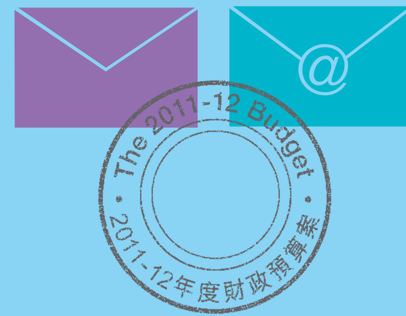
The 2011-12 Budget



The Financial Secretary invites your views

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The Financial Secretary is consulting Members of the Legislative Council, representatives from various sectors and the people of Hong Kong on the 2011-12 Budget.

We welcome and value your advice on the Budget. Please let us have your views via the budget website **www.budget.gov.hk** or in writing to
the Financial Secretary's Office,
5th floor, Main Wing, Central Government Offices,
Lower Albert Road, Hong Kong.

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Latest 2010 economic indicators

GDP real growth	January to September	7.1% (Third quarter 6.8%)
Unemployment rate	August to October	4.2% (May to July 4.3%)
CCPI inflation	January to October	2.3% (October 2.6%)

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

- Hong Kong's economy has swiftly emerged from the global financial crisis, benefiting from the robust performance of the Mainland and other Asian economies. Real GDP expanded distinctly by 7.1% in the first three quarters of 2010 over a year earlier, with solid support from both the external and domestic sectors.

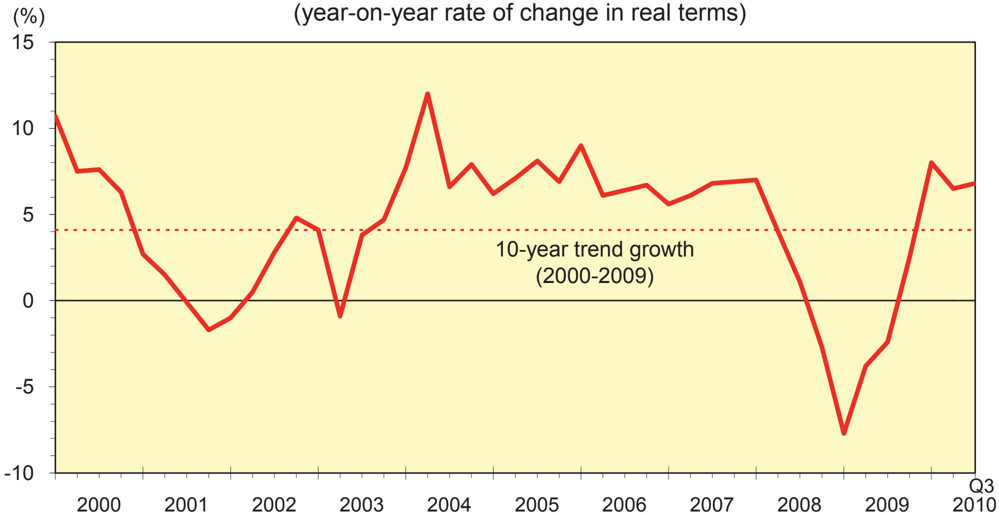
- Labour market has improved notably, with the unemployment rate coming down from a high of 5.5% in mid-2009 to 4.2% in August-October 2010. Inflationary pressure, though still moderate, has been edging up in the midst of strong economic growth and also rising import prices.

- As a small and open economy, the near-term outlook for the Hong Kong economy remains fraught with uncertainties, with the fundamentals of the advanced economies remaining fragile. We also need to stay alert to the asset market bubble risks in the region.

- Given the experience of the advanced economies in dealing with the recent global financial crisis, *should the Government play an even more active role in our economic development?*

Economy coming out of the global financial crisis in good shape

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

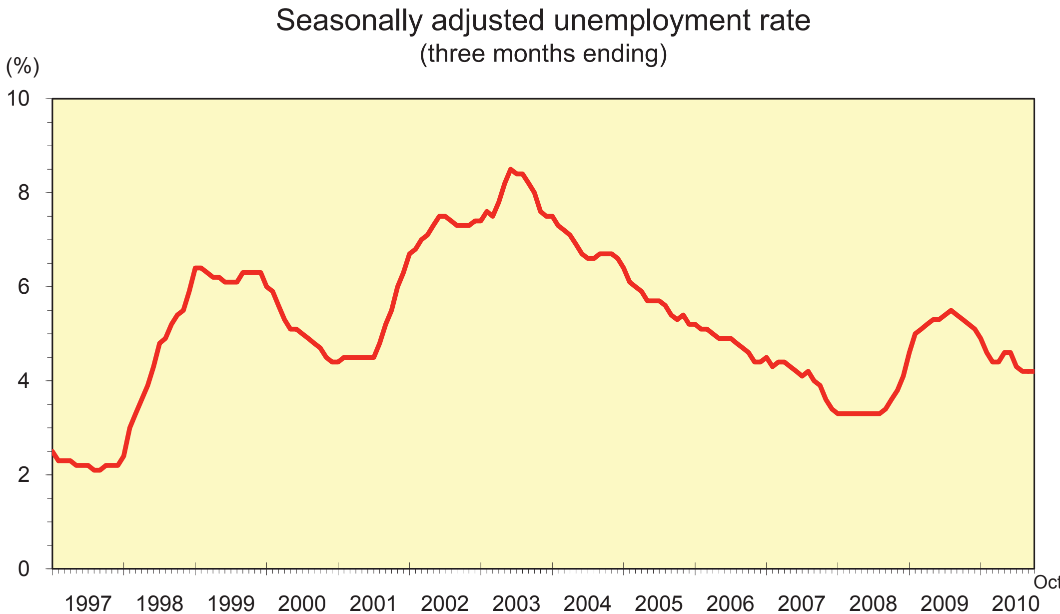


- Having embarked on the recovery track since the second quarter of 2009, Hong Kong's economy is now on a much firmer footing. However, the external environment remains challenging. The lingering European sovereign debt problem and the weak recovery of the advanced economies have continued to cloud the global economic outlook with considerable uncertainties.

- Whether the new round of quantitative easing by the Federal Reserve can spur the US economy remains to be seen. But the super-loose monetary environment on a global scale has increased drastically the asset market bubble risks in the region. We have put out several rounds of measures along four policy directions (i.e. increasing flat supply, curbing property speculation, ensuring transparency and preventing excessive leverage) to tackle the housing market bubble risk.

- On the fiscal side, the several rounds of relief measures since 2008, amounting to some $110 billion, have been effective in supporting the economic recovery. *How should we prioritise the use of resources to meet the various challenges from both the domestic and external fronts?*

Labour market showing marked improvement since mid-2009

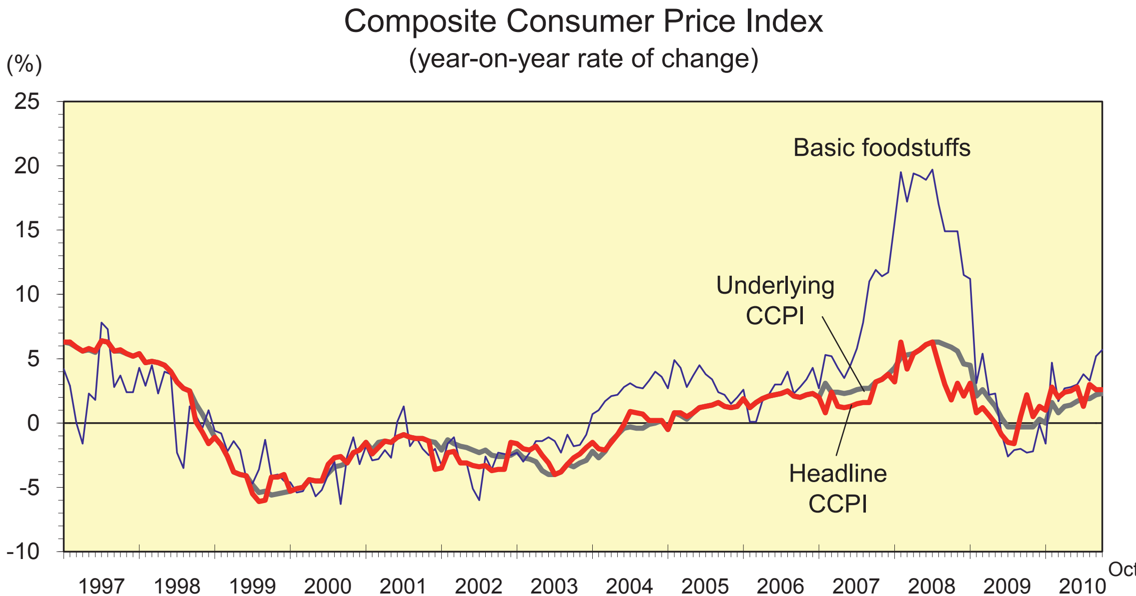


- Labour market has improved markedly since mid-2009, underpinned by the broad-based economic recovery. The unemployment rate fell to 4.2% in August-October 2010 from the peak of 5.5% in mid-2009. Total employment resumed increase. Wages and incomes also rose.

- Hong Kong's labour market has been more resilient during the current crisis as compared to the Asian financial turmoil earlier, thanks to the flexible labour market as well as the Government's timely measures to preserve and create employment. *How should we strengthen further the quality and competitiveness of our labour force?*

- Consistent with our pro-market economic policy, we will follow the principle of "from welfare to self-help" in reducing poverty, creating jobs, mobilising the business community to support social initiatives, and improving the livelihood of low-income groups and the disadvantaged. We have been investing heavily in education and training and re-training to enhance social mobility and mitigate inter-generational poverty. *What more should be done to promote self-help and prepare those who wish to join or re-join the work force?*

Inflationary pressure edging up



- Inflationary pressures are gradually coming back, against the backdrop of an increasingly entrenched recovery and a vibrant consumption market. Moreover, imported inflation is also rising due to a weaker US dollar and also greater price pressures in the region.

- The increase in food and other commodity prices in the international markets and the rise in local housing rentals will continue to pose upside risks to inflation. We will monitor closely the situation, especially the impact of food prices on the livelihood of low-income families.

Latest forecast for 2010

GDP real growth	6.5%
CCPI inflation	
Underlying	1.7%
Headline	2.5%

- The issues of fiscal sustainability and strength of recovery in the advanced economies will continue to pose downside risks to global economic recovery. Nevertheless, Hong Kong's economy should continue to benefit from the vibrant growth in the Mainland and the region, and the prevailing positive consumer and business sentiments. Support should also come from the sustained high level of infrastructure construction works.

- Taking into account the GDP growth of 7.1% in the first three quarters of 2010, Hong Kong economy is forecast to expand by 6.5% for 2010 as a whole.

- Inflationary pressure may edge up further in the near term as economic expansion proceeds and import prices rise further. Headline CCPI inflation is forecast to average 2.5% for 2010 as a whole.

- *What can the Government do to ensure sustainable economic growth and development over the medium to longer term?*

Economic uncertainties

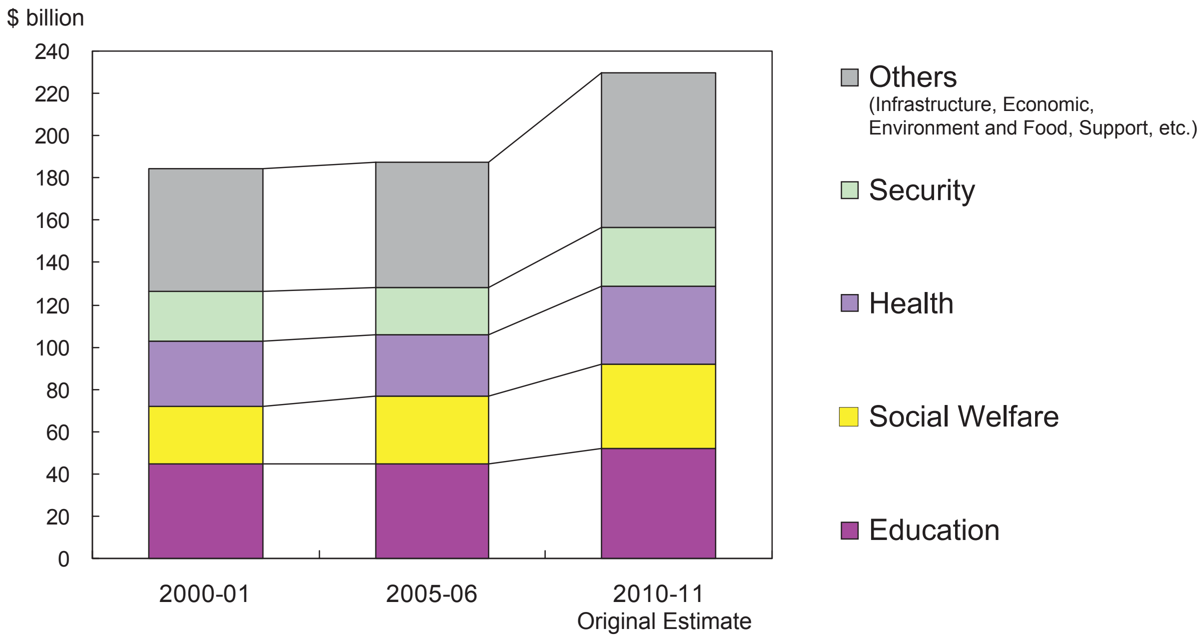
- Fading stimulus effect in the advanced economies
- European sovereign debt problem
- Heightened risks of asset market bubbles in Asia amid flush of liquidity
- Persistence of global imbalances and rise of protectionist sentiments
- Gyrations in exchange rates and financial market volatility
- Return of higher inflation

- Being a small and open economy, Hong Kong's well-being is inevitably affected by global fluctuations. We need to stay alert to the risks and uncertainties in the external environment. We also need to continuously enhance our flexibility to cope with the constant changes, and strengthen our competitiveness in the era of globalisation. *What growth strategies should we adopt to stay competitive? What more should we do to contain the bubble risks?*

- The global economic landscape has been shifting towards the East, especially so after the global financial crisis. *How should we respond to and capture the new opportunities? What more can we do to broaden and deepen our economic integration with the Mainland? While promoting regional economic integration, how should we chart our future economic development to maintain Hong Kong's unique advantages as the Chinese city with a difference?*

- We should also bear in mind medium-term issues and the long-term development needs, such as fiscal sustainability, while dealing with short-term challenges. *How should we ensure fiscal sustainability over the medium to long term given the immense challenge of an ageing population, when such an issue now tops the policy agenda in many advanced economies?*

Recurrent expenditure in past 10 years



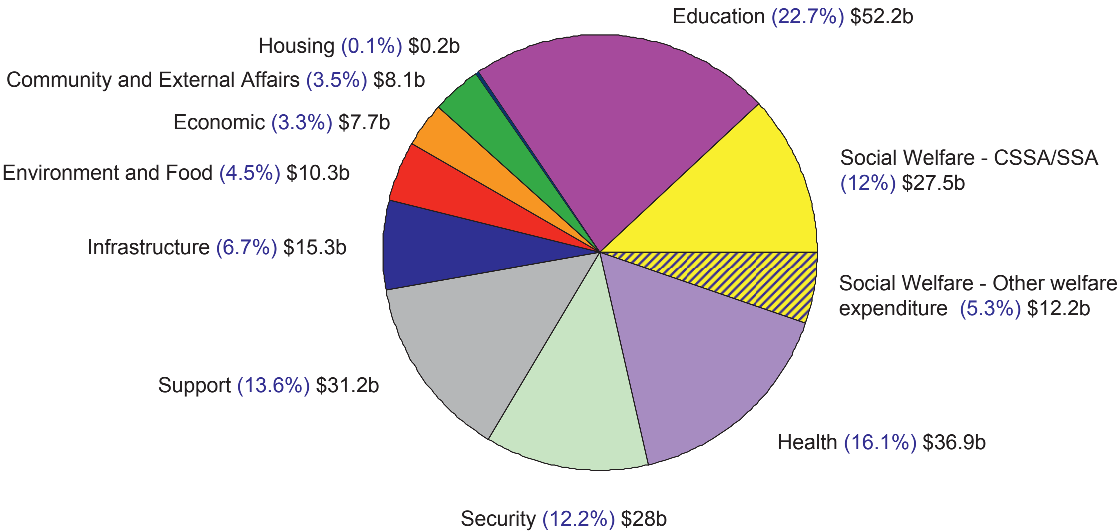
- Total recurrent government expenditure increased by some $45.1 billion or 25% over the past 10 years.

- Our recurrent expenditure on education, social welfare and health has been increasing –

• Education	+ 16%
• Health	+ 21%
• Social Welfare	+ 47%
– *Comprehensive Social Security Assistance (CSSA) Scheme*	*+ 37%*
– *Social Security Allowance (SSA) Scheme*	*+ 73%*
– *Other welfare expenditure*	*+ 47%*

- The increase in expenditure particularly in Social Welfare and Health is expected to continue in future with the ageing population. *How should we get prepared for the challenge?*

Recurrent expenditure for 2010-11

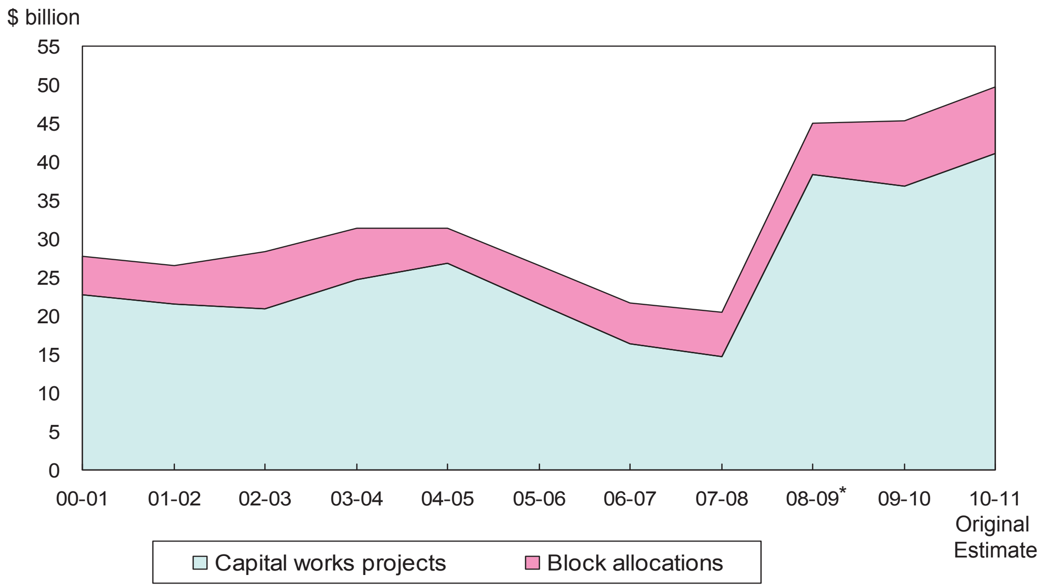


Total recurrent government expenditure: $229.6 billion (72% of total government expenditure of $317.2 billion)

- Based on the 2010-11 Estimates of expenditure, the spending on Education (22.7%), Social Welfare (17.3%) and Health (16.1%) together accounts for 56.1% of total recurrent government expenditure.

- In preparing the 2011-12 Estimates, we will ensure optimal allocation and efficient utilisation of resources according to strategic priorities. The Government has committed to increasing the share of recurrent health care expenditure to 17%. Inevitably percentage share of some of the other policy areas will have to be reduced. We need to prioritise the use of government resources to provide for changing needs. *Are there services which are no longer needed or may better be provided by more cost-effective means so that public funding can be redeployed to more pressing initiatives?*

Essential infrastructure



* including the upfront endowment of $21.6 billion to the West Kowloon Cultural District Authority

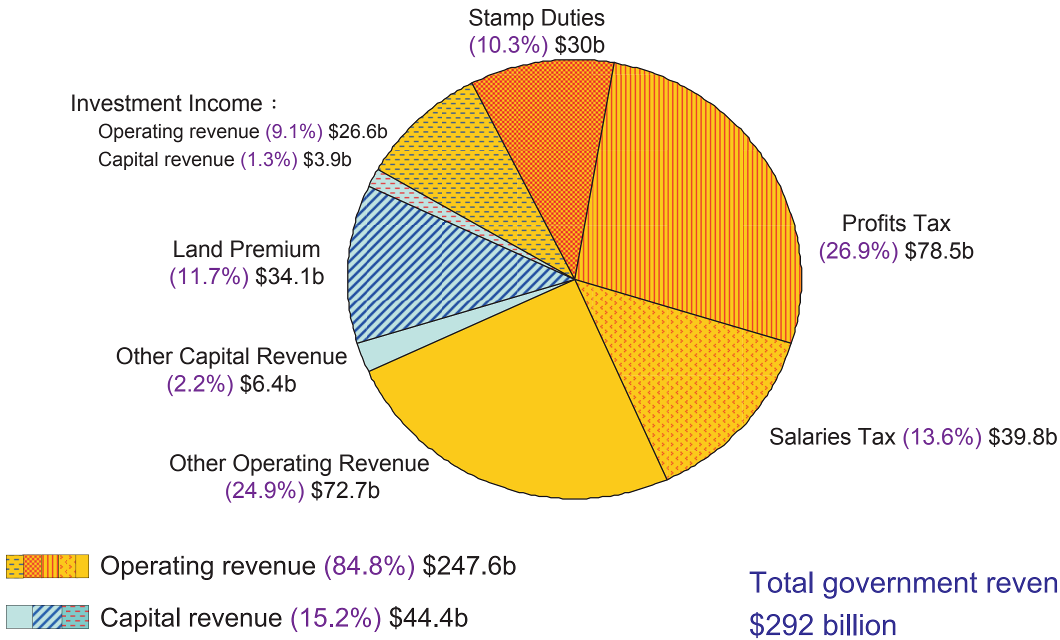
Capital works expenditure

- The Government remains committed to investing in infrastructure to facilitate economic growth and enhance the long-term competitiveness of Hong Kong.

- In the past, we have earmarked on average $29 billion a year for spending on public works projects. For 2010-11, the budget is $49.6 billion, representing a 9.5% increase from last year's actual expenditure. Over the next few years, we envisage that capital works expenditure will grow considerably with the major infrastructure projects, including the Ten Major Infrastructure Projects announced by the Chief Executive in the 2007-08 Policy Address, entering their construction peaks.

- In view of the rapid growth in infrastructure investment, we will need to monitor closely the construction industry's capacity and avoid the bunching of projects that may cause tension in the supply of construction labour and contract price fluctuations. We need also to be mindful of any impact on private sector construction activities, and avoid unnecessary competition for resources between the public and private sectors, which may in turn push up construction prices. *How should we manage our expenditure on infrastructure projects in order not to pose pressure to the construction industry while promoting sustainable economic growth?*

Revenue for 2010-11



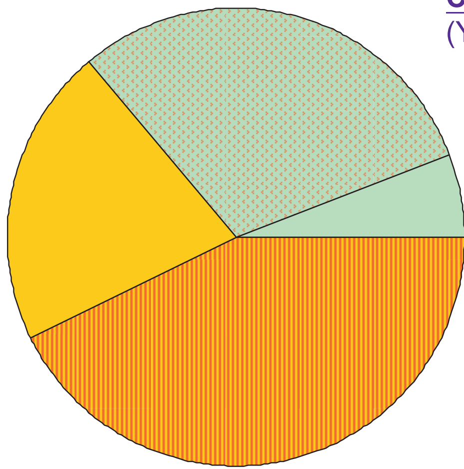
Total government revenue :
$292 billion

- The five major revenue items are profits tax (26.9%), salaries tax (13.6%), stamp duties (10.3%), investment return from fiscal reserves (mainly from placement of the fiscal reserves with the Exchange Fund) (10.4%) and land premium (11.7%). Together they account for 72.9% of total government revenue. Other than the investment return from fiscal reserves, the other four items are sensitive to economic fluctuations. *Do we need to reduce our reliance on these high yielding revenue sources? If so, how?*

Taxpayers

Actual Revenue 2008-09

Profits and salaries taxes: $143.2billion (45% of total government revenue)



Contribution from taxpayers
(Year of assessment 2008-09)

- Top 200 000 people paying salaries tax
- Remaining 1 178 000 people paying salaries tax
- Top 1 100 corporations paying profits tax
- Remaining 78 700 corporations paying profits tax

- In 2008-09, 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 84% of the revenue from salaries tax.

- Similarly for profits tax, of the 633 000 registered corporations, only 80 000 or 13% paid profits tax. Nearly 90% of the corporations do not pay any tax. 1 100 corporations (0.2% of registered corporations) contributed 67% of the corporate profits tax revenue.

- *Do we need to broaden the tax base? Any views?*

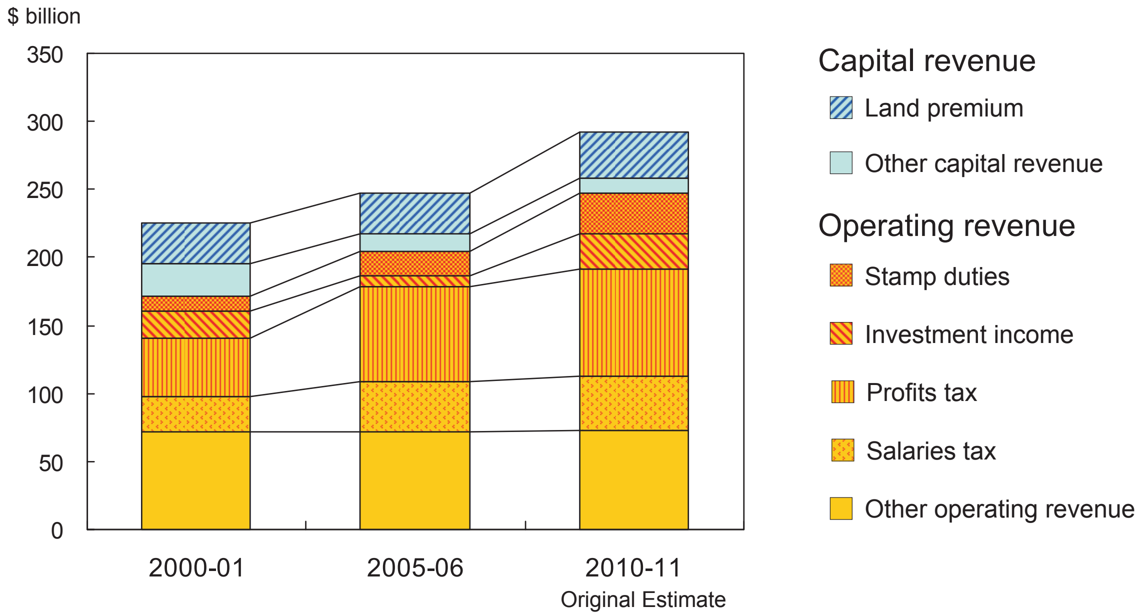
Salaries Tax
Effective Tax Rate for 2008-09

Annual Income	No. of Taxpayers	Average effective tax rate *
($)		(%)
108,001 – 150,000	190,000	0.2
150,001 – 300,000	562,000	2.0
300,001 – 600,000	426,000	5.1
600,001 – 900,000	98,000	9.5
900,001 – 1,500,000	62,000	12.2
1,500,001 – 3,000,000	29,000	14.1
Over 3,000,000	11,000	14.8
Total	**1,378,000**	**7.6**

* Before the one-off tax reduction of up to $8,000

- Because of our allowances and deductions under salaries tax, for 2008-09, even before the one-off tax reduction
  - 85.5% of taxpayers (up to annual income of $600,000) were subject to an average effective tax rate of less than 5.5%;
  - the average effective tax rate for taxpayers with annual income from $600,001 to $900,000 was only 9.5%; and
  - the overall average effective tax rate for all salaries tax payers was 7.6%.

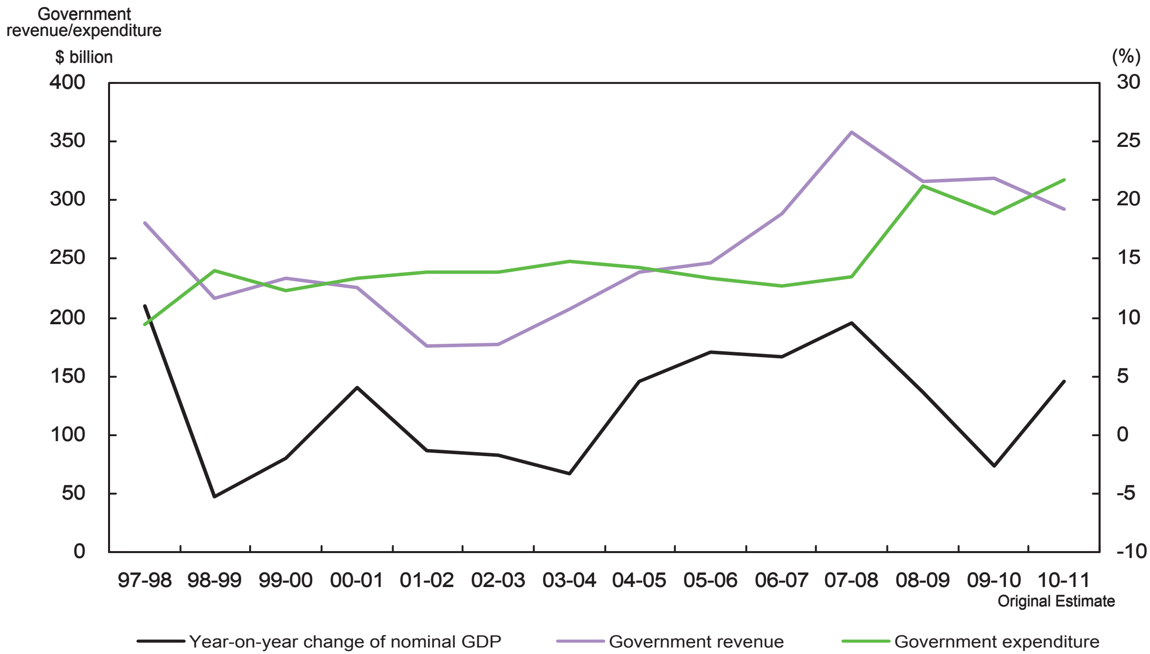
Revenue in past 10 years



Total government revenue

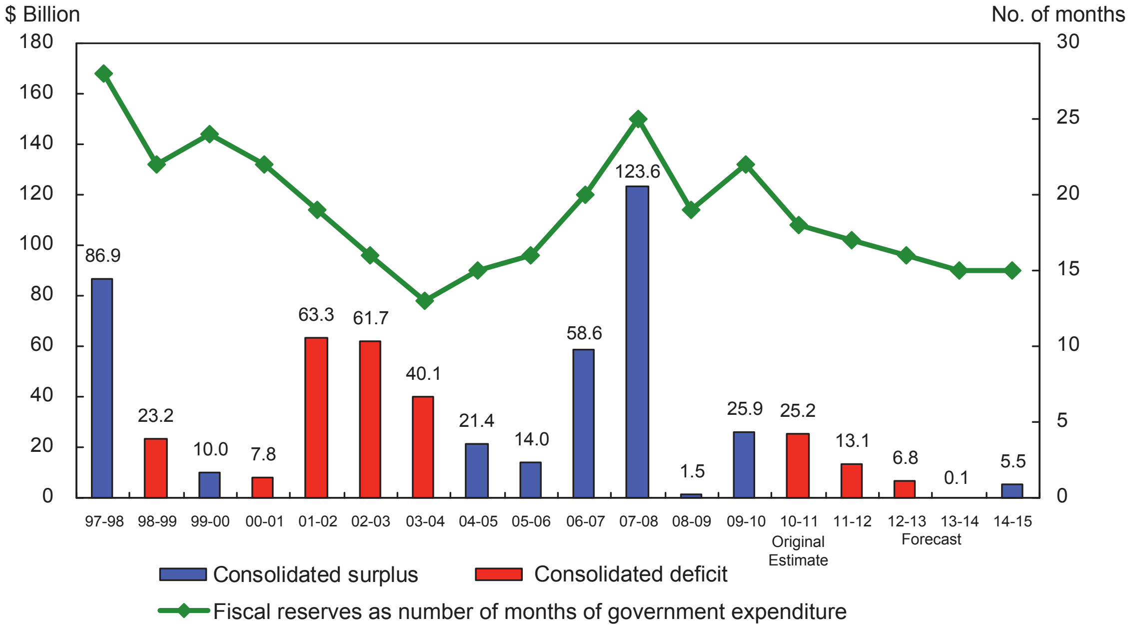
- Profits tax has been our largest operating revenue. It varied from $38.8 billion in 2002-03 to $104.2 billion in 2008-09.
- Salaries tax has been our second or third largest operating revenue. It varied from $26.3 billion in 2000-01 to $41.2 billion in 2009-10.
- Stamp duties varied from $7.5 billion 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 2009-10.
- As for capital revenue, land premium has been most volatile, fluctuating from $5.4 billion to $62.3 billion in the past 10 years.
- The volatility of our revenue income poses challenges to the management of public finances. Hitherto, we have used our fiscal reserves to serve as a cushion. *What else should we do?*

How we have used the fiscal reserves (1)



- Our fiscal reserves have served us well, helping us iron out income volatilities.
- We have used the reserves to fund budget deficits in times of economic and fiscal difficulties. This has enabled us to maintain our expenditure at a relatively stable level despite reductions in GDP and revenue.
- 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 as % of GDP increased from 16.7% in the 2008-09 Budget to 19.4% in the 2009-10 Budget.
- In the six years from 1998-99, we used the reserves to fund five deficits which reduced our reserves by some $200 billion.

How we have used the fiscal reserves (2)



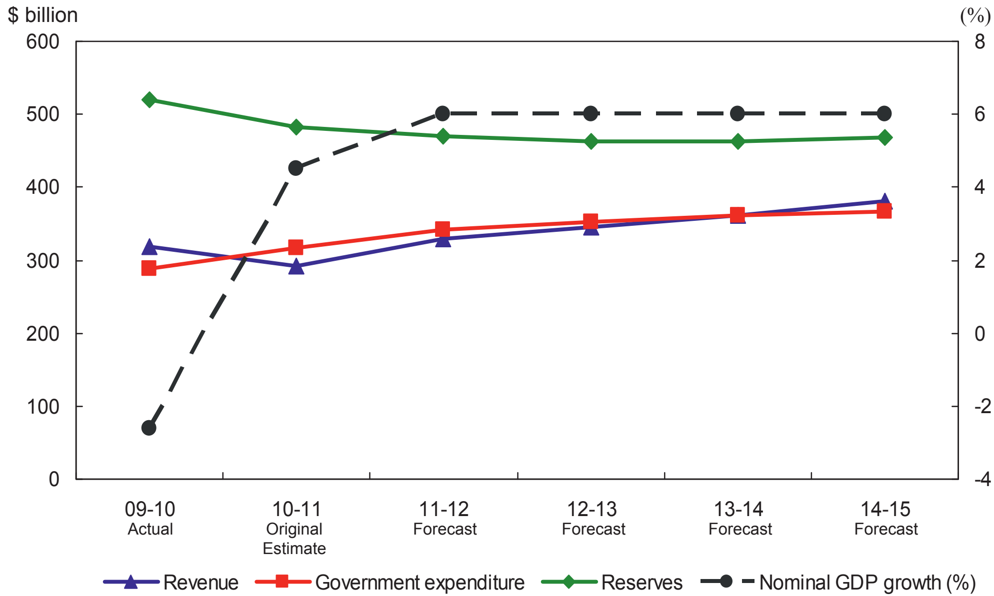
- In the Medium Range Forecast announced in the Budget this February, fiscal reserves were projected to fall to some 15 months of government expenditure by the end of 2014-15. This amounts to around half of the level achieved in March 1998.

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

- Investment return from the fiscal reserves is part of government revenue and is used to fund government services. In the 2010-11 Budget, it is the fourth largest government revenue item (10.4% of total). The amount of this investment income depends in part on the level of our fiscal reserves.

- In times of economic growth, we need to rebuild our reserves. We also need to address the community's demands for improved services. *What should be the appropriate balance between expenditure and fiscal reserves?*

Medium Range Forecast in 2010-11 Budget



- This is the Medium Range Forecast (MRF) announced with the 2010-11 Budget in February 2010. We will publish an updated MRF later together with the 2011-12 Budget.

- Over the period covered by the MRF, government spending was projected to continue to increase given the need to fund capital works expenditure which averaged more than $50 billion a year, and to provide for new or improved services that our society needs.

- Over time, we need to keep expenditure within the limits of revenues and keep expenditure growth commensurate with the growth rate of GDP. Looking ahead –
  - *What will be our GDP performance in 2011-12, and the rest of the MRF period?*
  - *What is the appropriate fiscal policy for 2011-12?*

Longer term challenges

- Sustainable economic growth
- Ageing population and liabilities

- While we have returned to positive economic growth, there are uncertainties ahead. *What should we do to ensure sustained economic growth?*

- Thirty years later, our population may approach some nine million with one quarter at the age of 65 or above. The overall dependency ratio is projected to increase from 337 per 1 000 in 2009 to 625 per 1 000 in 2039. This will have profound impact on our finances.

- Our revenue from direct taxes may be adversely affected by a lower percentage of economically active population. On the expenditure side, ageing will increase health and social welfare expenditure. According to an earlier report by the IMF, health care costs could result in cumulative deficits of almost 20% of GDP by 2030 and 50% of GDP by 2050 unless changes are made. Unfunded and contingent liabilities will also put pressure on our finances in the long term. We need to make preparations for the future. *Should we save up for future need? How to balance between service improvements now and preparing for the future? What kind of fiscal position should we leave to the next generation?*

Your views are welcome!

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