

**Consultation
on
2013 Policy Address and
2013-14 Budget**

December 2012

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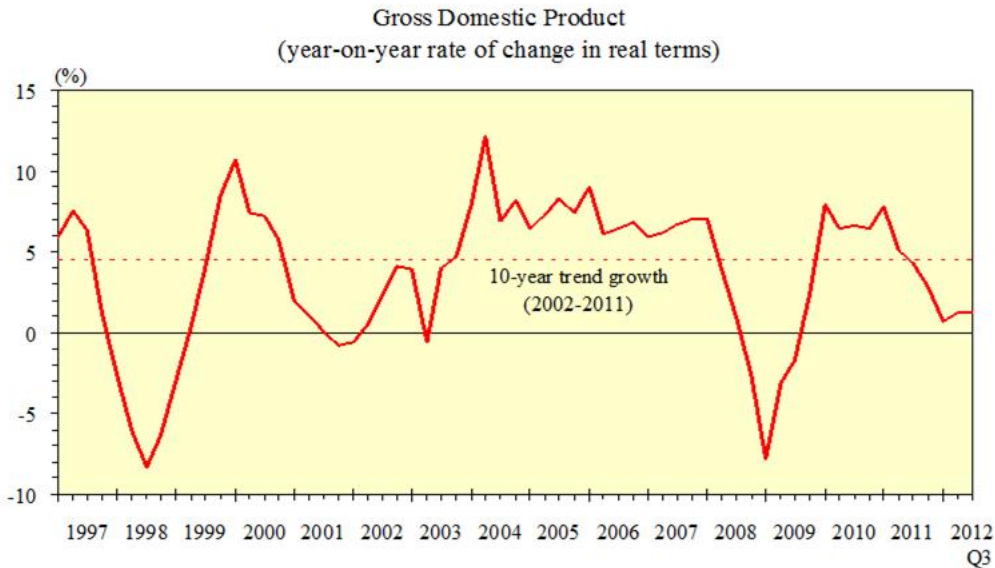
Latest 2012 economic indicators

GDP real growth	January to September	1.0% (Third quarter 1.3%)
Unemployment rate	August to October	3.4% (Third quarter 3.3%)
Consumer price inflation	January to October	4.1% (October 3.8%)

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

- Dragged by sluggish external demand, the Hong Kong economy only posted a 1.0% growth in real terms in the first three quarters of 2012 over a year earlier.
- Along with a steady growth in the domestic sector, the labour market held largely stable. The seasonally adjusted unemployment rate however edged up to 3.4% in the three months ending October, suggesting some deterioration in the labour market of late after four quarters of subpar economic growth. Inflation has been on an easing trend in 2012 amid the slower local economic growth and lower imported inflation.
- Downside risks to the global economy remain considerable, due mainly to the unsettling eurozone sovereign debt crisis, the unsteady US economic recovery and looming fiscal cliff, and the slowdown of the Asian economies. As a small and open economy, the Hong Kong economy will inevitably be affected, though the continued growth in local consumption and tourist spending, as well as infrastructure spending will provide some support. In sum, the economic outlook for the rest of 2012 and next year remains challenging. We need to stay alert to the downside risks and get prepared to cope with any adverse developments in the period ahead.

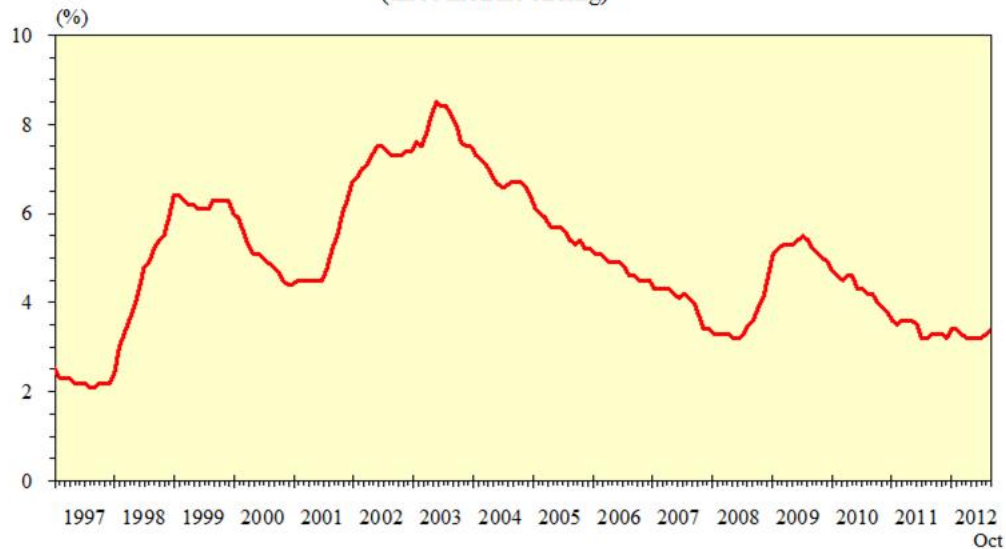
Economy remained rather sluggish so far in 2012



- The Hong Kong economy has seen only a tepid growth over the past year, mainly on account of the setback in goods trade. In view of the lull in the US and European economies and the negative spillovers to the Asian and other emerging economies, the Hong Kong economy is expected to grow modestly in the rest of 2012. Indeed, Hong Kong's merchandise exports have remained weak in recent months alongside a region-wide moderation in export and production activities.
- At the same time, the loose monetary stance in the advanced economies is set to prevail for an extended period of time, given their sluggish economic performance and deeply-rooted structural problems. We need to stay vigilant to the risks to our economy as well as financial and asset markets arising from the persistent global liquidity glut and the potential disruptions brought about by possible capital flow reversals.

Labour market held largely stable

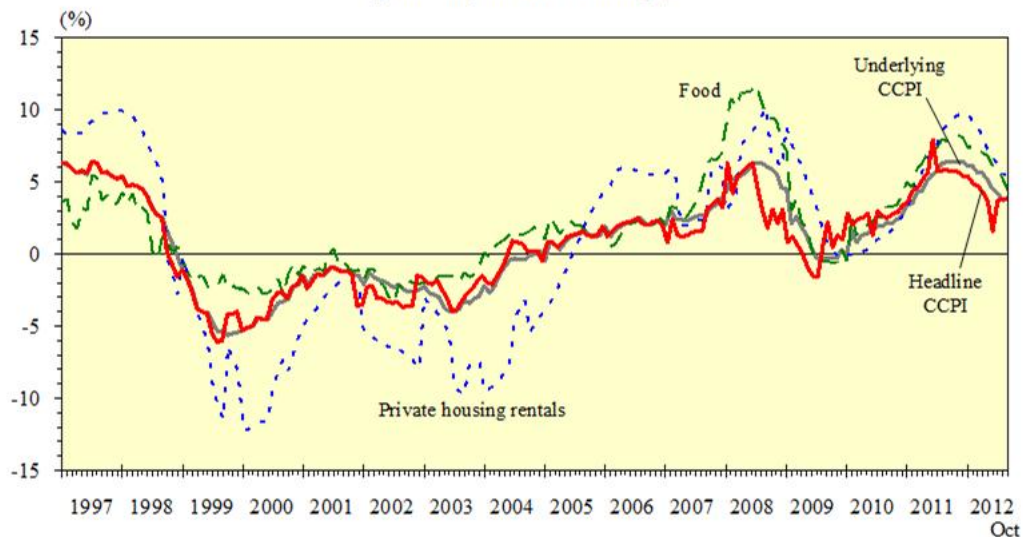
Seasonally adjusted unemployment rate
(three months ending)



- On the back of a relatively resilient domestic sector, the labour market has held largely stable, though with signs of slowdown in employment growth emerging of late amid the austere external environment, causing the unemployment rate to edge up to 3.4% in the latest period. Meanwhile, wages and incomes showed further albeit slower increases as the boost from statutory minimum wage implementation waned.

Inflation continued to taper in 2012

Composite Consumer Price Index
(year-on-year rate of change)



- Inflation has generally been tapering since 2012, reflecting the progressive feed-through of the earlier softening of global food and commodity prices, the relative stabilisation of fresh letting residential rentals in late 2011 and early 2012, and easing price pressures on the domestic front amid the growth moderation.
- The receding local and external price pressures should keep inflation contained for the rest of this year. However, there are still upside risks to inflation in the period ahead, given the abundant global liquidity and the volatile nature of food and commodity prices in the international markets, and the renewed pick-up in local fresh-letting rentals in recent months.
- We will stay vigilant to the developments on the inflation front and closely monitor its impact on the lower-income people.

Latest forecasts for 2012

GDP real growth 1.2%

Consumer price inflation

Headline 3.9%

Underlying 4.5%

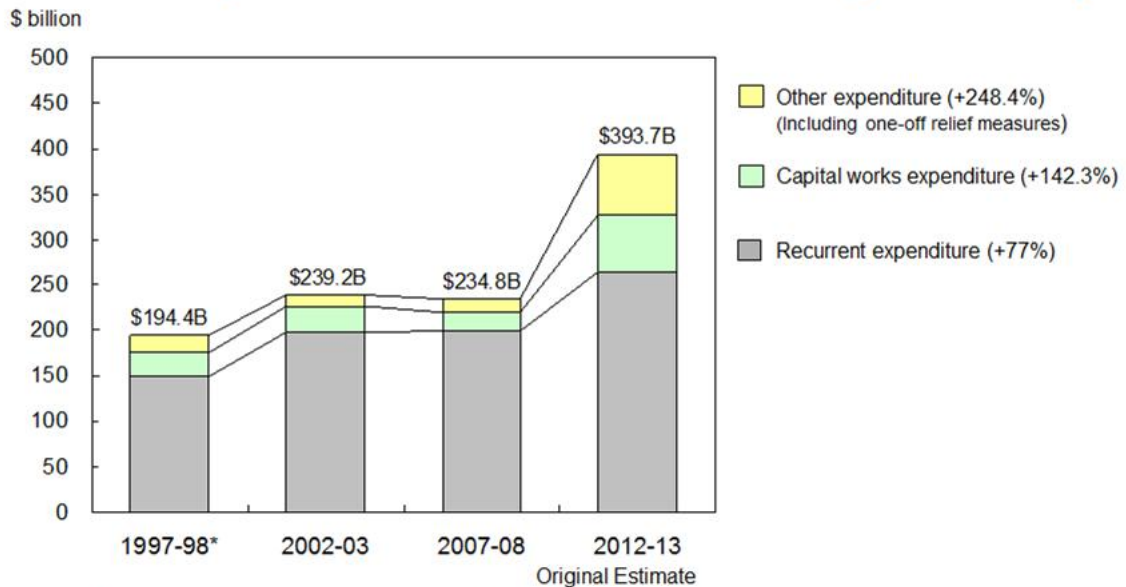
- Amid mounting headwinds to the global economy, the external environment would remain difficult and continue to overshadow Hong Kong's near-term export outlook. The domestic sector is expected to hold up better and hopefully provide some cushioning effect to the local economy.
- Given the actual outturn in the first three quarters and in view of the considerable downside risks on the external front, the economy is forecast to grow by 1.2% for 2012 as a whole.
- On inflation outlook, in view of the slower economic growth and the more moderate imported inflation, inflation should remain contained in the rest of 2012. Headline and underlying consumer price inflation rates for 2012 as a whole are forecast at 3.9% and 4.5% respectively.

Economic uncertainties

- Eurozone sovereign debt crisis
- US fiscal cliff
- Risk of prolonged slack in the advanced economies
- Resurgence of protectionist sentiment
- Abundant global liquidity and gyrations in exchange rate, financial and asset markets

- As a small and open economy, Hong Kong can hardly be unscathed from an austere external trading environment stemming from the sluggishness of the advanced economies. We shall continue to ride on the growing economic prowess of the Asian region and foster overseas linkages to build on Hong Kong's competitive edge as a global financial centre and regional business hub as well as the gateway to the Mainland.
- Leveraging on our sound fundamentals and institutional strengths, the Government will proactively serve as the market facilitator to promote economic and industrial development, with a view to allowing our enterprises to thrive and enhancing our overall competitiveness. In this regard, Hong Kong's economic prospects over the medium to long term remain bright while continuing to shift towards a knowledge-based, high value-added economy.

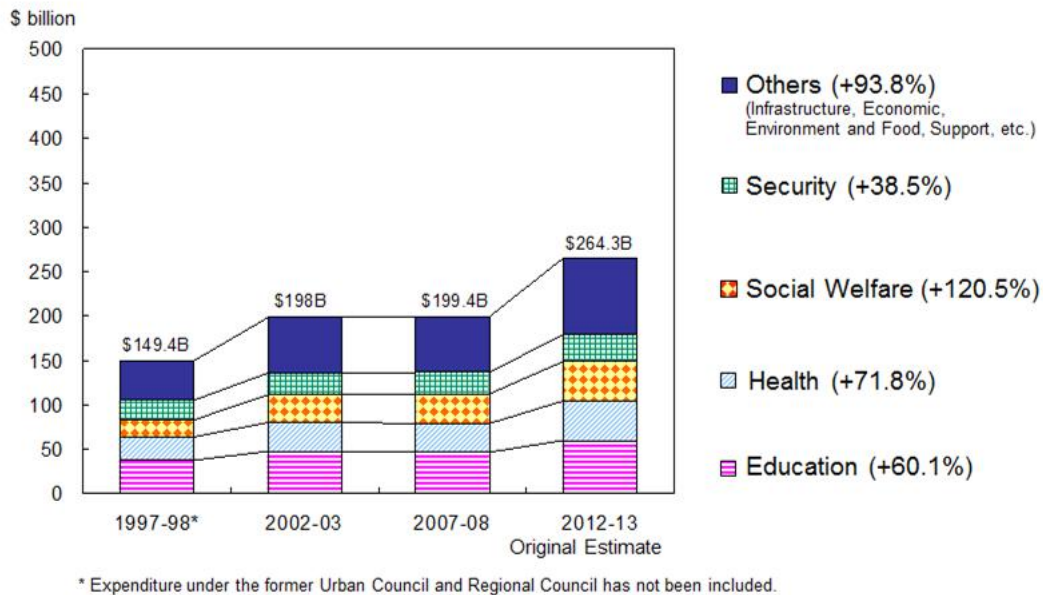
Total expenditure since 1997-98 (+102.6%)



- Total expenditure for 2012-13 is estimated to reach \$393.7 billion, representing an increase of \$29.7 billion, or 8%, over the actual expenditure for 2011-12. It is more than double when compared with 1997-98 —

	<u>Compared with 1997-98</u>
➤ Recurrent Expenditure	+77%
➤ Capital Works Expenditure	+142%

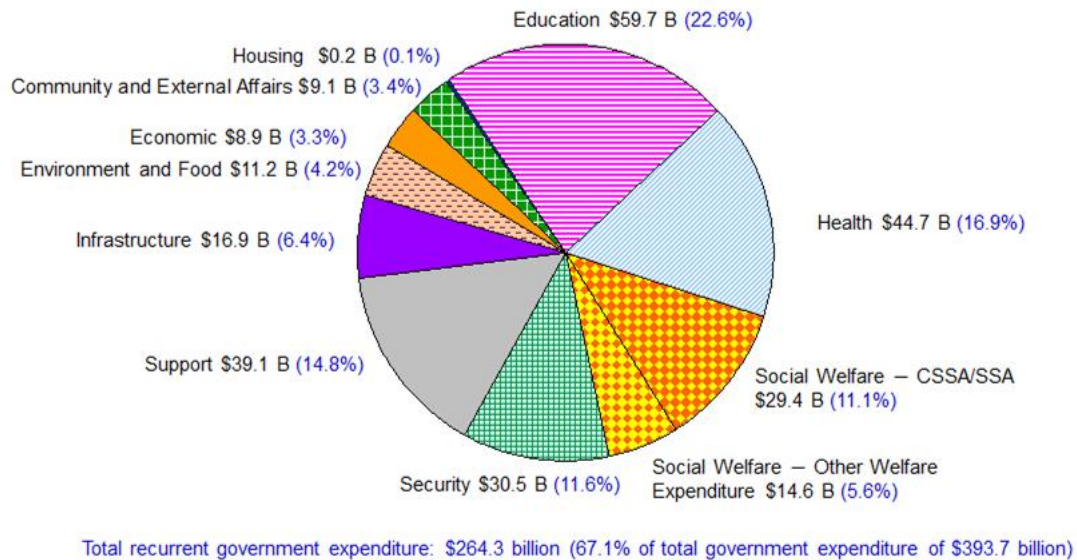
Recurrent expenditure since 1997-98 (+77%)



- Recurrent expenditure for 2012-13 is estimated to reach \$264.3 billion, representing an increase of \$21.8 billion, or 9%, over the actual expenditure for 2011-12. It is more than 70% higher when compared with 1997-98. The increase in recurrent expenditure reflects the Government's long term commitment to improving people's livelihood.
- Our recurrent expenditure on education, health and social welfare has been increasing –

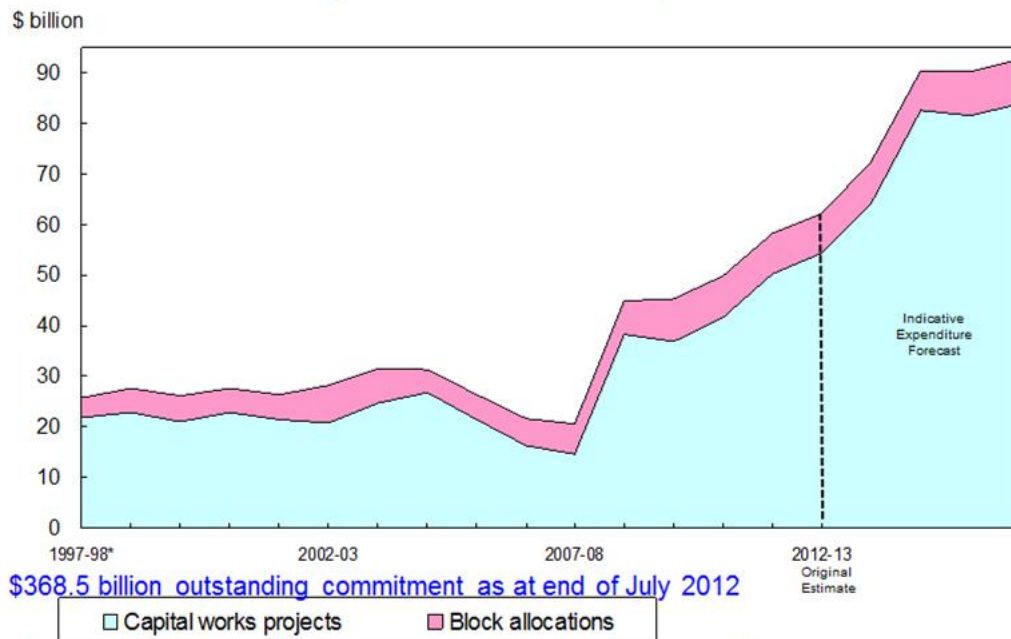
	<u>Compared with 1997-98</u>
➤ Education	+60%
➤ Health	+72%
➤ Social Welfare	+121%
<i>Comprehensive Social Security Assistance (CSSA) Scheme</i>	+105%
<i>Social Security Allowance (SSA) Scheme</i>	+127%
<i>Other welfare expenditure</i>	+140%

Recurrent expenditure for 2012-13



- Based on the 2012-13 Estimates of Expenditure, the spending on Education (22.6%), Health (16.9%) and Social Welfare (16.7%) together accounts for 56.2% of total recurrent government expenditure.
- The introduction of the Old Age Living Allowance and increase in the amount of health voucher per annum will further increase the expenditure on Social Welfare and Health.

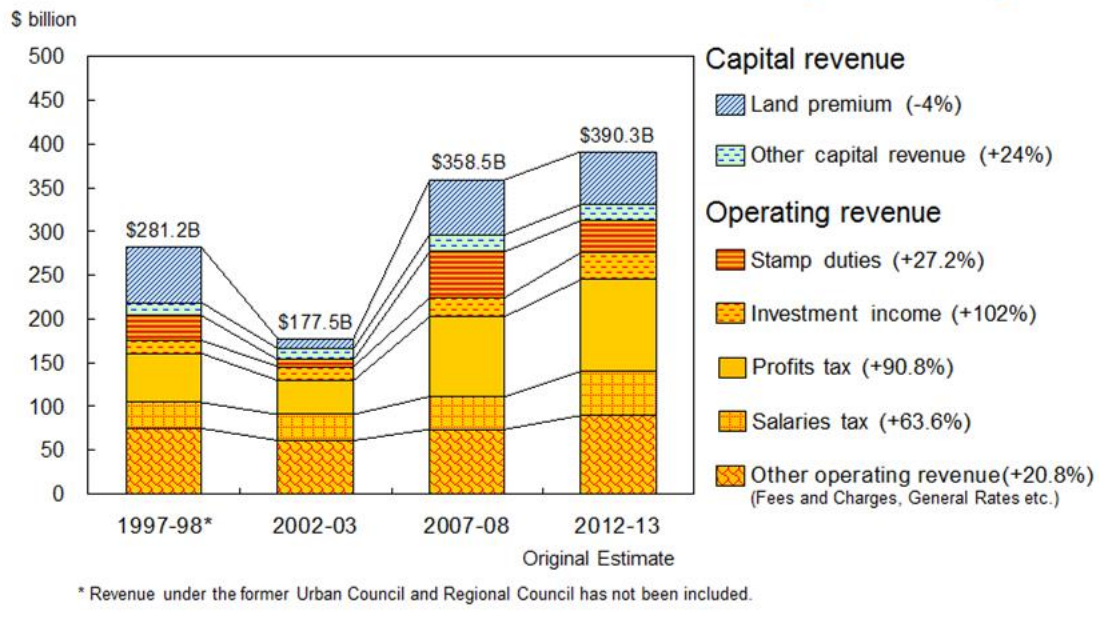
Capital Works Expenditure



* Expenditure under the former Urban Council and Regional Council has not been included.

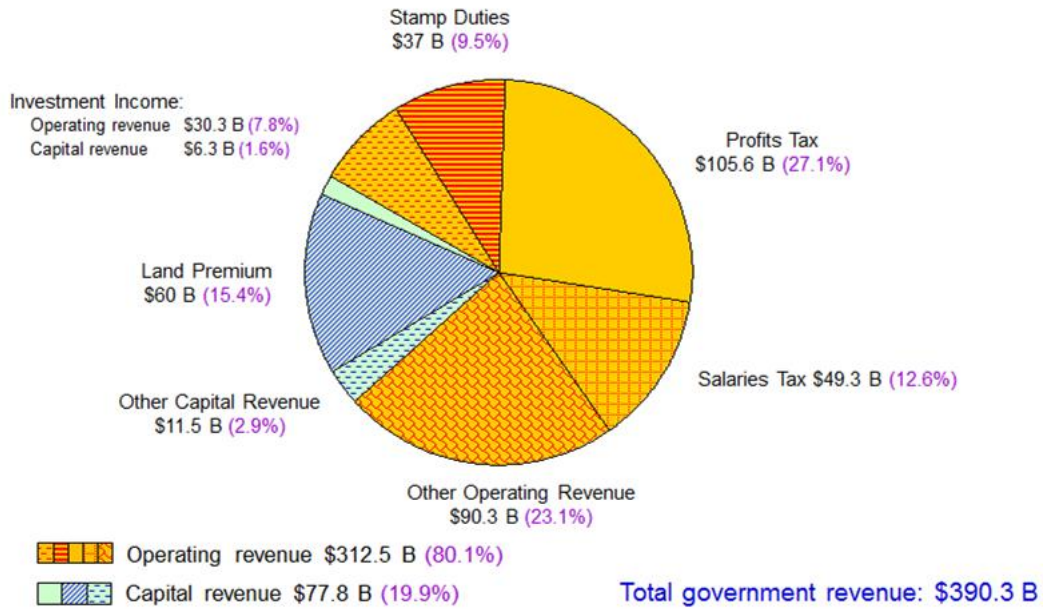
- The 2012-13 estimated expenditure on capital works under the Capital Works Reserve Fund will reach \$62.3 billion (including \$8 billion allocation for minor works), representing an increase of 7% over the actual expenditure for 2011-12. It is 1.4 times higher than the actual for 1997-98. Capital works expenditure is expected to increase to over \$70 billion per year in the next few years. As at end July 2012, outstanding commitment of capital works projects approved by the Legislative Council was \$368.5 billion in money-of-the-day prices.

Total revenue since 1997-98 (+38.8%)



- Profits tax has been our largest operating revenue. It varied from \$37.7 billion in 1999-2000 to \$118.6 billion in 2011-12.
- Salaries tax has been our second or third largest operating revenue. It varied from \$24.8 billion in 1999-2000 to \$51.8 billion in 2011-12.
- 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 volatility of investment income. The average annual revenue from this source exceeded \$35 billion for the years from 2007-08 to 2012-13.
- As for capital revenue, land premium has been most volatile, fluctuating from \$5.4 billion to \$84.6 billion in the period.
- The volatility of our revenue income poses challenges to the management of public finances.

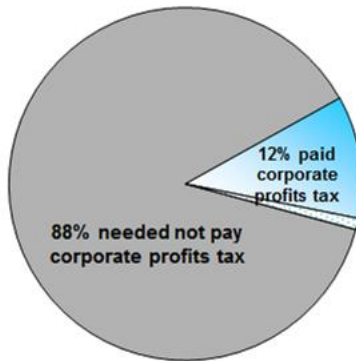
Revenue for 2012-13



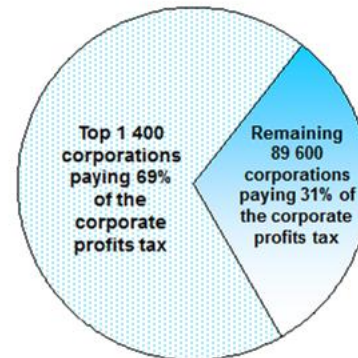
- The five major revenue items are profits tax (27.1%), salaries tax (12.6%), stamp duties (9.5%), investment income (mainly from placement of the fiscal reserves with the Exchange Fund) (9.4%) and land premium (15.4%). Together they account for 74% of total government revenue.

Profits Tax (Year of assessment 2010-11)

Registered corporations



Contribution from tax-paying corporations



Actual Revenue 2010-11: Profits Tax : \$93.2 billion (25% of total government revenue)

- Only 91 000 or 12% of the 776 000 registered corporations paid profits tax. Nearly 90% of the corporations do not pay any tax. 1 400 corporations (0.18% of registered corporations) contributed 69% of the corporate profits tax revenue.

Profits Tax for Year of Assessment 2010-11

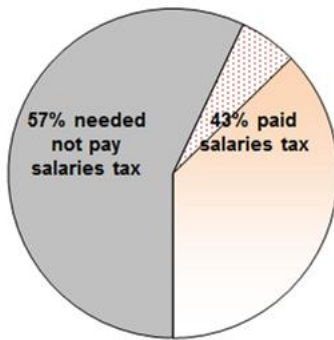
Net Assessable Profits	No. of Registered Corporations	Average Tax
(\$)		(\$)
1 – 500,000	52 600	24,710
500,001 – 1,000,000	10 900	119,270
1,000,001 – 2,000,000	9 300	236,560
2,000,001 – 3,000,000	4 200	404,760
3,000,001 – 5,000,000	4 200	642,860
5,000,001 – 7,500,000	2 600	1,000,000
7,500,001 – 10,000,000	1 500	1,400,000
10,000,001 – 20,000,000	2 600	2,307,690
20,000,001 – 30,000,000	900	4,111,110
30,000,001 – 50,000,000	800	6,750,000
50,000,001 – 100,000,000	700	11,428,570
Over 100,000,000	700	82,571,430
Total	91 000	1,040,660

- Almost 58% 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.

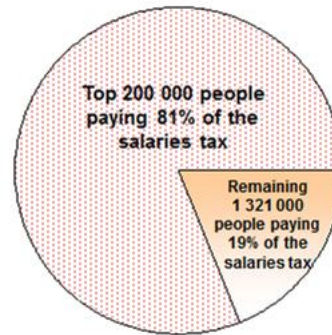
Salaries Tax

(Year of assessment 2010-11)

Working population



Contribution from taxpayers



Actual Revenue 2010-11: Salaries Tax : \$44.3 billion (12% of total government revenue)

- In 2010-11, of the 3.5 million working population, 2 million or 57% of the working population need not pay any salaries tax.
- Of the 1.5 million who paid salaries tax, 200 000 (6% of working population) contributed 81% of the revenue from salaries tax.

Salaries Tax for Year of Assessment 2010-11

Annual Income (\$)	No. of Taxpayers	Average effective tax rate *	Average tax *
(\$)		(%)	(\$)
108,001 – 150,000	216 000	0.3	350
150,001 – 300,000	611 000	1.9	4,170
300,001 – 600,000	470 000	5.3	21,960
600,001 – 900,000	110 000	9.7	70,300
900,001 – 1,500,000	66 000	12.3	137,960
1,500,001 – 3,000,000	33 000	14.2	287,060
Over 3,000,000	15 000	14.9	1,053,080
Total	1 521 000	8.1	36,160

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

- As a result of allowances and deductions under salaries tax, for 2010-11, even before the one-off tax reduction –
 - 85.3% of taxpayers (up to annual income of \$600,000) were subject to an average effective tax rate and average tax of less than 5.3% 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 around \$70,000 respectively; and
 - the overall average effective tax rate and average tax for all salaries tax payers was 8.1% and \$36,160 respectively.

Fiscal Reserves

Fund	Balance as at 31.3.2012
	\$M
General Revenue Account	360,659
Capital Works Reserve Fund	70,280
Capital Investment Fund	1,193
Civil Service Pension Reserve Fund	24,373
Disaster Relief Fund	7
Innovation and Technology Fund	2,857
Land Fund	198,140
Loan Fund	2,250
Lotteries Fund	<u>9,329</u>
Total	<u>669,088</u>

- Fiscal reserves is the total of the balances under the General Revenue Account and eight Funds established for specific purposes under s 29 of the Public Finance Ordinance.
- This is all we have to meet our day to day operational needs, outstanding commitments (including \$368.5 billion for capital works as at 31 July 2012) and liabilities (such as public officers' pensions, the present value of which as at 31 March 2011 was \$533.8 billion).

Commitments and Liabilities

- \$368.5 billion outstanding commitments on capital works
- \$533.8 billion unfunded pension liabilities
- \$94.9 billion guarantees given

- As at end July 2012, outstanding commitment of capital works projects approved by the Legislative Council was \$368.5 billion in money-of-the-day prices.
- Key unfunded liabilities include public officer's pensions, bonds issued in 2004 etc. The 2012-13 pension expenditure is estimated at \$23.1 billion and the pension liability at present value as at 31 March 2011 was \$533.8 billion.
- Government has provided guarantees of \$94.9 billion as at 31 March 2012.

Functions of the Fiscal Reserves

- Strengthening HK\$ stability
- Fiscal cushion for economic downturn
- Supporting day to day operational needs
- Generating investment income
- Coping with challenges from an ageing population

- Mostly placed with the Exchange Fund, the fiscal reserves help to strengthen the stability of the Hong Kong dollar. At the end of March 2012, the fiscal reserves amounted to one quarter of the Exchange Fund's total assets.
- For the six years from 1998-99 to 2003-04, we experienced five years of deficits. Fiscal reserves declined from 28 months of government expenditure in March 1998 to 13 months in March 2004.
- As government expenditure is relatively evenly spread throughout the year but revenue mostly collected at year end, we need a buffer to meet in-year cashflow needs.
- Investment income from fiscal reserves is a major source of revenue generating some \$37 billion in 2012-13, equivalent to around 10% of the total government revenue. Investment income will be reduced if our fiscal reserves are reduced.
- Our population is ageing. We need to accumulate savings in our fiscal reserves to cope with the fiscal pressure arising from such structural changes. In an earlier report, the International Monetary Fund was of the view that fiscal pressures arising from population ageing could mean additional reserves equivalent to 30% of the GDP by 2030. For reference, 30% of the 2012 forecast GDP amounts to some \$590 billion.

Your views are welcome!

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