

**Legislative Council
Panel on Financial Affairs**

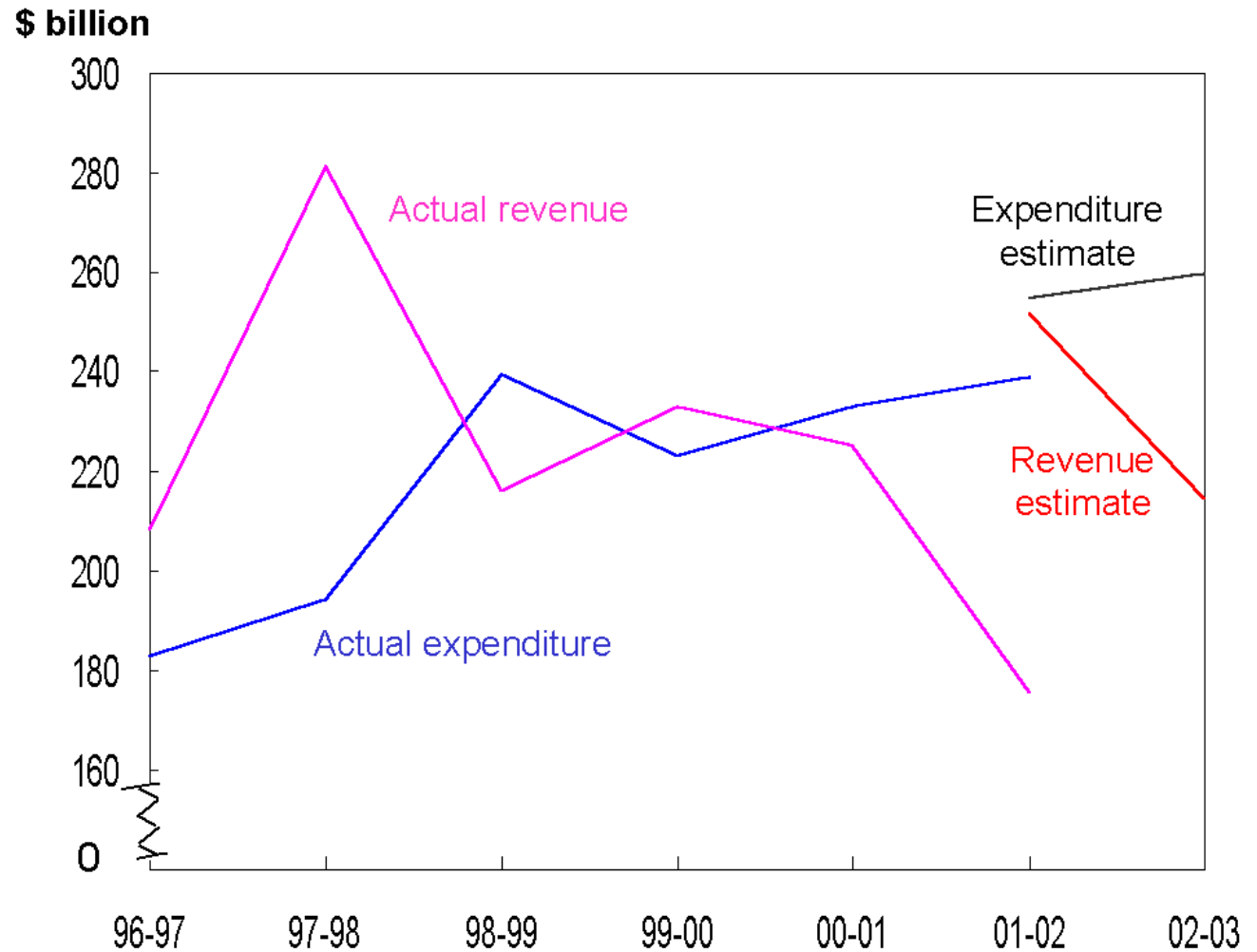
The Budget Deficit

16 December 2002

Fiscal deficit very serious

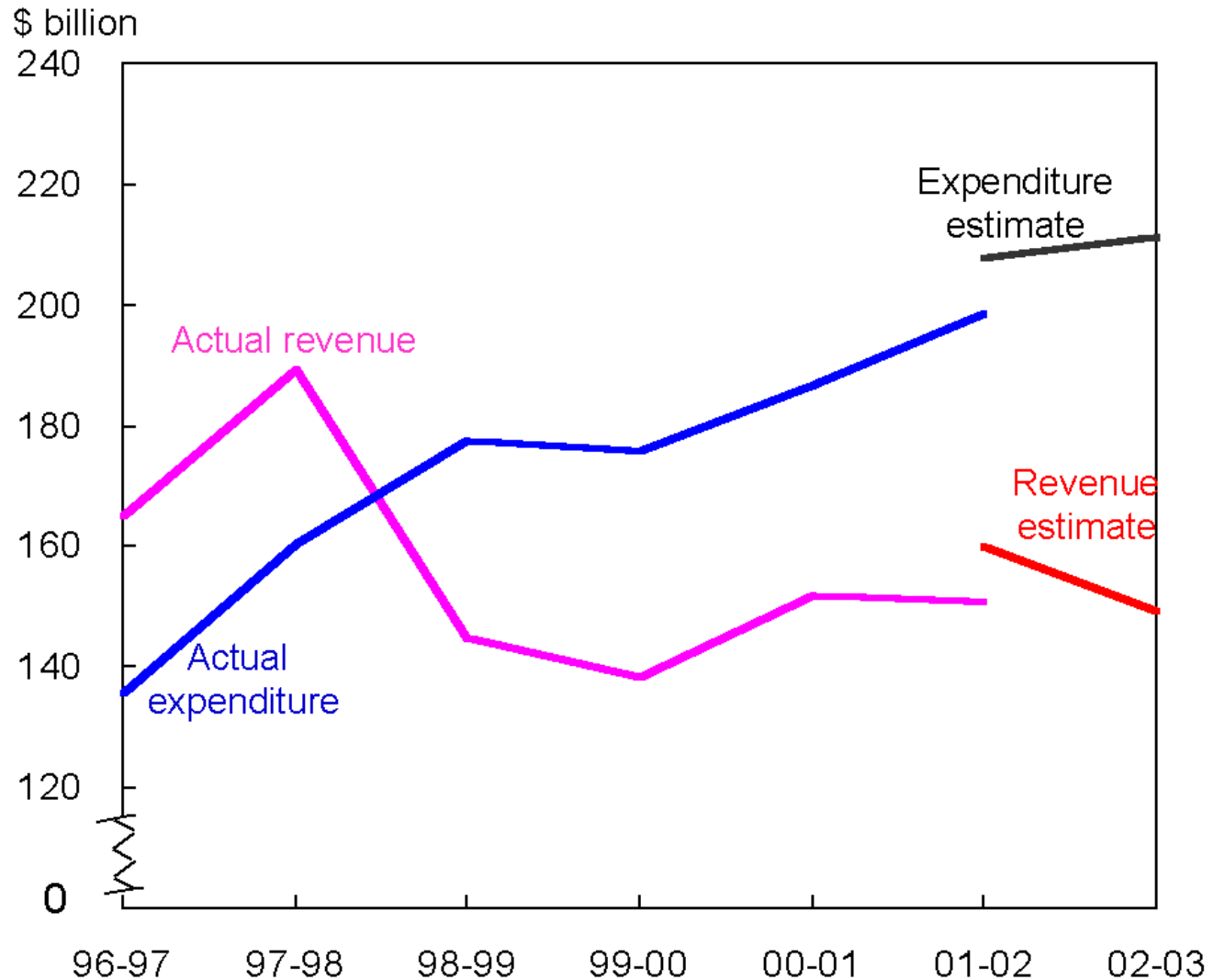
Consolidated deficit:

- 2001-02: 5% of GDP
- 2002-03: will be > 5%



Persistent Deficit in Operating Account

- Rating agencies/ investors/ speculators place equal emphasis on operating deficit
- Persistent problem since 1998



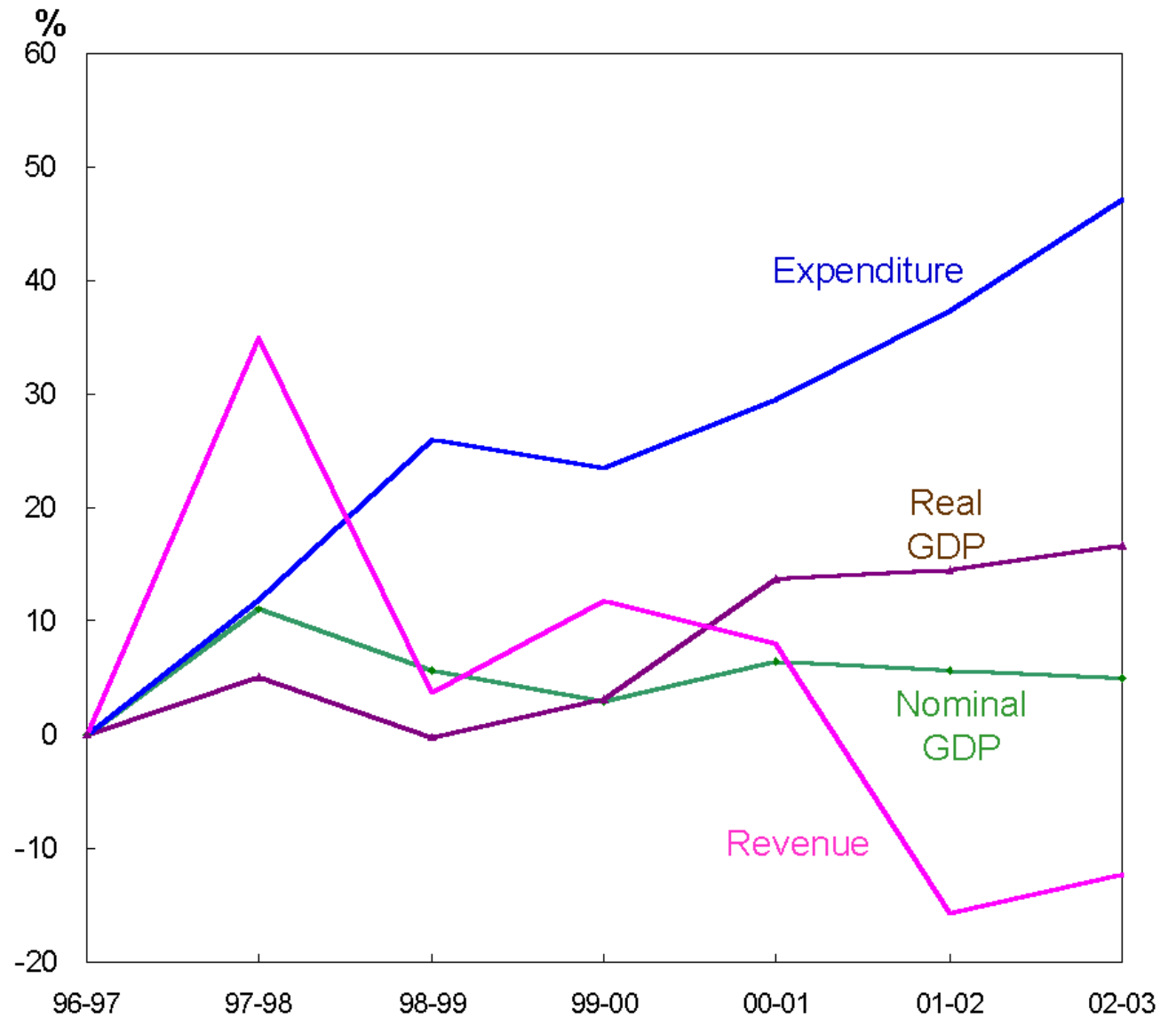
Deficit Problem, if unresolved, can affect Overall Economy

- Reduce public confidence
- Possible downgrade by rating agencies and bank analysts
- Pressure on Hong Kong dollar link
- Higher interest rate
- Economic recession
- Further deflation

Cumulative Growth in Total Revenue and Expenditure

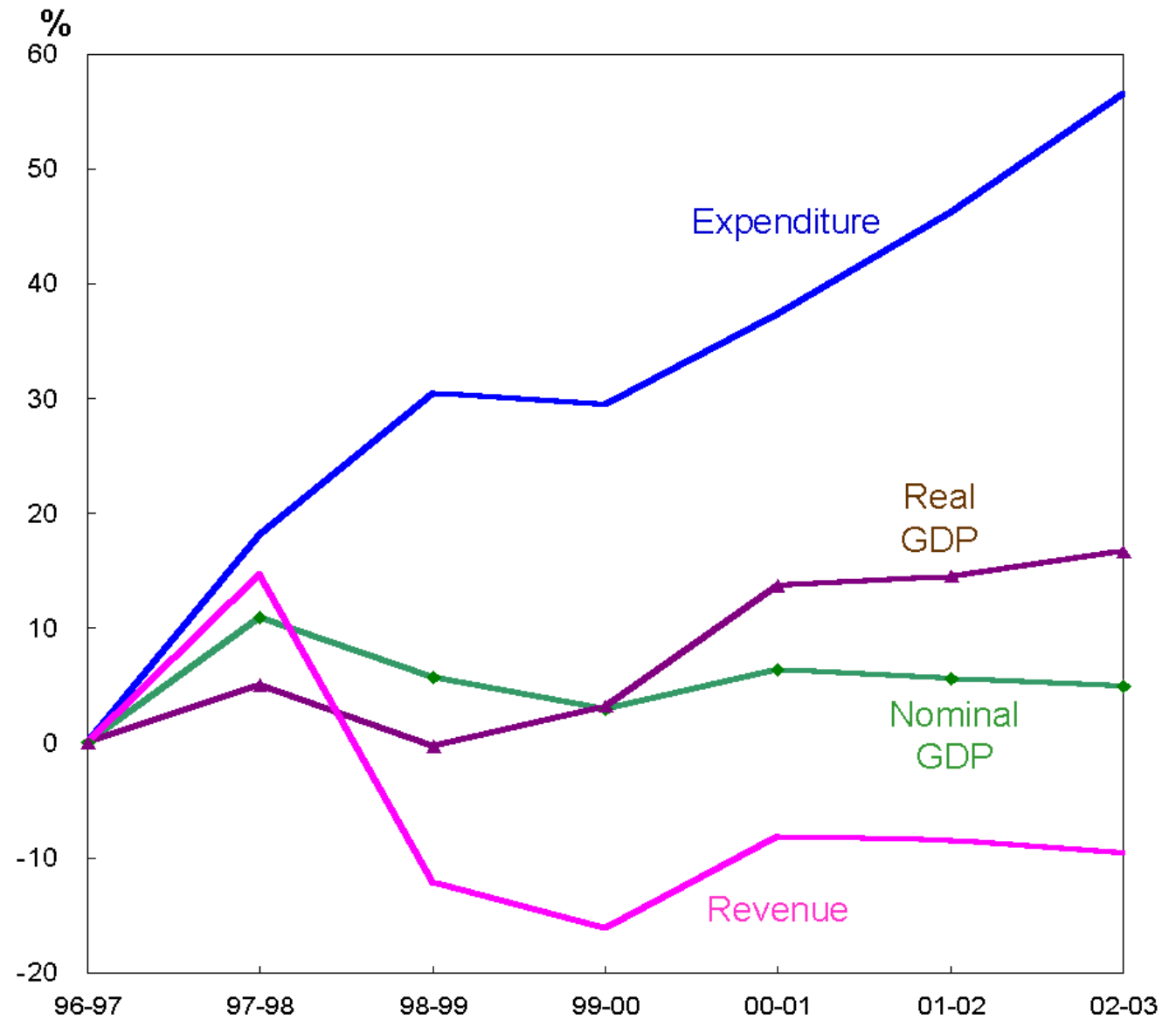
Reason for problem:

- Expenditure increased faster than GDP
- Deflation further aggravated the problem as nominal GDP matters more to revenue than real GDP



Cumulative Growth in Operating Revenue and Expenditure

Similar problem in operating account



Major Expenditure Increases

	Real increase from 96-97 to 02-03	
	\$Bn	%
Health, Welfare and Food	13.2	38
-Health	7.3	29
-Welfare	5.1	96
-Food	0.8	20
Education and Manpower	12.8	34
- Education	11.8	32
- Manpower	1.0	193
Salary increase (in money terms)	12.0	n/a
CSSA/SSA	9.3	75
Pensions	2.8	29
Environment, Transport and Works	2.9	25
Home Affairs	1.4	21
Economic Development and Labour	1.0	38
Housing, Planning and Lands	0.8	27
Security	0.6	3

Deflation Worsening

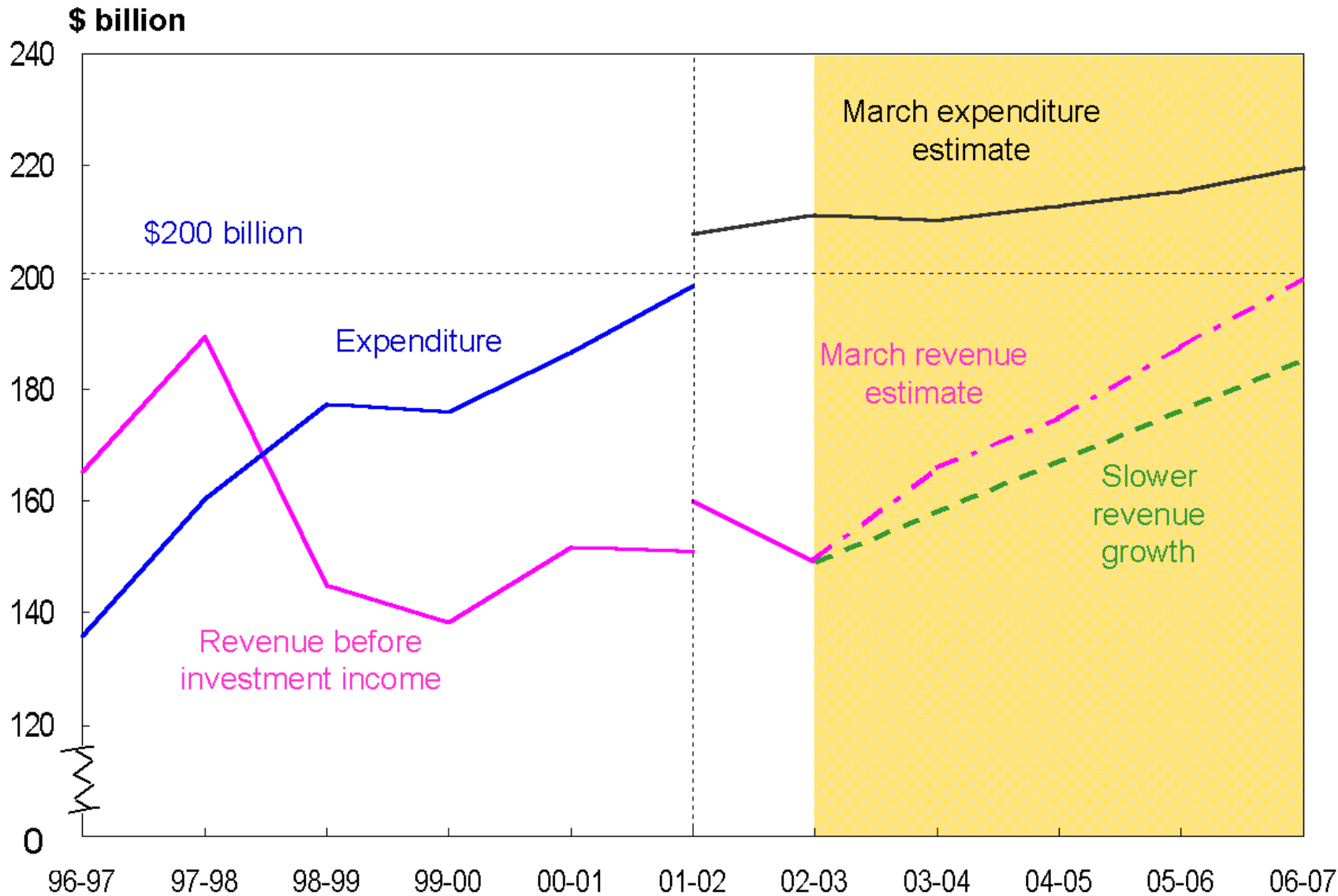
→ Deficit Problem Getting More Serious

(%)	2002Q1	2002Q2	2002Q3
GDP deflator	-2.1	-2.1	-3.0
CPI	-2.6	-3.2	-3.5

(%)	Forecast for 2002	
	Mar 02	Latest
Real GDP	1.0	2.0
GDP deflator	-1.5	-2.5
Nominal GDP	-0.5	-0.5

March forecast for 2003-06 nominal GDP growth of 4.4% may not be attainable.

Need to Take Measures to Address Operating Deficit



Note: Curves for 2003-04 to 2005-06 are for illustration only and do not represent the actual figures.

2003-04 Budget Preliminary Consultation Results

Consultation targets and channels include:

- Members of the Legislative Council
- Major chambers of commerce and industrial associations
- District Board Chairmen
- Academics
- Heads of Government Departments and staff
- Written submissions from the public and concerned bodies
- Newspaper commentaries

Overall Views Collected

- Acknowledge seriousness of the deficit problem
- See an urgent need to resolve the problem
- Support a three-pronged approach of :
 - reviving the economy
 - cutting expenditure
 - raising revenue
- Share responsibility
- Other views: implement counter-cyclical measures to stimulate demand and revive the economy

Views Collected on Expenditure Reduction

- Strong appeals for the Government to introduce robust expenditure cutting measures
- Further streamlining of Government through re-organisation and re-prioritization
- Review of civil service pay
- Reduce size of civil service
- Review of CSSA
- Other views: expenditure on infrastructural projects and education should not be reduced

Views Collected on Revenue Measures

- General rejection of General Sales Tax (GST)
- Suitably widen the tax base
- Increase profits tax rate
- Increase salaries tax rates; reduce salaries tax allowances
- Introduce progressive rate structures for profits tax and salaries tax
- Implement Boundary Facilities Improvement Tax
- Introduce green tax
- Introduce levy on foreign domestic helpers
- Introduce soccer betting duty; increase existing betting duty rates
- Issue bonds; sale/securitization of Government assets
- Other views: extend specific duty concession; continue to freeze livelihood-related fees

Conclusions and Follow-up

- Emerging consensus by the community
- Common commitment to sharing the responsibility during the difficult time
- A comprehensive “three-pronged” approach
- Continued consultations with different sectors of the community

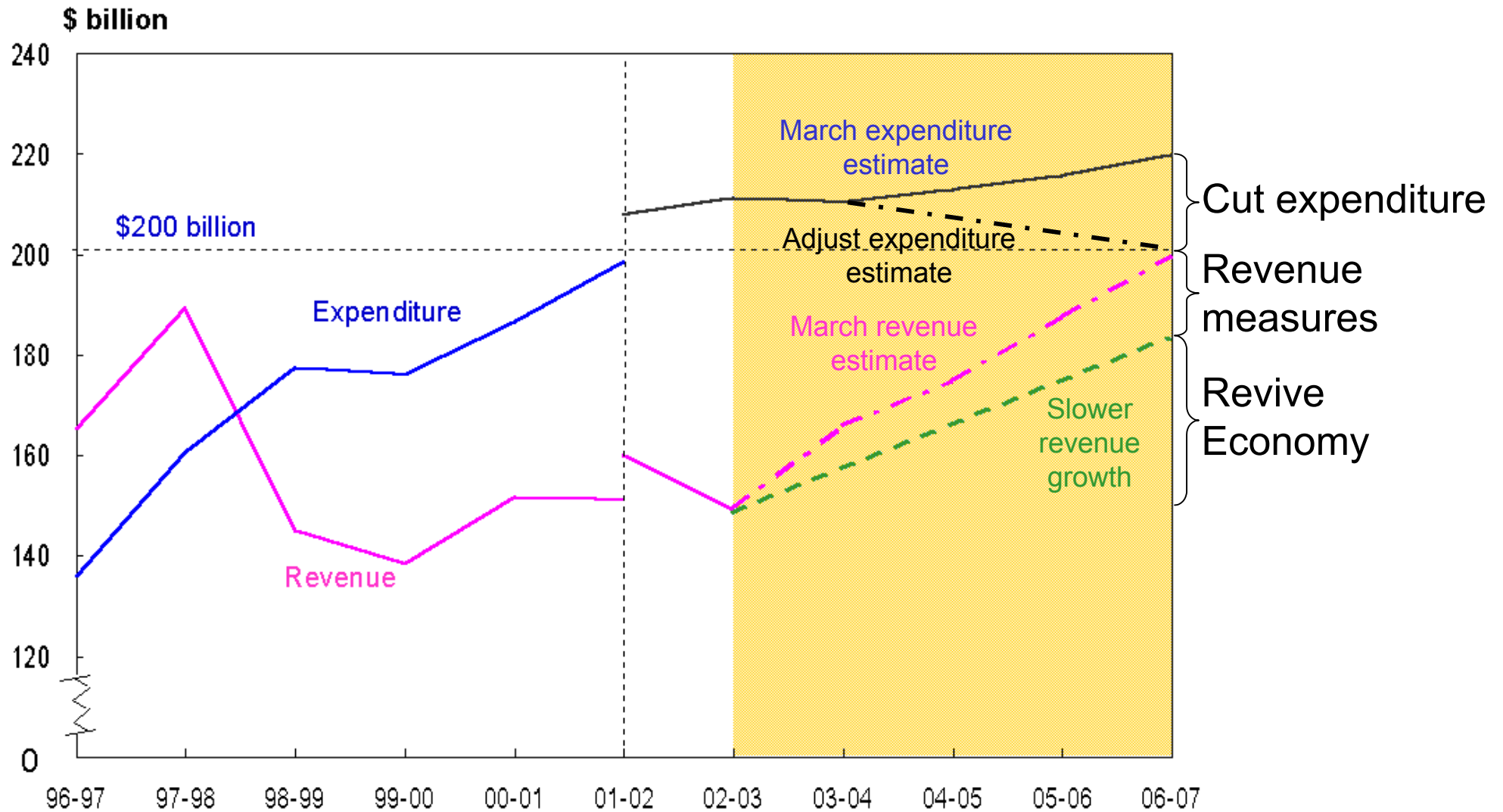
Need Your Support

- Understand community's expectation on public services and wish for no increase in taxes/ fees
- But dire consequence if deficit problem not resolved
- Entire community have to share responsibility
- Government to show leadership, striving to control public expenditure

Tentative Expenditure Cut Targets

- Opex of \$210.4b in 2003-04 remains unchanged
- Opex of \$219.8b in 2006-07 (taken into account of 4.8% cut) reduced to \$200.0b
- % cut larger for bureaux/departments because pensions, CSSA/SSA will increase

Need to Take Measures to Address Operating Deficit



Note: Curves for 2003-04 to 2005-06 are for illustration only and do not represent the actual figures.

Expenditure Reduction Approach

- “Opex Envelopes” to be given
- Bureaux/departments given flexibility and discretion on exact measures for reducing expenditure
- 1.8% cut in 2003-04 intact
- Have to act **as soon as possible** to achieve 2006-07 targets

Major Revenue Items in 2001-02 and 2002-03

	<u>2001-02</u> (Actual)		<u>2002-03</u> (Original Estimate)	
	\$Billion	(%)	\$Billion	(%)
Profits Tax	44.4	(25.3%)	42.9	(20.0%)
Salaries Tax, Personal Assessment and Property Tax	33.4	(19.0%)	35.5	(16.5%)
Land Premium	10.3	(5.9%)	25.0	(11.6%)
Investment Income on Fiscal Reserves	0.9	(0.5%)	13.8	(6.4%)
Betting Duty	11.6	(6.6%)	12.6	(5.9%)
Utilities, Fees and Charges	14.3	(8.1%)	12.0	(5.6%)

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

2003-04 Revenue Proposals

- Implement soccer betting duty
(at least \$1 billion per annum)
- Implement Boundary Facilities Improvement Tax
(about \$1 billion per annum)
- Other possible adjustments to taxes and fees except GST

Reviving The Economy

Current Economic Situation

- Two recessions since 1997
- Persistent Deflation (48 months, CPI -12%)
- High Unemployment (7.2%)
- Huge Fiscal Deficit (>5% GDP)

Reasons for the Economic Adjustment

Congruence of :

(1) Cyclical downturns

- In Hong Kong (Property bubble)
- US / Europe (IT bubble)

(2) Structural shifts

- Knowledge economy
- Globalisation and China factor

Limited Macro Economic Adjustment Tools in Hong Kong

- No independent monetary policy (Linked exchange rate)
- Fiscal policy - limited effect on economy (multiplier = 0.5)
- Hence, focus on improving competitiveness of real economy

Overarching Strategy – War for Talents

- Knowledge and talents are the only competitive edges in knowledge economy
- Education reforms
- Change policies to attract more :
 - professionals, talents, academics, quality students and
 - investment immigrants / entrepreneurs

Overarching Strategy – War for Talents

- Talents will be attracted by :
 - Opportunities
 - Lifestyle
- Hong Kong as Asia's World City is attractive :
 - Economically as Asia's international financial and business hub
 - Maximise opportunities in Mainland particularly Pearl River Delta
 - A society which is free, affluent and civil; and treasures diversity and meritocracy

Guiding Principles

- Belief in Free Market
- Government's role: limited but pro-active

Strategy

- War for Talents

- From enclave to metropolis
 - Increase 2-way flows with the Mainland: people, cargo, capital, information and services
 - Form a Greater PRD economic region
 - Joint overseas marketing programmes by Greater PRD
 - Promote Hong Kong's strengths to various provinces and cities in the Mainland

Strategy

- Small Government, big market
 - Reduce public expenditure from 23% of GDP to 20% of GDP
 - 3R (Reprioritise, Reorganise, Reengineer) and 1M (greater use of market – corporatisation, privatisation, outsourcing)

Strategy

- Clarify role of Government in property market
 - Cease the role as developer
 - Continue to supply land through a market responsive mechanism
 - Provide shelter for the needy

Strategy

- Invest in infrastructure, including:
 - Transportation links with the Mainland
 - Environmental related projects
 - Cultural and sports facilities

Strategy

- Promote development of high-value added activities, including:
 - Financial services
 - Logistics
 - Professional and producer services
 - Creative industries
 - Niche areas of technology

Strategy

- Grow sectors that provide jobs for lower-skilled labour, including:
 - Tourism
 - Local community economy

Strategy

- Maintain institutional strengths
 - Rule of law
 - Level playing field
 - Clean and efficient Government
 - Free flow of information
 - Low and simple tax
 - Good security

Measures to Control Deflation

To increase external demands, including—

- Tourists
- Investment immigrants
- Foreign companies using Hong Kong as regional headquarters
- Investors (QDII, regional bond funds)
- Regional demand for health care & learning

Government's Measures producing effects

- 3rd quarter GDP +3.3%
- Exports of goods +11.4%
- Exports of services +14.1%
- Unemployment rate falling from 7.8% to 7.2%
- GDP growth cautiously optimistic in the short term

- Medium term uncertainties abound
- Deflation likely to continue, worse than March forecast

Concluding Remarks

- Continued deflation undermining revenue forecast
- Serious budget deficit problem, which will affect overall economy if unresolved
- Government will strive to revive the economy, control expenditure and consider revenue measures
- Need the support of Members and the public, and shared responsibility by the community

Thank you