The 2003-04 Budget

Information Pack for

The Financial Secretary's Consultations

with LegCo Members

October 2002

Introduction

The Financial Secretary will hold a series of meetings with Members of the Legislative Council in November 2002 to consult Members on the 2003-04 Budget. Members are invited to send in their written submissions before or after those consultation sessions.

To facilitate discussions during the consultation sessions, we have prepared the attached charts for Members' reference. These charts are based on forecasts made in March 2002.

As in the past, the Government will continue to follow the guiding principle of prudent management of public finances. Earlier, the Financial Secretary set three targets for our public finances in 2006-07. We aim to achieve these targets step by step through reducing the growth of government expenditure and modestly raising revenue.

Chart 1

Contents

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.

I. Budget Principles

Chart 3

Targets/ Benchmark in 2006-07

Targets

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

Benchmark

- Maintain fiscal reserves equivalent to around 12 months of government expenditure

- In the 2002 Budget Speech, the Financial Secretary set three targets for our public finances on 2006-07:

  - first, restore balance in the Consolidated Account;
  - second, attain a balanced Operating Account; and
  - third, reduce public expenditure to 20% of GDP or below.

- He also stated that the Government should have fiscal reserves equivalent to around 12 months of Government expenditure in 2006-07 to meet operating and contingency requirements.

II. Medium Range Forecast (in 2002 Budget Speech)

Chart 4

Medium Range Forecast 2002-03 To 2006-07

Economic Assumptions

- Trend annual nominal growth of 3.4%
  - Average annual real growth of 3%
  - Average annual GDP Deflator of 0.4%
- Trend annual CCPI of 0.3%

- The Medium Range Forecast (MRF) is a projection of expenditure and revenue for the forecast period based on the forecasting assumptions and budgetary criteria outlined in 2002 Budget Speech.
- This chart shows the parameters of economic assumptions adopted by the MRF for 2002-03 to 2006-07.

Chart 5

Medium Range Forecast 2002-03 To 2006-07

Expenditure Assumptions

- Nominal growth of 0.6% in 2002-03 over the original estimate for 2001-02, or 6.2% over the revised estimate and average annual growth of 1% in 2003-04 to 2006-07
- Underlying real growth of 2% in 2002-03 over the original estimate for 2001-02, or 7.7% over the revised estimate and average annual real growth of 1.5% in 2003-04 to 2006-07
- 4.75% civil service pay cut with annual expenditure savings of $6 billion

- This chart shows the expenditure assumptions employed by the MRF for 2002-03 to 2006-07.
- The actual civil service pay cut in 2002 only produces annual expenditure savings of $3 billion, half of the original assumption.

Chart 6

Medium Range Forecast 2002-03 To 2006-07

Revenue Assumptions

- Revenue to grow broadly in line with nominal GDP
- Annual land premium at 2% of nominal GDP
- Rate of Investment Return on Fiscal Reserves at 4% in 2002-03 and 5.5% in 2003-04 to 2006-07
- Additional recurrent revenue of $1 billion expected in 2003-04 onwards on reversion of duty on ULSD from $1.11/ litre to $2.89/ litre on 1.4.2003

- This chart shows the revenue assumptions adopted in the MRF of 2002-03 to 2006-07.

II. Medium Range Forecast (in 2002 Budget Speech)

Chart 7

Medium Range Forecast 2002-03 To 2006-07

Other Assumptions

- Additional recurrent revenue raising / expenditure reduction measures of $2 billion in 2003-04, rising to $9 billion in 2005-06 ($1 billion per annum expected from Boundary Facilities Improvement Tax from 2004-05)

- Additional one-off capital revenue / expenditure reduction of $10 billion each in 2004-05 and 2005-06

- This chart shows other assumptions adopted in the MRF of 2002-03 to 2006-07.

II. Medium Range Forecast (in 2002 Budget Speech)

Chart 8

Medium Range Forecast 2002-03 To 2006-07 Consolidated Deficit

(in $ billion)	2002-03	2003-04	2004-05	2005-06	2006-07
Government Revenue	214.6	223.2	245.3	262.2	265.6
Operating and Capital Revenue	200.8	206.4	230.0	247.3	250.8
Investment Income	13.8	16.8	15.3	14.9	14.8
Government Spending	259.8	261.9	261.2	262.1	265.5
Government Expenditure	254.3	253.3	255.6	259.1	264.0
Capital Investment Fund investments and advances	5.5	8.6	5.6	3.0	1.5
Consolidated surplus / (deficit)	(45.2)	(38.7)	(15.9)	0.1	0.1
As a % of GDP (Note)	3.6%	2.9%	1.1%	0.0%	0.0%

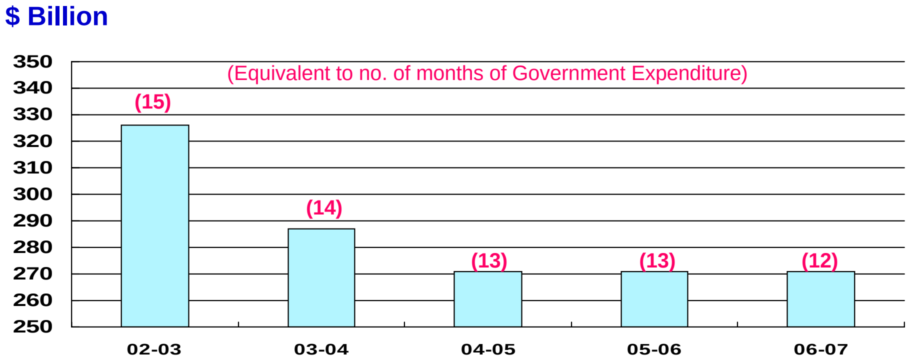
Note: GDP forecast based on August 2002 update

- This chart shows that the Consolidated Account will be in deficit from 2002-03 to 2004-05. The financial position will improve gradually and attain a balanced account in 2005-06 to 2006-07.

II. Medium Range Forecast (in 2002 Budget Speech)

Chart 9

Fiscal Reserves



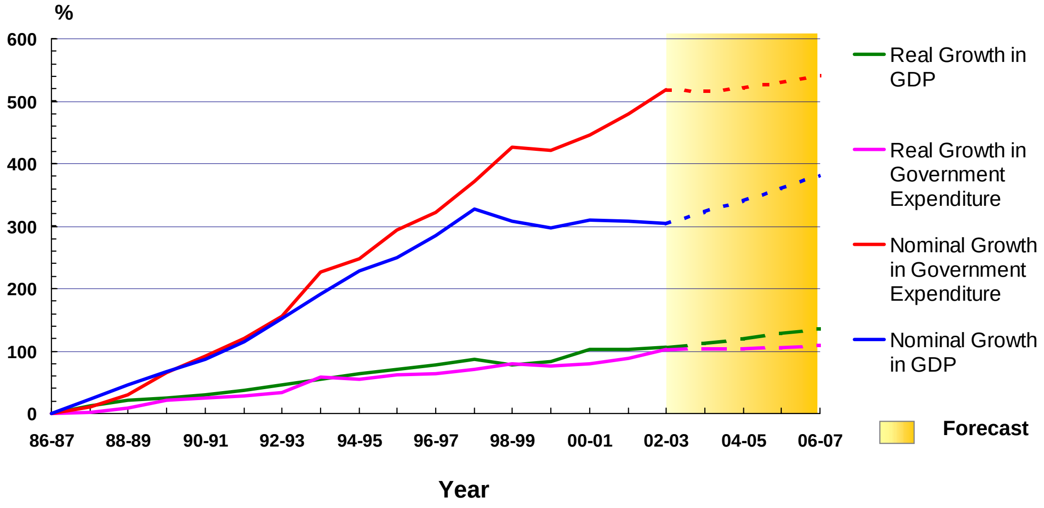
- Fiscal reserves will fall in the medium term.

- This chart shows that the fiscal reserves are forecast to decrease from $325.6 billion in 2002-03 to $271.2 billion in 2006-07. Reserves in 2006-07 will be equivalent to 12 months of government expenditure.

II. Medium Range Forecast (in 2002 Budget Speech)

Chart 10

Comparison of Cumulative Growth in Government Expenditure and Cumulative Growth in GDP given the Introduction of Medium Range Forecast



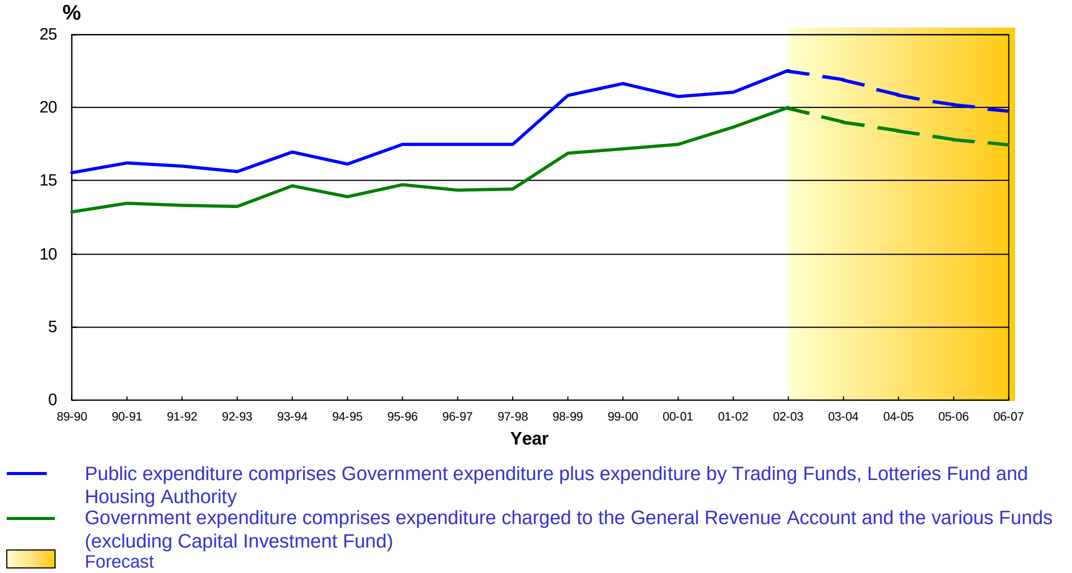
Note: GDP forecast based on August 2002 update

- Real growth in Government expenditure has been broadly in line with the growth in GDP in real terms.
- Nominal growth in Government expenditure has overshot nominal growth in GDP in recent years.

II. Medium Range Forecast (in 2002 Budget Speech)

Chart 11

Public/ Government Expenditure As a Percentage of GDP



Note: GDP forecast based on August 2002 update

- This chart shows that the Public/ Government Expenditure as a percentage of GDP has been rising in recent years. Public expenditure will reach 23% of GDP in 2002-03.

III. Expenditure

Chart 12

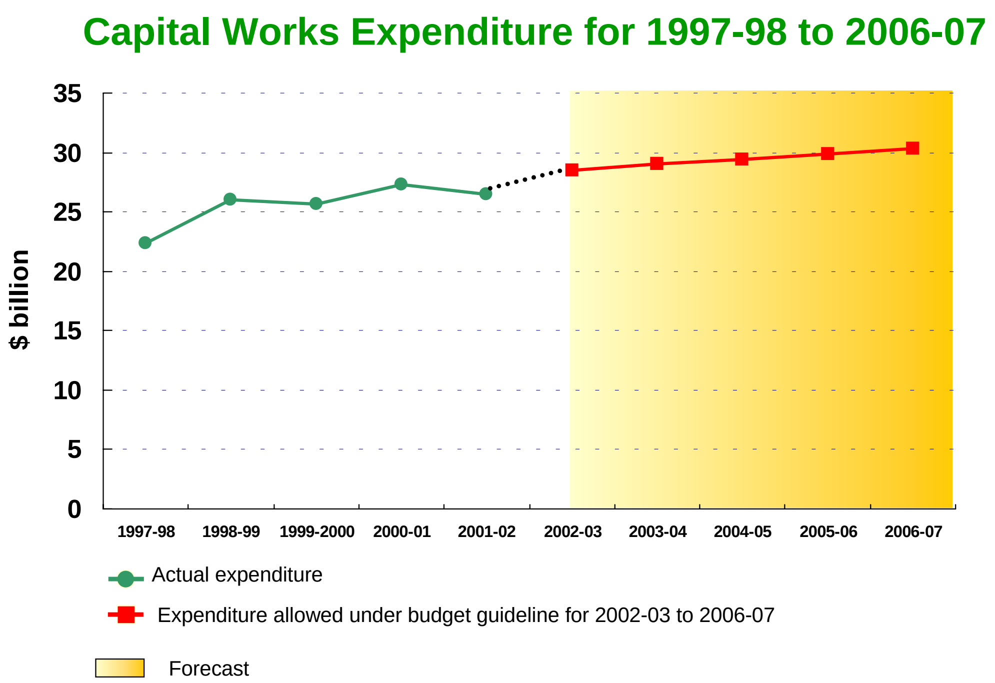
Rigidity of Government Expenditure

Major Operating Expenditure Components	2001-02 % of Operating Expenditure	2001-02 % of Total Expenditure
Personal Emoluments	26.12	21.76
Personnel Related Expenses (e.g.pension)	8.94	7.45
Subventions (Staff related)	33.91	28.24
Social Security	9.89	8.23
Total	78.86	65.68

- This chart shows that 79% of Government's operating expenditure or 66% of total expenditure is resistant to reduction in both real and nominal terms.

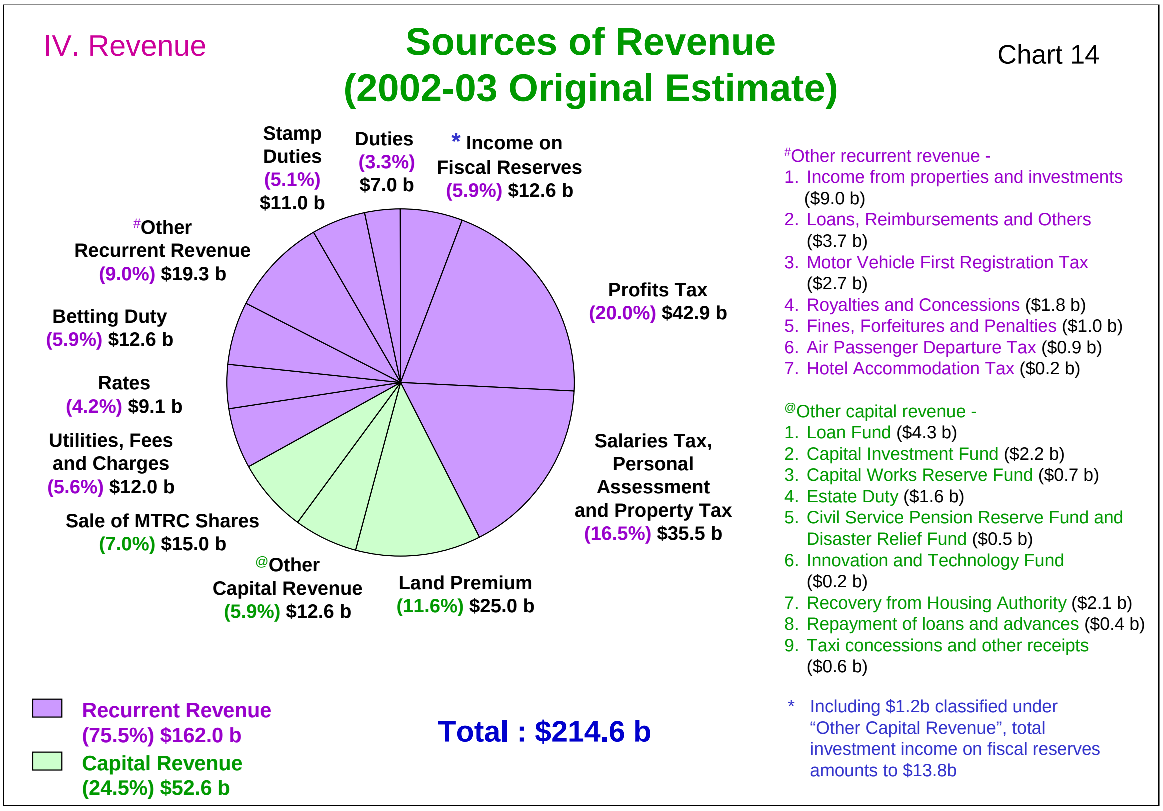
III. Expenditure

Chart 13



- The green line on this chart shows the actual expenditure on capital works for the period 1997-98 to 2001-02. During this five-year period, the average annual capital works expenditure was around $27 billion.

- The expenditure allowed under the budget guideline for the period 2002-03 to 2006-07 totals $147 billion. As reflected through the red line, this provision implies an average annual capital works expenditure of about $29 billion, which is higher than the average spending in the past few years.



- This chart gives an overview of Government recurrent and capital revenue sources based on the 2002-03 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 2002-03. Together they contribute 36.5% of total Government revenue.

- Land premium, an important source of capital revenue, contributes 11.6% of Government revenue in 2002-03.

IV. Revenue

Chart 15

Revenue from Investment Income on Fiscal Reserves and Land Premium Declining

Government Revenue	1998-99 $Billion (%)	1999-2000 $Billion (%)	2000-01 $Billion (%)	2001-02 $Billion (%)	2002-03 (Original Estimate) $Billion (%)
Profits Tax	45.3 (20.9%)	37.7 (16.2%)	43.0 (19.1%)	44.4 (25.3%)	42.9 (20.0%)
Salaries Tax, Personal Assessment and Property Tax	30.5 (14.1%)	29.2 (12.5%)	30.9 (13.7%)	33.4 (19.0%)	35.5 (16.5%)
Utilities, Fees and Charges	15.0 (6.9%)	14.2 (6.1%)	14.3 (6.3%)	14.3 (8.1%)	12.0 (5.6%)
Investment Income on Fiscal Reserves	39.3 (18.2%)	41.9 (18.0%)	23.5 (10.4%)	0.9 (0.5%)	13.8 (6.4%)
Land Premium	19.3 (8.9%)	34.8 (14.9%)	29.5 (13.1%)	10.3 (5.9%)	25.0 (11.6%)
Sale of MTRC Shares	--	--	10.0 (4.4%)	--	15.0 (7.0%)

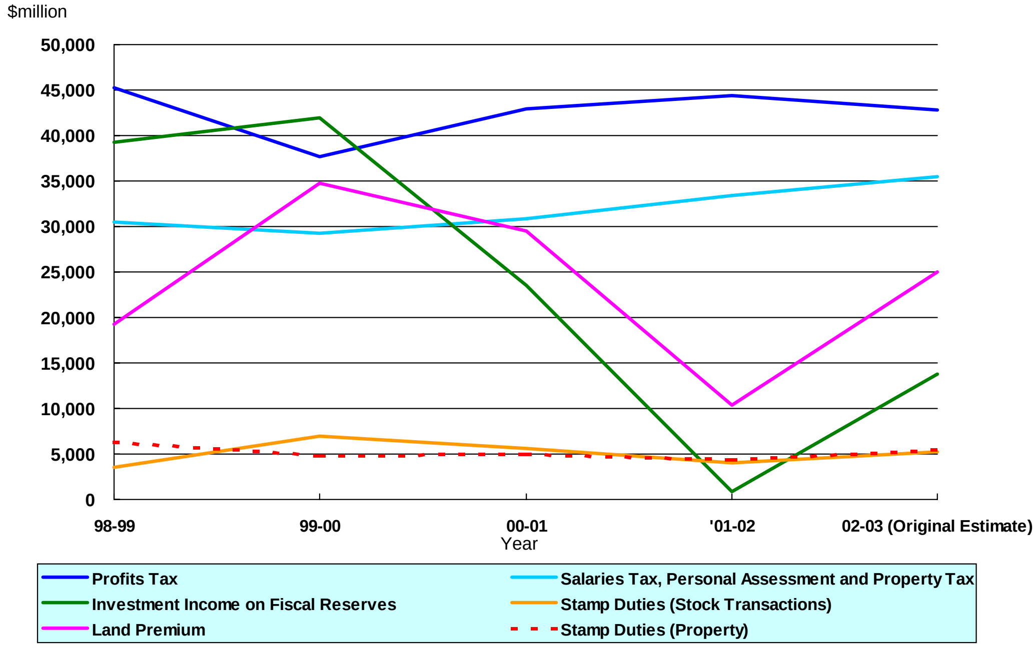
*** Figures in brackets represent the % out of total government revenue**

- This chart shows the revenue figures from the five largest revenue sources in the five years from 1998-99 to 2002-03, and revenue from the sale of MTRC shares.

IV. Revenue

Chart 16

Major Revenue Sources On Declining Trend

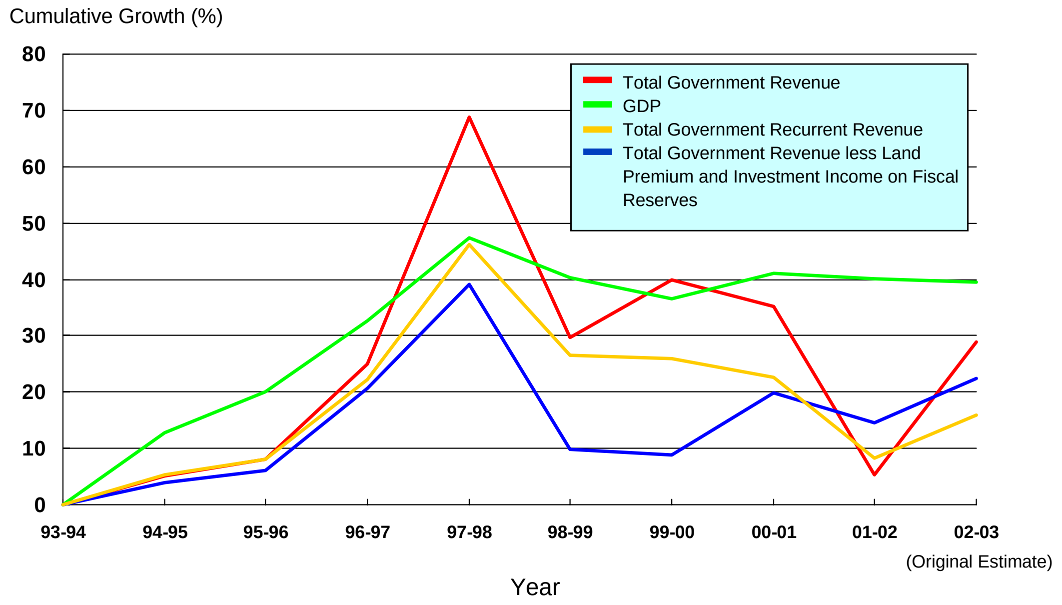


- Revenue from the major sources (namely, profits tax, investment income on fiscal reserves, salaries tax, personal assessment and property tax, land premium, stamp duty on property and stamp duty on stock transactions) have been on a declining trend over the past four years.

IV. Revenue

Chart 17

Growth in Government Revenue Falls Behind Growth in GDP



- This chart compares the cumulative growth in total Government revenue with the cumulative growth in GDP over the last ten years.

- The growth in recurrent revenue has been falling behind the growth in GDP in recent years.

IV. Revenue

Chart 18

Major Recurrent Revenue Sources As Percentages of Total Recurrent Expenditure Declining

Government Revenue	1997-98		2002-03 (Original Estimates)	
	$ Billion	(%)	$ Billion	(%)
Profits Tax	55.3	(37.0%)	42.9	(20.9%)
Salaries Tax, Personal Assessment and Property Tax	36.2	(24.2%)	35.5	(17.3%)
Utilities, Fees and Charges	18.0	(12.0%)	12.0	(5.8%)
Rates	6.3	(4.2%)	9.1	(4.5%)
Betting Duty	13.5	(9.0%)	12.6	(6.2%)
Investment Income on Fiscal Reserves	17.9	(12.0%)	13.8	(6.7%)
Stamp Duties	29.1	(19.5%)	11.0	(5.4%)
Duties	8.5	(5.7%)	7.0	(3.4%)
Total	184.8	(123.6%)	143.9	(70.2%)

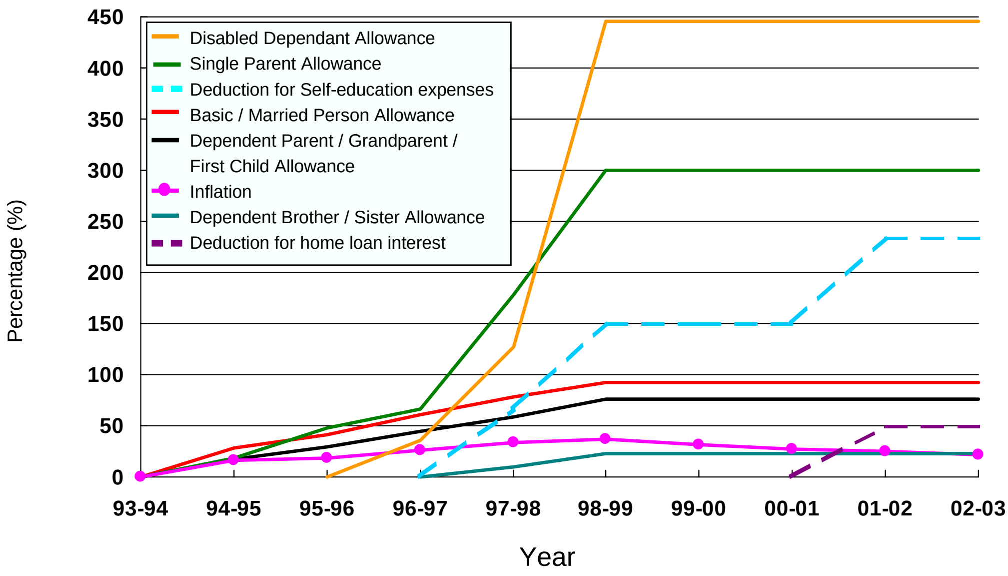
*** Figures in brackets represent the % out of total recurrent expenditure**

- 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 duties) have declined during the past six 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 2002-03, it is estimated that these recurrent revenue sources would drop to 70.2% of total recurrent expenditure.

Chart 19

Salaries Tax Allowances and Deductions Increase Faster Than Inflation



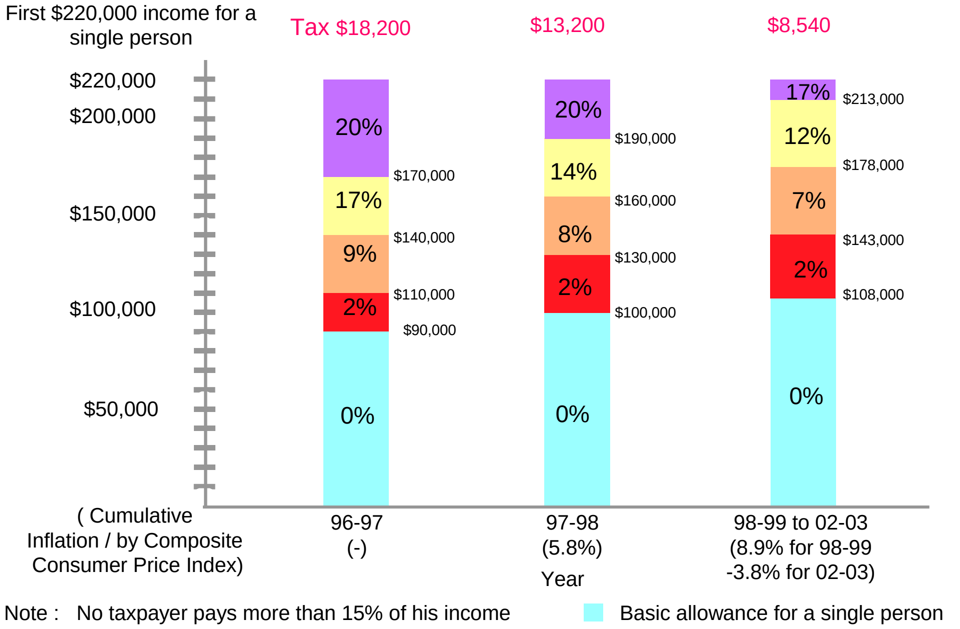
- This chart compares the cumulative increases in the allowances and the major types of deductions under Salaries Tax with cumulative inflation over the last ten years.

- Over the last ten years, the amounts of the various allowances and deductions have been adjusted upwards on many occasions, providing relief to taxpayers. The cumulative rates of increase in these allowances and deductions are significantly above the cumulative rate of inflation (as measured by Composite Consumer Price Index).

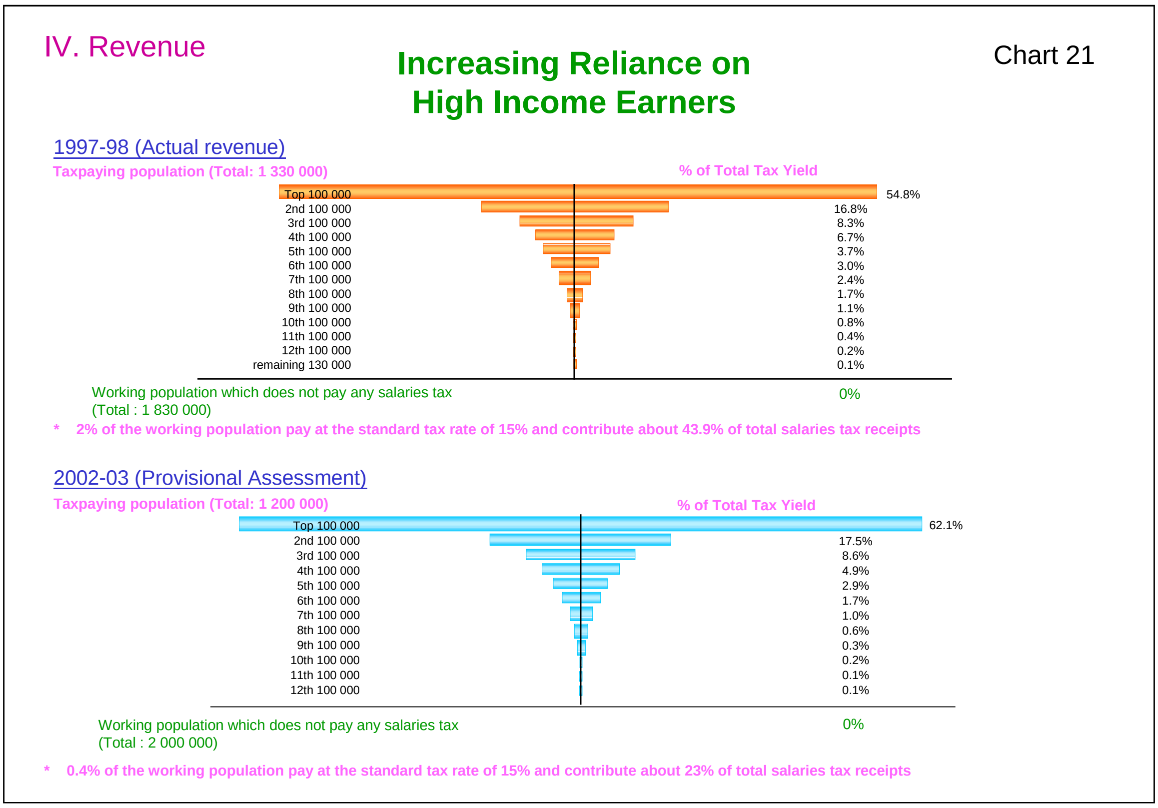
IV. Revenue

Chart 20

Adjustments to Marginal Rates of Salaries Tax Reduce Burden on Taxpayers



- This chart shows the changes in tax bands and marginal tax rates since 1996-97.
- These revisions to the marginal rate structure have substantially reduced the tax burden on taxpayers, inevitably impairing the revenue position.



- These charts arrange salaries taxpayers in 1997-98 and 2002-03 in steps of 100,000 each according to their salaries tax bills, and measure their respective contributions to the salaries tax yield.

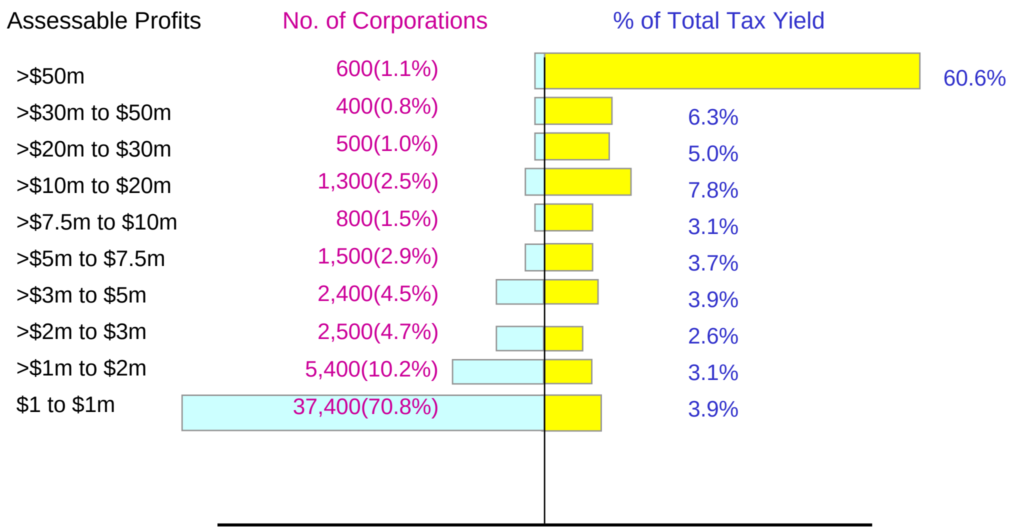
- In 1997-98, the top 100,000 taxpayers contributed 54.8% of the total revenue from salaries tax. The share of revenue contributed by these top 100,000 taxpayers is estimated to increase to 62.1% in 2002-03, signifying an increasing reliance on high-income earners.

- In 1997-98, there were 1.33 million taxpayers. In 2002-03, taxpaying population is estimated to decrease to 1.2 million, despite a growth in the number of employees from 3.16 million to 3.2 million over the same period.

IV. Revenue

Chart 22

Top 600 Corporations Pay Most Profits Tax (in the Year of Assessment 2000-01)



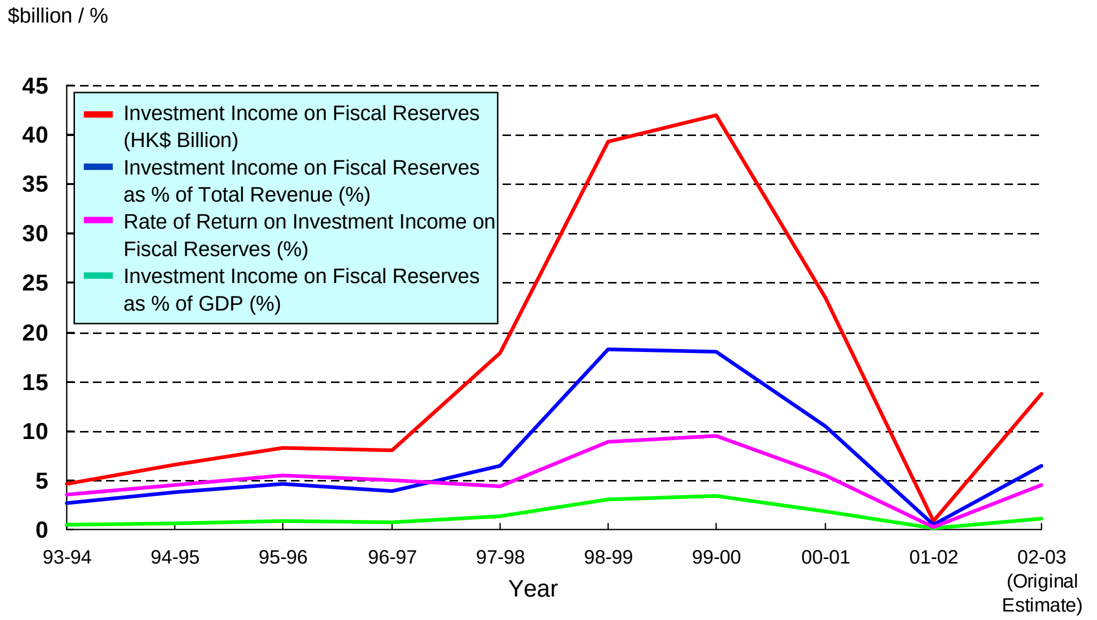
- This chart shows the distribution of our profits tax burden among the corporate taxpaying population in the Year of Assessment 2000-01.

- 60% of our profits tax was contributed by the top 600 taxpaying corporations out of more than 50,000 corporations. Most small businesses pay little or no tax.

IV. Revenue

Chart 23

Investment Income on Fiscal Reserves Declining



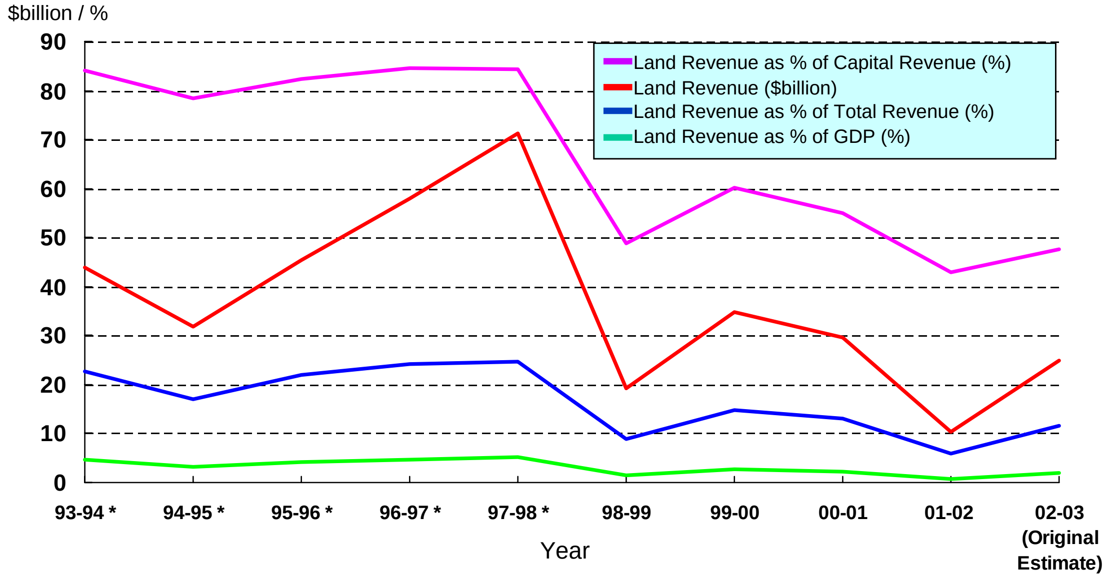
- Investment income on fiscal reserves has declined substantially since 2000-01 after a period of sharp growth.

- Its contribution to Government revenue and its income as a percentage of GDP has likewise dropped drastically.

IV. Revenue

Chart 24

Land Revenue Declining



* The figures before 1 July 1997 include the proceeds of land sales in Hong Kong paid to the former Trustees of the Hong Kong Special Administration Region Government Land Fund. With effect from 1 July 1997, the Land Fund was set up to enable the investments held by the former Trustees to be formally brought into the Government's accounts

- Land revenue has declined significantly after 1997-98. Its contribution to Government revenue and its level as a percentage of GDP have likewise dropped drastically.

IV. Revenue

Chart 25

Fees and Charges

Types of Fees & Charges

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

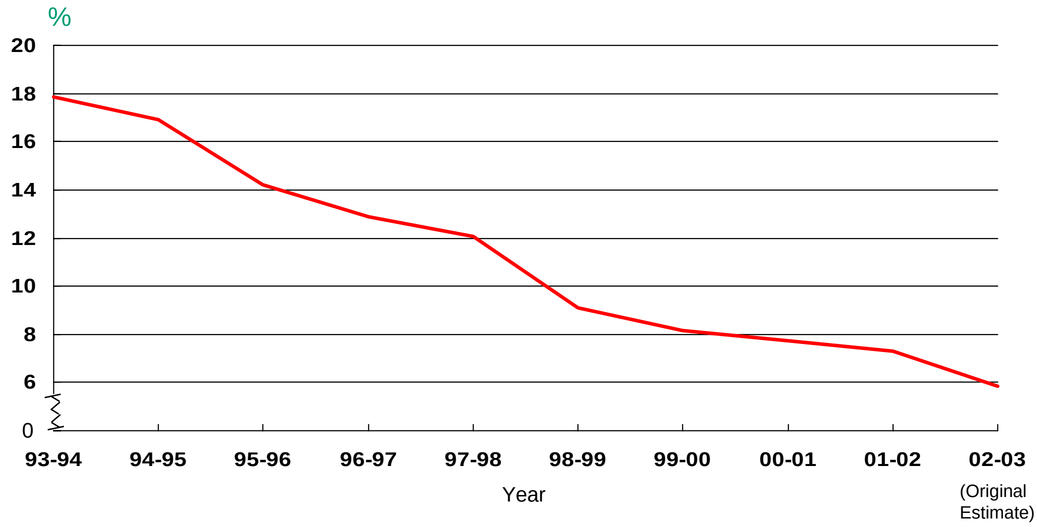
- It is a well-established policy of the Government to apply the “user pays” and “full cost recovery” principle for setting the fees and charges for services where a Government subsidy is not justified.

- 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 26

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 6% in 2002-03.

- 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.

- Following the onset of a further economic slowdown in 2001, the Government has decided this year to freeze Government fees and charges up to the end of March 2003 and provide some one-off concessions by reducing water and sewage charges and trade effluent surcharge, and waiving the business registration fees for one year in 2002-03.

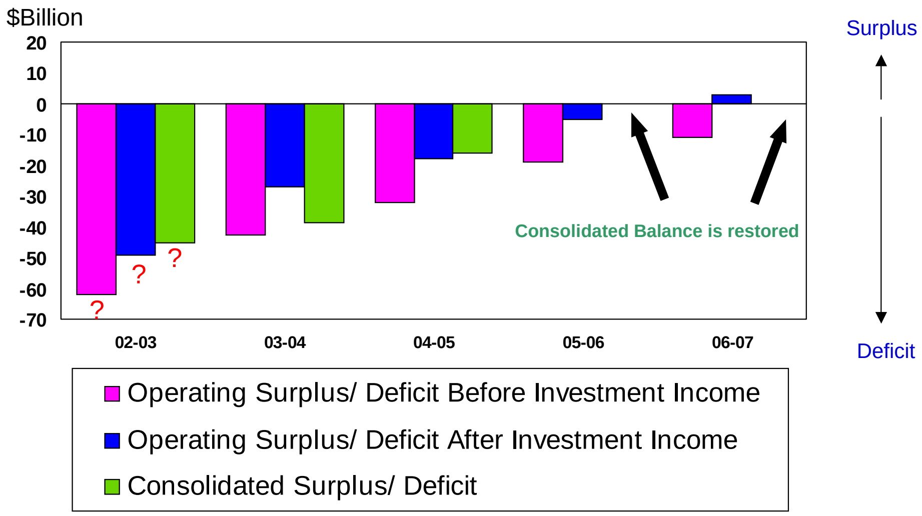
- We need to consider when is the appropriate time to restore the “user pays” and “full cost recovery” principles, taking into account the affordability of the people and the impact on the overall economy.

V. Balance

Chart 27

Plan to Restore Fiscal Balance

- Operating and consolidated balances restored in 2006-07



- This chart shows that as a result of the expenditure-control and revenue-raising measures, the government's operating and consolidated accounts will achieve balance in 2006-07.

Uncertainties for 2002-03 Fiscal Outturn

- Government Expenditure – pretty in line with original estimate of $254.3 billion

- Revenue – two major uncertain elements

  - Budgeted $15 billion sale of the second tranche of MTR shares
  - Original estimate of $25 billion land premium as against receipts of $6 billion up to end-August 2002

Chart 29

The fiscal deficit problem must be completely solved

- Ensure stability of our economy and financial system.
- Need strong support from Members of Legislative Council and the whole community.
- Every sector of the community needs to share the responsibility.
- Revival of our economy being the fundamental solution.
- Need effective control on expenditure.
- Raise revenues.
- Welcome suggestions by the community.

Chart 30

Some economic indicators since early 2002

Gross Domestic Product	2nd Quarter	+0.5%
Unemployment rate	June to September	7.4% (peak is 7.8%)
Value of exports of goods	First 8 months	+0.9% (August only +5.7%)
Value of exports of services	2nd Quarter	+8.6%
Exports of containers	First 7 months	+3.3% (July only +10.2%)
Exports of air cargoes	First 9 months	+25.5%(September only +26.4%)
Loan-to-deposit ratio	August	89.1%
Consumer price	First 9 months	-3.1% (September only -3.7%)
Consumption expenditure	2nd Quarter	-2.4%
Investment expenditure	2nd Quarter	-1.7%