |

- Almost 60% of the tax-paying corporations were subject to an average tax of less than $25,000.
- Another 22% of the tax-paying corporations paid an average tax of far less than $250,000.

# Salaries Tax

## Actual Revenue 2009-10

Salaries Tax : $41.2 billion (13% of total government revenue)




- In 2009-10, of the 3.5 million working population, 2.1 million or 60% of the working population need not pay any salaries tax.

- Of the 1.4 million who paid salaries tax, 200 000 (6% of working population) contributed 82% of the revenue from salaries tax.

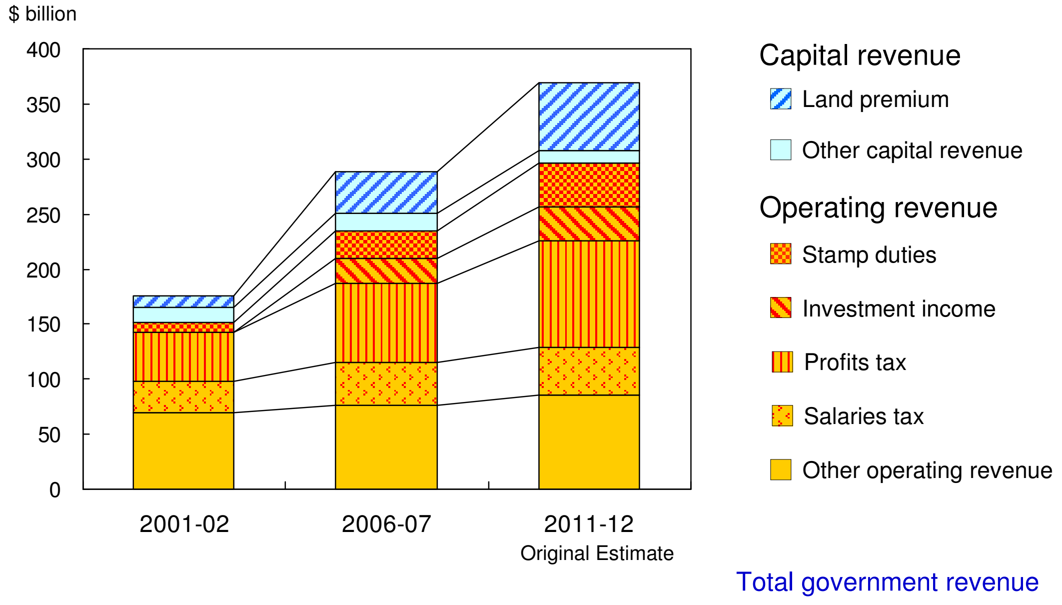
## Salaries Tax for Year of Assessment 2009-10

| Annual Income | No. of Taxpayers | Average effective tax rate * | Average tax * |
|---|---|---|---|
| ($) | | (%) | ($) |
| 108,001 – 150,000 | 211 000 | 0.3 | 350 |
| 150,001 – 300,000 | 577 000 | 1.8 | 4,030 |
| 300,001 – 600,000 | 436 000 | 5.2 | 21,490 |
| 600,001 – 900,000 | 99 000 | 9.7 | 69,740 |
| 900,001 – 1,500,000 | 62 000 | 12.2 | 137,350 |
| 1,500,001 – 3,000,000 | 29 000 | 14.1 | 284,860 |
| Over 3,000,000 | 12 000 | 14.8 | 1,022,450 |
| **Total** | **1 426 000** | **7.8** | **33,440** |

* Before the one-off tax reduction of up to $6,000

- As a result of allowances and deductions under salaries tax, for 2009-10, even before the one-off tax reduction -
  - 85.8% of taxpayers (up to annual income of $600,000) were subject to an average effective tax rate and average tax of less than 5.5% and $22,000 respectively;
  - the average effective tax rate and average tax for taxpayers with annual income from $600,001 to $900,000 was only 9.7% and less than $70,000 respectively; and
  - the overall average effective tax rate and average tax for all salaries tax payers was 7.8% and $33,440 respectively.

# Revenue in past 10 years




- Profits tax has been our largest operating revenue. It varied from $38.8 billion in 2002-03 to $104.2 billion in 2008-09.

- Salaries tax has been our second or third largest operating revenue. It varied from $28 billion in 2003-04 to $44.3 billion in 2010-11.

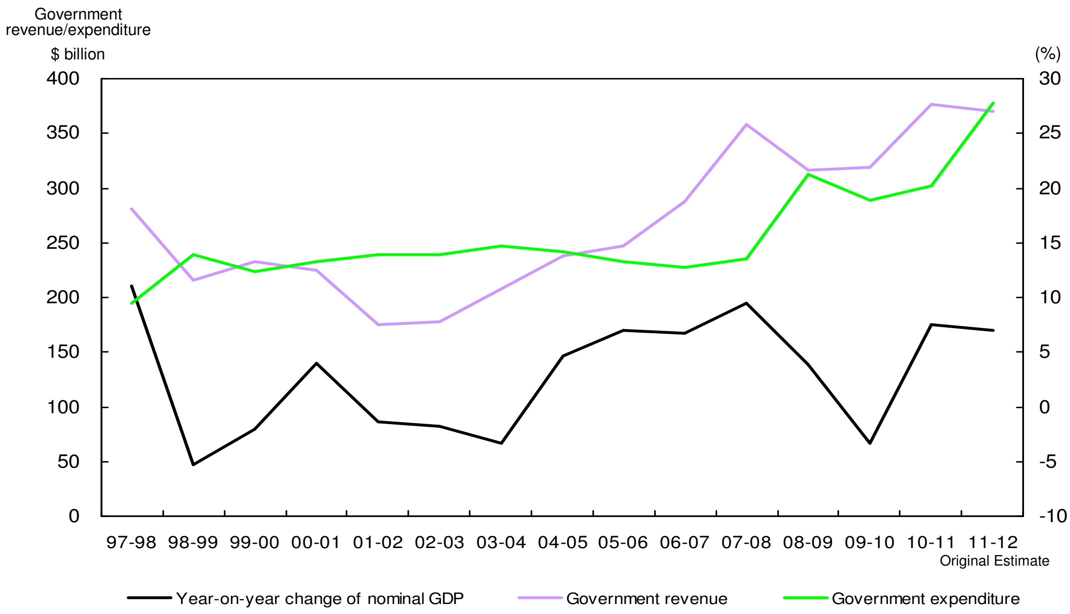
- Stamp duties varied from $7.5 billion to $51.5 billion for the period.

- Since 1 April 2007, we have adopted an arrangement whereby the rate of investment return is pre-determined based on past returns. This has greatly reduced the uncertainty in budgeting. The average annual revenue from this source exceeded $30 billion for the years from 2007-08 to 2010-11.

- As for capital revenue, land premium has been most volatile, fluctuating from $5.4 billion to $65.5 billion in the past 10 years.

- Revenue volatility poses challenges to the management of public finances.

# Fiscal Reserves (1)



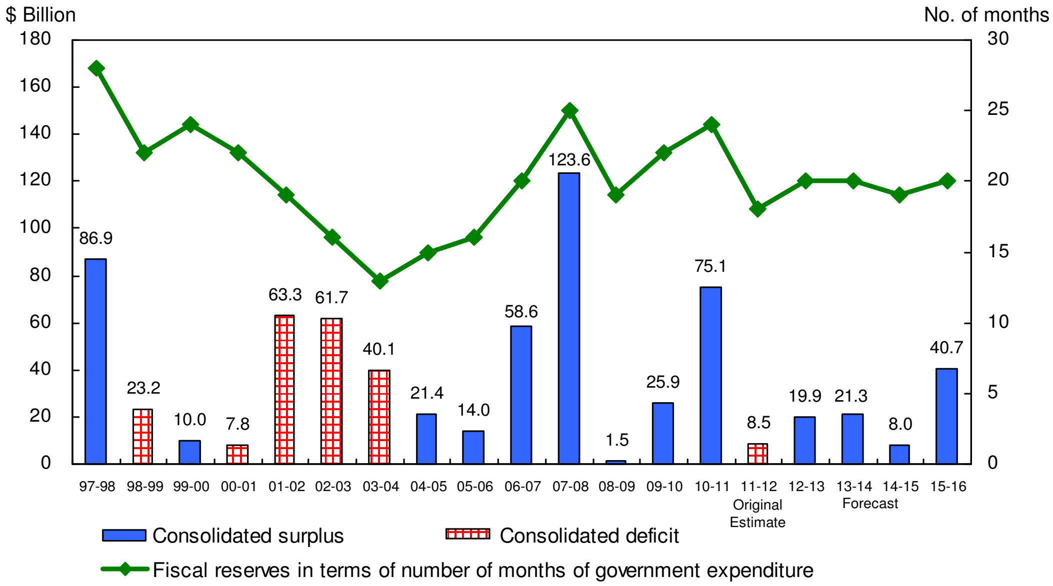

- Our fiscal reserves have helped us iron out income volatilities.

- Using the reserves to fund budget deficits in times of economic and fiscal difficulties, we managed to maintain our expenditure at a relatively stable level despite reductions in GDP and revenue.

- In the six years from 1998-99, we used the reserves to fund five years of deficit, reducing the reserves by some $200 billion.

- When GDP was forecast to contract by 2.5% in 2009, we adopted a counter-cyclical fiscal policy and put forward an expansionary budget. Excluding expenditure items not having immediate impact on the economy, public expenditure in terms of percentage of GDP increased from 16.7% in the 2008-09 Budget to 19.4% in the 2009-10 Budget.

# Fiscal Reserves (2)




- The fiscal reserves provide a safety cushion to shield us from the year-on-year volatility of our revenue. This enables us to achieve fiscal balance over a period of time.

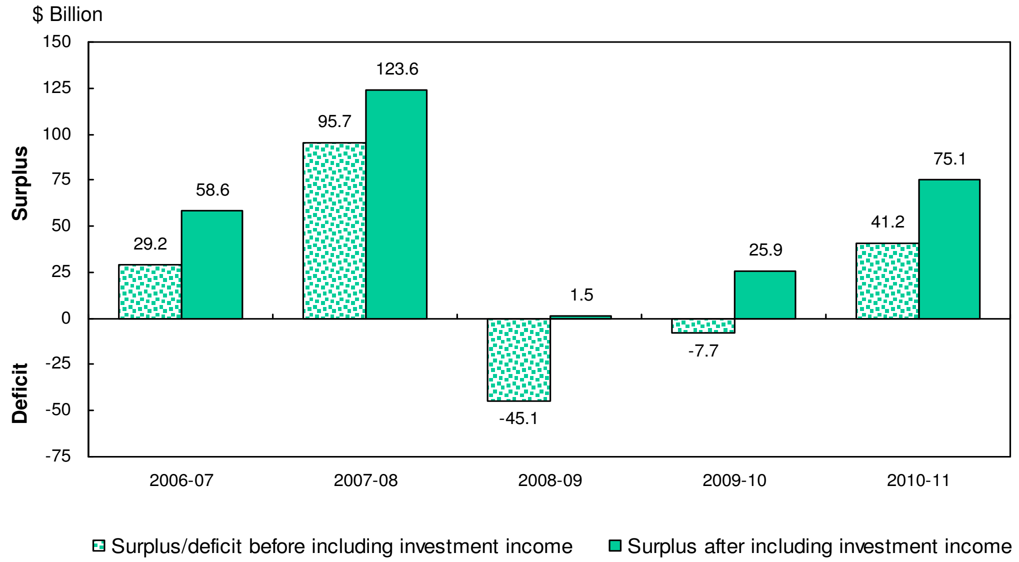
- We rely on the fiscal reserves as a means of paying our unfunded liabilities and the expenditure on projects already launched.

  - The present value of public officers pension obligations was estimated at $470 billion as at 31 March 2010.

  - As at 30 September 2011, outstanding commitment of existing capital works projects stood at $207 billion in money-of-the-day prices.

- In terms of number of months of government expenditure, fiscal reserves at 31 March 2011 was 24 months, compared to 28 months at 31 March 1998.

# Fiscal Reserves (3)

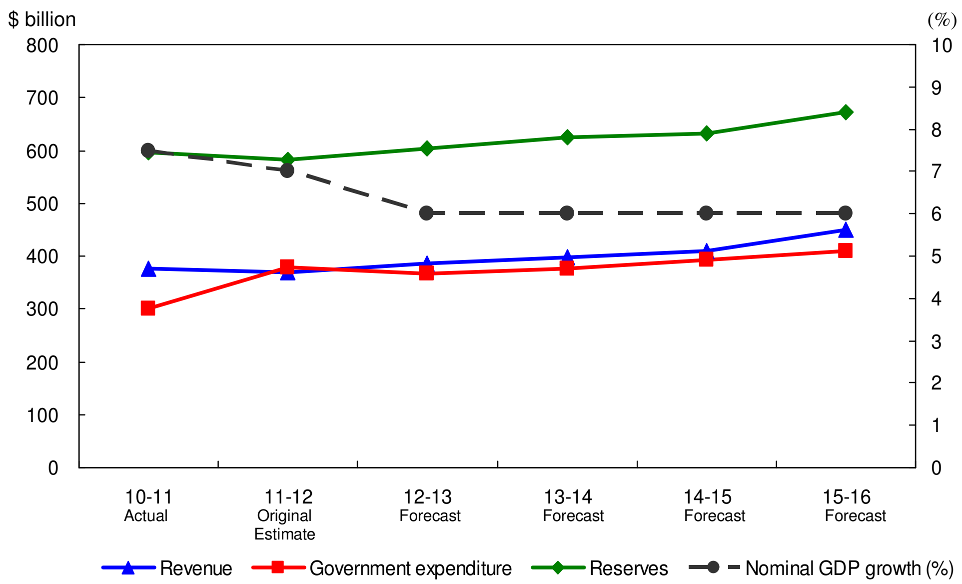



- Investment income from the fiscal reserves is part of government revenue and is used to fund government services. In the 2011-12 Budget, it is the fifth largest government revenue item (9.6% of total).

- The amount of investment income depends, in part, on the level of our fiscal reserves.

- If not for the investment income generated by the fiscal reserves, we would have experienced two deficits (instead of none) in the past five years.

## Medium Range Forecast in 2011-12 Budget




- This is the Medium Range Forecast (MRF) announced in the 2011-12 Budget. We will publish an updated MRF later together with the 2012-13 Budget.

- Over the period covered by the MRF, government spending was projected to continue to increase given the need to fund capital works expenditure and to provide for new or improved services that our society needs.

# Your views are welcome!

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