

**Consultation
on
2015-16 Budget**

24 December 2014

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2014 economic indicators

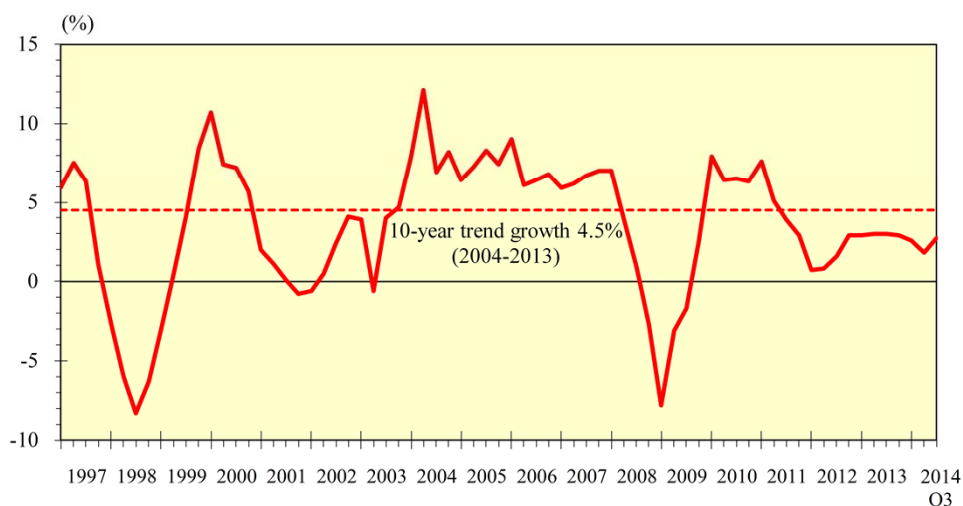
GDP real growth	Q1-Q3	2.4%
	Q3	2.7%
Unemployment rate	Sep – Nov	3.3%
Underlying consumer price inflation	Jan – Nov	3.5%
	Nov	3.3%

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

- The Hong Kong economy grew modestly in the first three quarters of 2014, by 2.4% in real terms over a year earlier. The subpar performance was mainly weighed down by the slackening of tourist spending and the slowdown in domestic demand.
- The labour market held largely stable, with the seasonally-adjusted unemployment rate staying at 3.3% in September - November 2014. Underlying inflation continued to show an easing trend, averaging 3.5% in the first eleven months of 2014.

Economy grew only modestly in the first three quarters of 2014

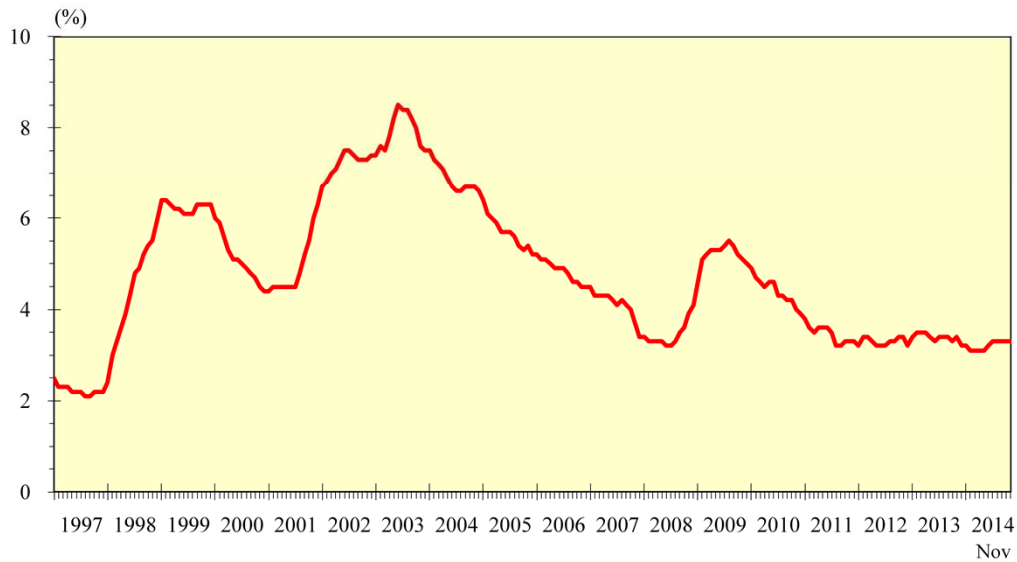
Gross Domestic Product
(year-on-year rate of change in real terms)



- The Hong Kong economy grew by 2.7% in the third quarter, faster than in the previous quarter, but the expansion pace remained below the 10-year average trend.
- The recovery of merchandise exports was moderate thus far, due to tepid demand in the advanced markets. Concurrently, after brisk growth in the past few years, visitor spending fell off, though the decline narrowed visibly by the third quarter. Domestic demand was also soft in overall terms, mainly held back by the decline in investment expenditure.

Labour market conditions held generally stable

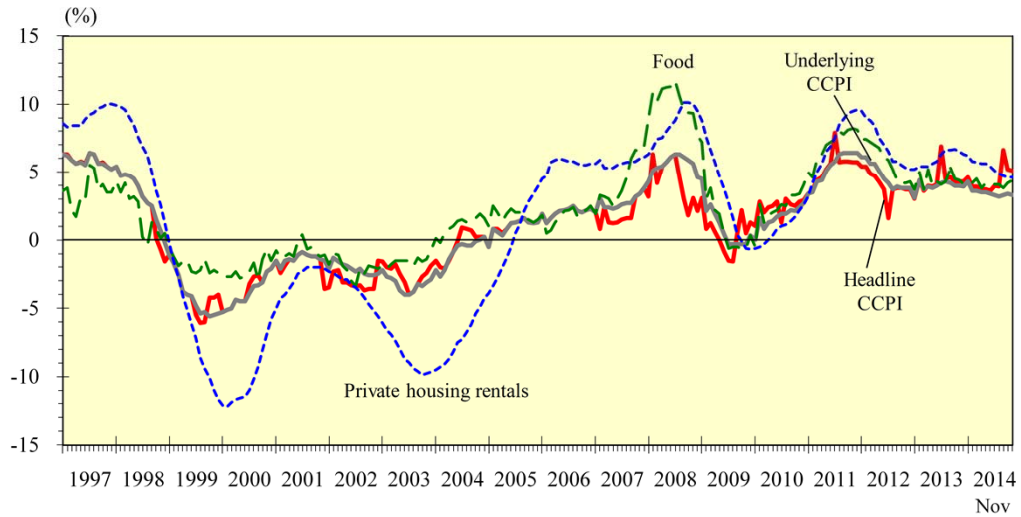
Seasonally adjusted unemployment rate
(three months ending)



- The labour market held largely stable, with the seasonally-adjusted unemployment rate staying at 3.3% in September – November 2014, and employment keeping moderate year-on-year gains. Wages and earnings maintained steady growth, while average employment earnings for the grassroots workers also sustained improvement in real terms in the first three quarters of 2014.

Underlying inflation followed an easing trend

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



- Underlying consumer price inflation eased to 3.5% in the first eleven months of 2014, down from 4.0% in 2013 as a whole, thanks to the milder increases in rentals and relatively gentle imported inflation.

Latest forecasts for 2014

GDP real growth 2.2%

Consumer price inflation

Headline 4.3%

Underlying 3.4%

- Given uneven recovery in the advanced economies, the pace of global economic expansion is at best moderate in the period ahead. This would continue to restrain the performance of Hong Kong's exports.
- With exports poised for only modest growth in the coming months, coupled with disruptions to the local consumption market caused by the "Occupy Movement", the real GDP growth for 2014 is forecast at 2.2%.
- On inflation outlook, the upside risks to inflation in the near term should recede further as local cost pressures remain moderate while global inflation stays benign. The headline and underlying consumer price inflation rates for 2014 as a whole are forecast at 4.3% and 3.4% respectively.

Economic uncertainties

- Timing of US interest rate hikes
- Large swings in oil price
- Weak import demand from advanced economies
- Geopolitical tensions in various parts of the world
- Slackening in tourist spending
- Slowdown in domestic demand

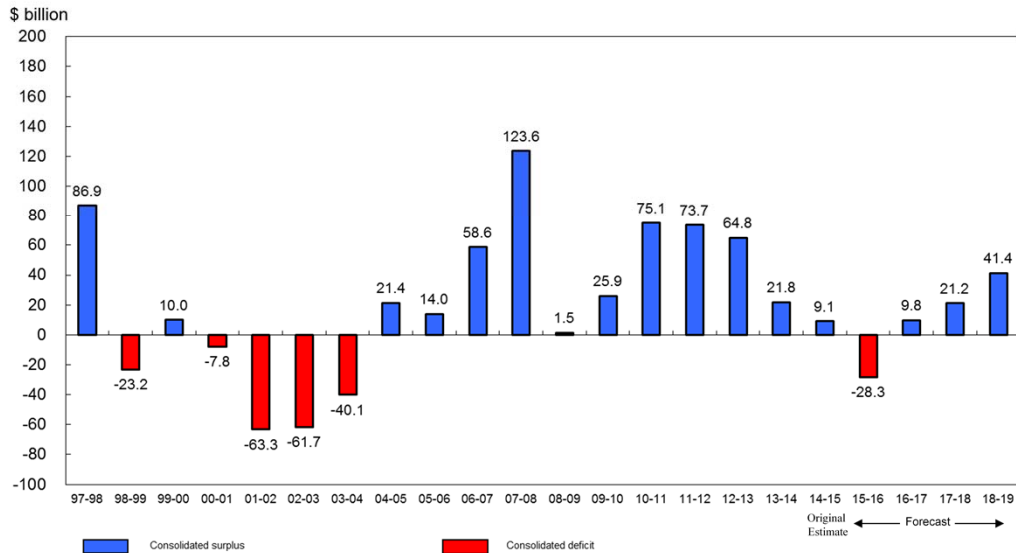
- The considerable uncertainties arising from the US monetary policy normalisation could cause marked shifts in market expectations about capital flows and interest rates, with the timing and pace of US interest rate hikes being contingent on the incoming economic data. Also, the divergence in monetary policy among the major central banks and large swings in oil price will further complicate the already unsteady global economic and financial environment.
- The growth of import demand in the advanced economies has been weak. The recoveries of Japan and Europe, being held back by structural issues, still lack momentum. The volatile and less supportive external environment might have become the new norm after the global financial crisis.
- Geopolitical risks are likely to remain elevated, affecting the global economic outlook.
- Locally, retail sales softened in October 2014, conceivably reflecting the adverse impacts of the protests on consumer sentiment. Also, the uncertainties stemming from possible changes in visitor spending pattern and domestic demand slowdown warrant concern.

The principles of fiscal sustainability are clearly enshrined in the Basic Law

- Basic Law Article 107
 - ... follow the principle of keeping expenditure within the limits of revenues
 - ... strive to achieve a fiscal balance, avoid deficits
 - ... keep the budget commensurate with the growth rate of its gross domestic product

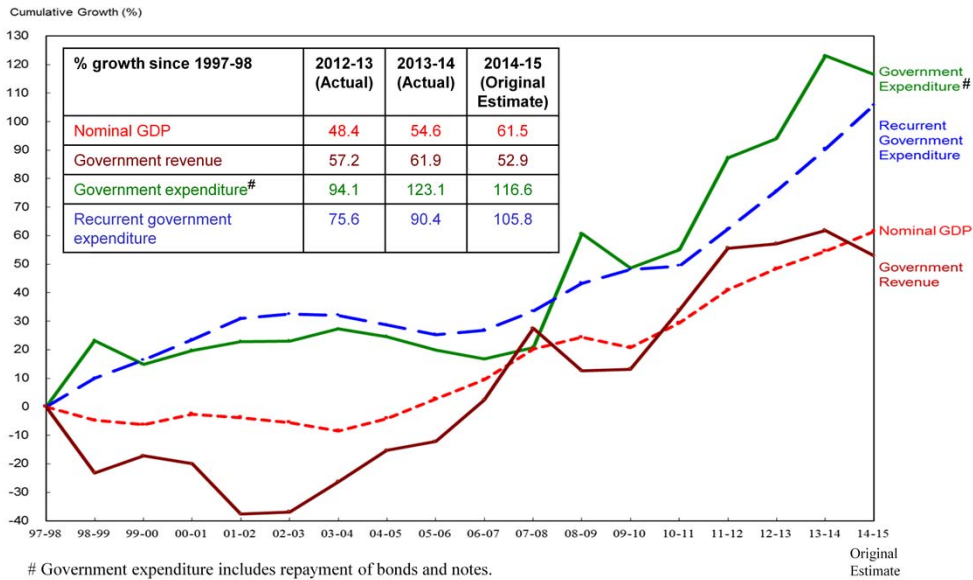
- Fiscal prudence has been the guiding principle of the HKSAR Government. Under the Basic Law (BL), we shall -
 - (a) follow the principle of keeping expenditure within the limits of revenue in drawing up the budget;
 - (b) strive to achieve a fiscal balance, avoid deficits; and
 - (c) keep the budget commensurate with the growth rate of the Gross Domestic Product (GDP).
- All three prongs of BL Article 107 have to be complied with.
- These principles are integral to sustaining the health of the Hong Kong economy and maintaining the confidence of local and international investors.

Since 1997-98, we have encountered 12 years of budget surplus, five years of deficit



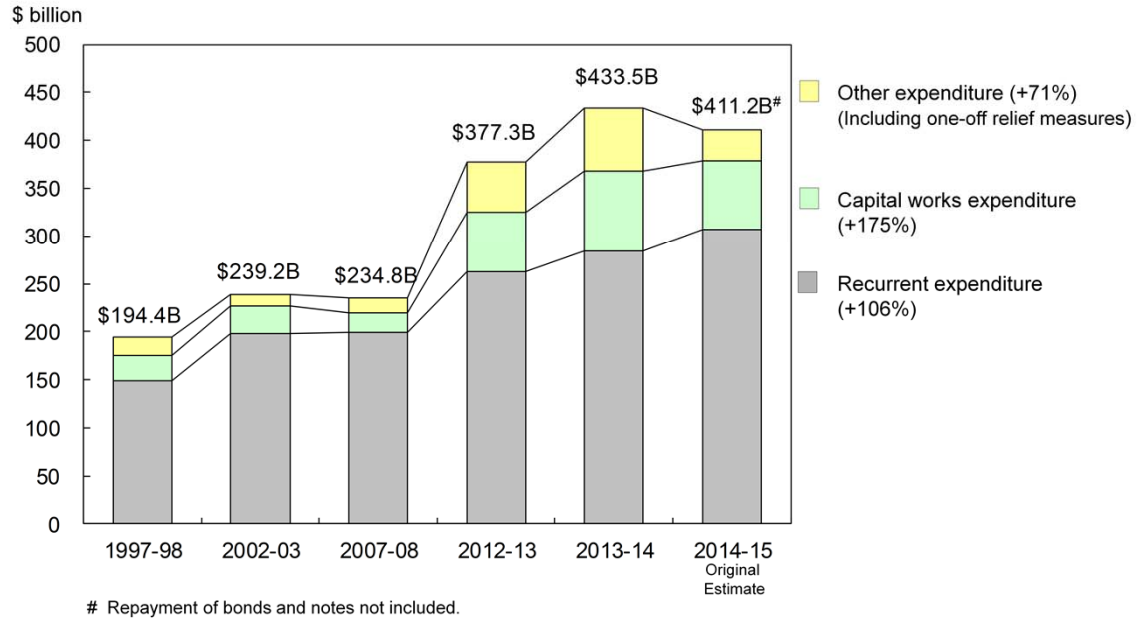
- The Basic Law requires us to strive to achieve a fiscal balance and avoid deficits.
- We have achieved budget surpluses for 12 years since 1997-98. But budget deficits had beset us for five years between 1998-99 and 2003-04 and the drain on the fiscal reserves was substantial.

Over time, government revenue has grown in line with GDP but government expenditure has surpassed GDP growth



- The Basic Law requires us to keep the budget commensurate with the growth rate of the GDP.
- GDP has grown over 60% since 1997-98.
- Government expenditure has more than doubled from nearly \$200 billion in 1997-98 to over \$400 billion in 2014-15.
- Recurrent expenditure has doubled from about \$150 billion to about \$307 billion.
- On the other hand, government revenue has grown broadly in line with GDP since 1997-98.
- There is a clear need to contain the growth of government expenditure.

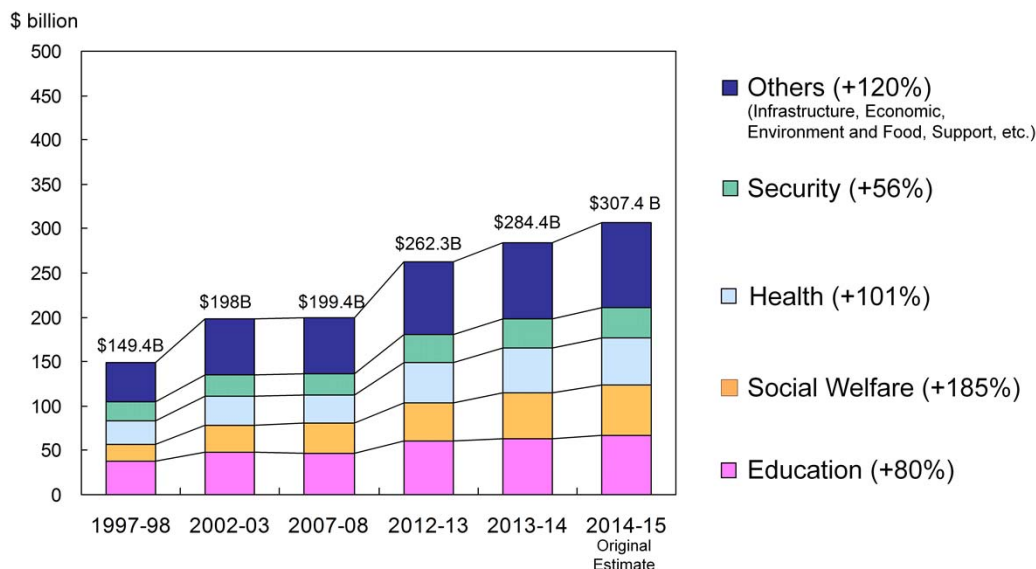
Total expenditure grew over 100% since 1997-98



- Total expenditure for 2014-15 is estimated to reach \$411.2 billion, representing a decrease of \$22.3 billion, or 5%, against the actual expenditure for 2013-14, mainly due to the reduction of one-off relief measures and one-off injections into funds for designated uses. Nonetheless, it is more than doubled when compared with 1997-98 –

	<u>Compared with 1997-98</u>
➤ Recurrent Expenditure	+106%
➤ Capital Works Expenditure	+175%

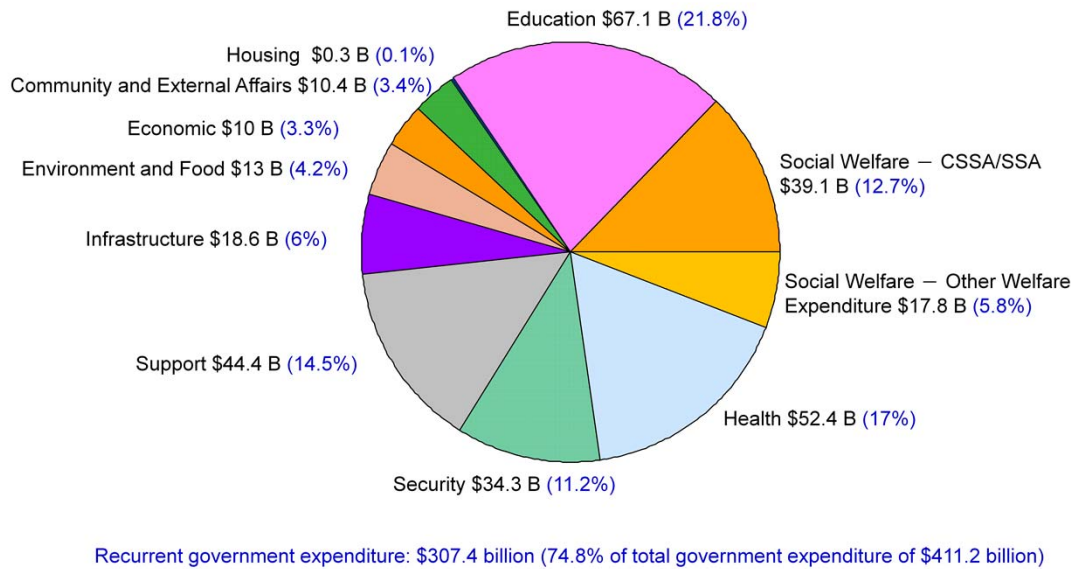
Recurrent expenditure grew by 106% since 1997-98



- Recurrent expenditure for 2014-15 is estimated to reach \$307.4 billion, representing an increase of \$23 billion (or 8%) over the actual expenditure for 2013-14. It is more than doubled 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, social welfare and health has been increasing –

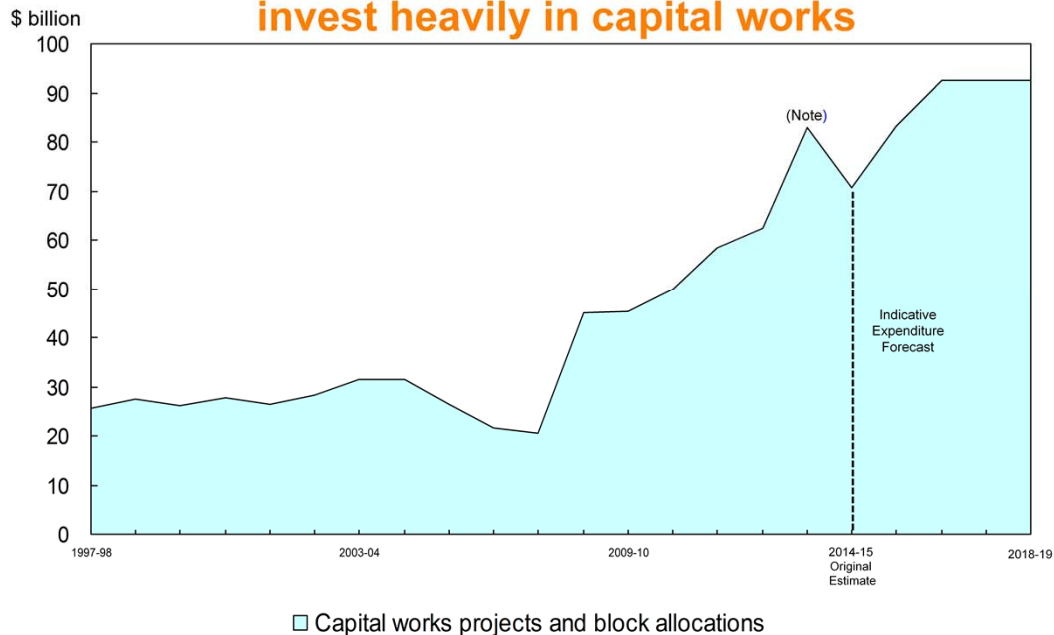
	<u>Compared with 1997-98</u>
➤ Education	+80%
➤ Social Welfare	+185%
Comprehensive Social Security Assistance (CSSA) Scheme	+129%
Social Security Allowance (SSA) Scheme	+295%
Other welfare expenditure	+192%
➤ Health	+101%

Recurrent expenditure for 2014-15



- Based on the 2014-15 Estimates of Expenditure, the spending on Education (21.8%), Social Welfare (18.5%) and Health (17%) together accounts for 57.3% of total recurrent government expenditure.

Government continuing to invest heavily in capital works



Note: Including the one-off grant of \$13 billion provided to the Hospital Authority in 2013-14.

- The 2014-15 estimated expenditure on capital works under the Capital Works Reserve Fund will reach \$70.8 billion (including \$8.5 billion allocation for minor works). Excluding the one-off grant of \$13 billion provided to the Hospital Authority, the actual expenditure in 2013-14 (\$70 billion) is comparable to the estimated expenditure in 2014-15.
- Compared with the actual expenditure for 1997-98, the level of expenditure has increased by about 175%.
- With the various major infrastructure projects entering their construction peak, capital works expenditure is expected to maintain at the current high level over the next few years.

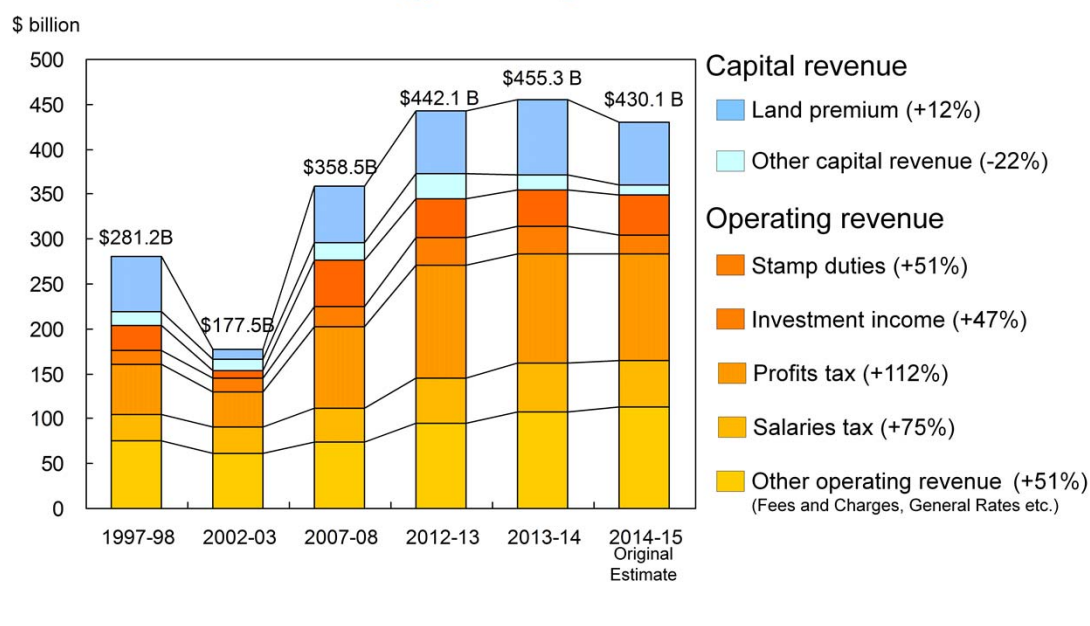
The unfunded commitment for approved projects amounted to about \$340 billion

- No provision set aside for future expenditure of projects approved by the Finance Committee

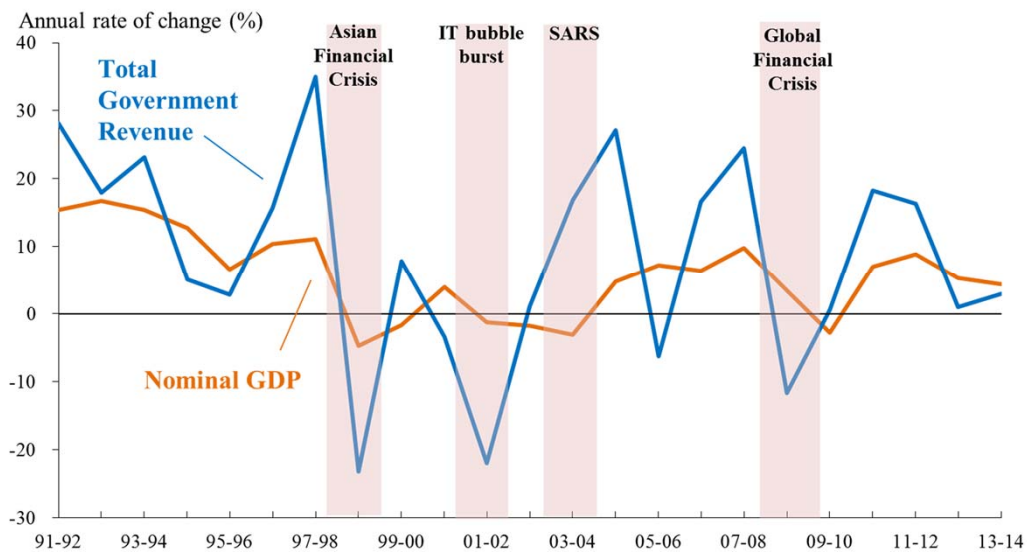
Unfunded commitment =
Approved project estimate – cumulative expenditure

- To foster economic development and enhance the quality of life of the community, our package of capital works projects covers land production, hospitals and health-care facilities, transport infrastructure, welfare facilities for the elderly, cultural and recreational facilities.
- As at end March 2014, outstanding commitment of the ongoing capital works projects was about \$340 billion. This is unfunded.

Total revenue grew by 53% since 1997-98

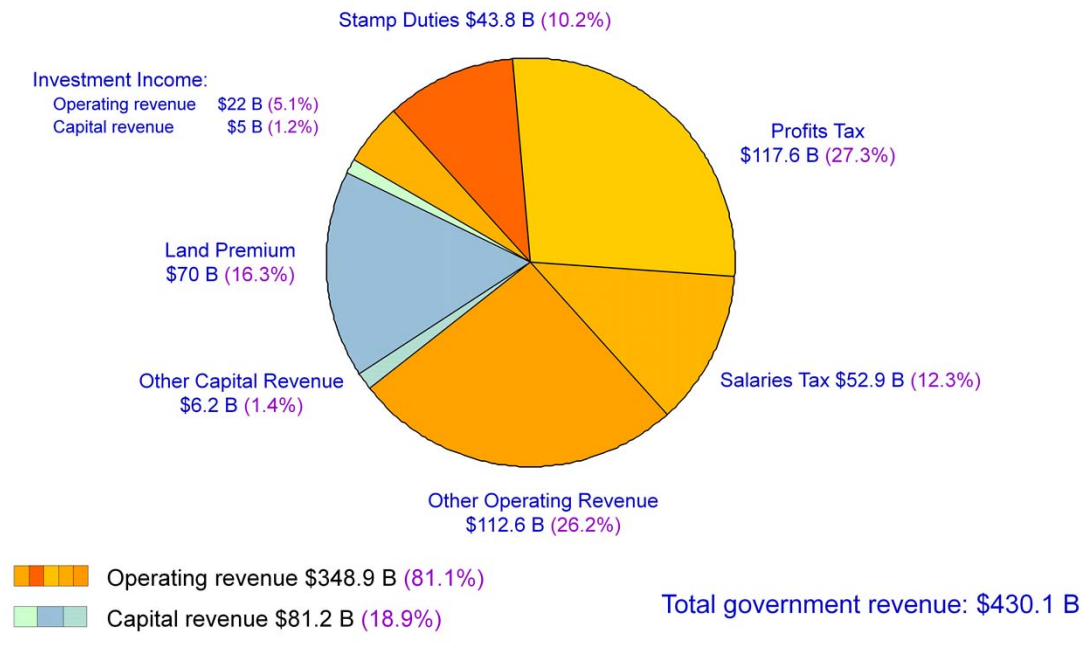


- Profits tax has been our largest operating revenue. It varied from \$37.7 billion (1999-2000) to \$125.6 billion (2012-13).
- Salaries tax has been our second or third largest operating revenue. It varied from \$24.8 billion (1999-2000) to \$55.6 billion (2013-14).
- Stamp duties varied from \$7.5 billion (2002-03) to \$51.5 billion (2007-08).
- 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 2014-15.
- 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.

Volatility of Government Revenue

- Hong Kong is a small and open economy. Our tax base is narrow and government revenue is sensitive to economic fluctuations depending on the broader economic changes beyond government's control.
- The volatility of our revenue income poses challenges to the management of public finances. Profits tax, salaries tax, stamp duties and land premium account for 66% of the 2013-14 total government revenue.

Revenue Estimates for 2014-15



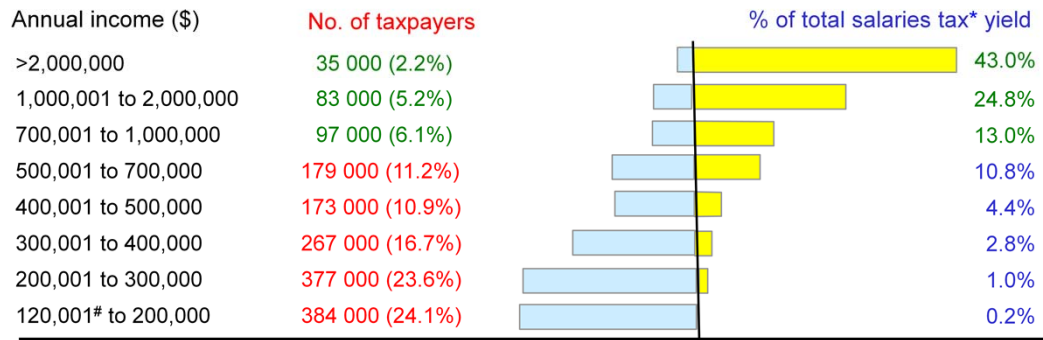
- The five major revenue items are profits tax (27.3%), salaries tax (12.3%), stamp duties (10.2%), investment income (mainly from placement of the fiscal reserves with the Exchange Fund) (6.3%) and land premium (16.3%). Together they account for 72.4% of total government revenue.

Only 43% of the working population paid salaries tax, with 14% taxpayers paying over 80% of the total salaries tax

Salaries tax

2012-13 (Year of assessment)

Taxpaying population : 1 595 000[^]



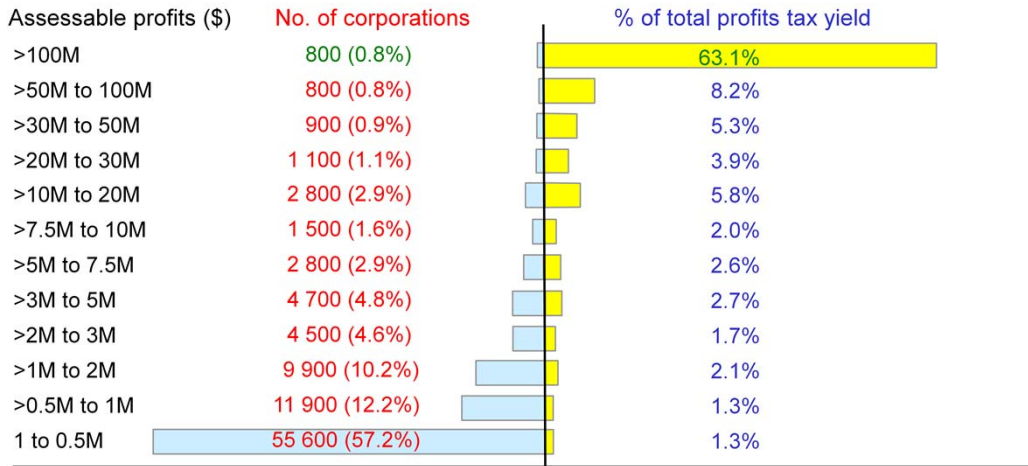
[^] Of the 3 670 000 working population, 2 075 000 do not pay any salaries tax
^{*} After the one-off tax reduction up to \$10,000
[#] The basic allowance for individuals in the 2012-13 year of assessment is \$120,000

- In the year of assessment 2012-13, of the 3.67 million working population, about 2.07 million or 57% of the working population need not pay any salaries tax.
- Of the 1.6 million who paid salaries tax, about 215 000 (5.9% of the working population or 13.5% of the taxpaying population) contributed 81% of the revenue from salaries tax.

Only 10% of registered corporations paid profits tax, with less than 1% paying over 60% of the total profits tax

Profits tax

2012-13 (Year of assessment)



Registered Corporations: 960 000, with 97 300 (10%) taxpaying.

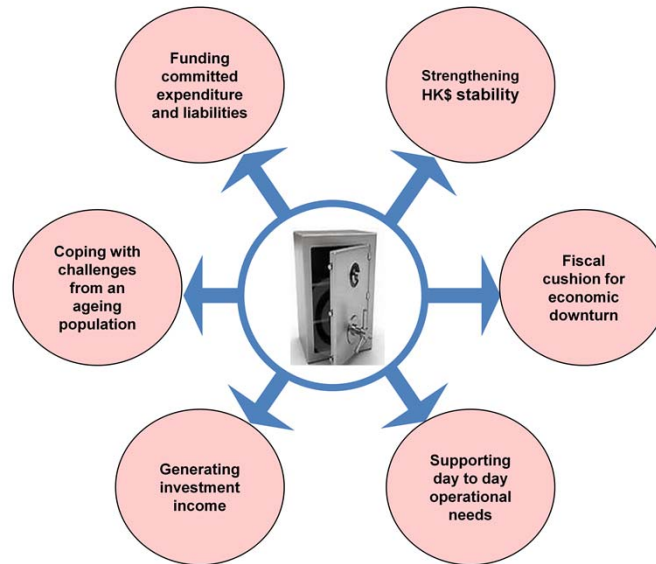
- In the year of assessment 2012-13, about 63% of our profits tax is contributed by the top 800 taxpaying corporations out of 97 300 corporations. Around 863 000 registered companies (about 90% of the total registered corporations) do not pay any profits tax.

“Fiscal Reserves” is the aggregate of cash balances, much of which is locked up in funds with designated use

(\$ million)	2013–14 Actual
General Revenue Account	402,786
Funds with designated use	133,201
Capital Works Reserve Fund	79,773
Capital Investment Fund	1,994
Civil Service Pension Reserve Fund	27,029
Disaster Relief Fund	31
Innovation and Technology Fund	1,812
Loan Fund	1,389
Lotteries Fund	21,173
Land Fund	219,730
Total	755,717

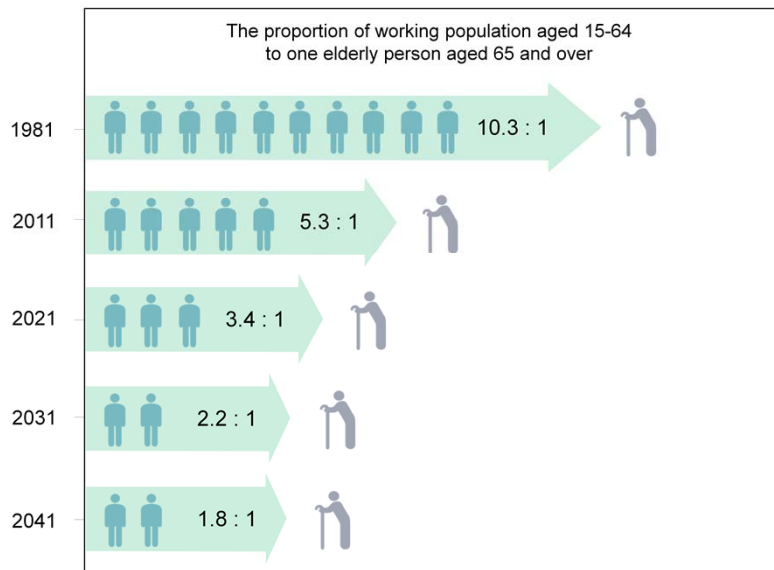
- “Fiscal Reserves” stands for the total of the balances under the General Revenue Account and eight Funds established for specific purposes under s 29 of the Public Finance Ordinance.
- This is all we have to meet our day-to-day operational needs, outstanding commitments (including about \$340 billion for capital works) and liabilities (such as public officers’ pensions, the present value of which as at 31 March 2014 was \$747.2 billion).

“Fiscal Reserves” offers multiple functions



- The fiscal reserves help to strengthen the stability of the Hong Kong dollar. At the end of March 2014, the fiscal reserves constituted a quarter of the Exchange Fund’s total assets.

Ageing Population



- In 2011, about five working age persons supporting one dependent elderly person, or 5.3 : 1.
- With the population ageing, the ratio will reduce to 1.8 : 1 in 2041, or about two working age persons supporting one dependent elderly person.

Long-Term Fiscal Sustainability

- Government's fiscal position remains healthy in the short to medium term
- Ageing population will put massive pressure on public finance
- A structural deficit could surface within a decade or two should government expenditure growth keep exceeding revenue growth
- Resolute and effective fiscal measures required

- The Working Group on Long-Term Fiscal Planning published its report in early March, providing a scientific and objective basis on Hong Kong's fiscal sustainability.
- According to the Working Group, if government expenditure keeps growing and outpacing economic and revenue growth amid an ageing population and slower economic growth, a structural deficit would be inevitable.
- As a responsible government, we shall not subject Hong Kong to any fiscal crisis. To avoid structural deficit, the Government must take a multi-pronged approach. Apart from developing our economy, it should also work on its expenditure, revenue and savings.

Stricter Fiscal Discipline

- Containing expenditure growth
- Preserving, stabilising and broadening the revenue base
- Saving for the future
- Stepping up the management of the Government's assets

- While it is important for the Government to continue promoting the growth of the economy, the key to resolving the anticipated structural deficit or reducing its quantum is to contain the growth of government expenditure, along with safeguarding the revenue base, saving for the future and to manage its assets more proactively.



- To address structural deficit problems, the Government and the community would need to acknowledge the problem ahead and adjust.
- The Government would take serious and early action to realign the growth of government expenditure with that of government revenue and of the economy.

Thank you