

**Commission on Strategic Development
Committee on Governance and Political Development**

**Public Finance Policy
and Financial Position of the HKSAR**

Introduction

Article 107 of the Basic Law stipulates that the Hong Kong Special Administrative Region (“HKSAR”) Government “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.” Article 108 of the Basic Law stipulates that the HKSAR “shall, taking the low tax policy previously pursued in Hong Kong as reference, enact laws on its own concerning types of taxes, tax rates, tax reductions, allowances and exemptions, and other matters of taxation.”

2. Paper CSD/GC/4/2006 provides background information to facilitate Members’ discussion on how we could ensure that the Basic Law principles regarding the capitalist economy could be implemented in designing a universal suffrage system for the Chief Executive and the Legislative Council. This paper provides information on the public finance policy and the financial position of the HKSAR for Members’ reference.

Public Finance Policy

3. The HKSAR Government has all along been observing the guiding principles set out in the Basic Law. Prudent management of public finances is conducive to effective governance and sustainable development of the Government. It is also integral to maintaining confidence of investors. The Government adheres to a low and simple tax regime. It always works towards maintaining the stability and integrity of the monetary system. Robustness of our public finances is one of the main economic strengths of Hong Kong.

4. Upon the impacts of the Asian financial crisis, the downward adjustment of the property market and the “SARS” outbreak on the economy, Hong Kong has run operating deficits for seven consecutive years since 1998-99. For example, for the years 2001-02 and 2002-03, operating deficits reached \$47 billion, and the consolidated deficit each year exceeded \$61 billion.

Notwithstanding this, the HKSAR Government has not abandoned the policy of “implementing prudent financial management and striving to achieve a fiscal balance”.

5. In 2004, the Financial Secretary set a target to strive to restore a fiscal balance by 2008-09. A three-pronged approach had been adopted in this respect.

(a) Boosting economic growth

6. The Government has launched a series of measures to boost economic development of Hong Kong, including furthering economic cooperation with the Mainland (e.g. implementation of the Closer Economic Partnership Arrangement with the Mainland), facilitating development of financial markets (e.g. expanding the scope of Renminbi business), and promoting development of tourism and logistics, etc.

7. Hong Kong’s economy is now on a solid footing and continues to expand at a brisk pace. Our Gross Domestic Product (GDP) grew by 7.3% in real terms in 2005.

(b) Cutting Public Expenditure

8. Over the past ten years, total recurrent expenditure has increased by about \$56.7 billion or 40%. The Government has firmly committed to investing in education and helping the disadvantaged groups. Hence, recurrent expenditure for education has increased by 41% over the same period, and that for social welfare by 110%. However, in accordance with the principle of “keeping expenditure within the limits of revenues”, we believe that the public expenditure as a proportion of GDP should be maintained at an appropriate level.

9. From the 1980s to early 1990s, public expenditure as a proportion of GDP was about 16% on average. Since then, the proportion had been rising, and reached its peak of 22% in 2003/04. In view of this, the Government undertook to control public expenditure as a proportion of GDP at 20% or below. In order to achieve the objective of “cutting down on expenditure through containing operating expenditure”, we have introduced measures to reduce the size of civil service establishment. By end March 2007, we will have been able to reduce the civil service establishment from some 198 000 at the beginning of 2000 to about 160 000.

(c) Increasing Revenue

10. The sources of our operating revenue are mainly taxes, stamp duties and government fees and charges. As for capital revenue, land premium is a key

component. In 2005/06, total government revenue is about \$241.7 billion, with profits tax and salaries tax being the major sources of revenue, accounting for about 44% of the total. However, the tax base of salaries tax and profits tax is narrow. Although the working population has increased from 3.16 million in 1997/98 to 3.37 million in 2005/06, the taxpaying population is expected to drop from 1.33 million to 1.22 million over the same period. The top 100 000 taxpayers contributed 58% of the total revenue of salaries tax in 2005/06. Moreover, 60% of our profits tax was contributed by the top 600 taxpaying corporations out of more than 57 000 corporations. Most small businesses pay little or no tax. Over the past decade, the operating revenue has only increased by \$38.8 billion or 23%.

11. Moreover, land premium, investment income and stamp duties on property transactions and stock transfers are unstable revenue items as they are susceptible to market and economic fluctuations. Over the past decade, land premium fluctuated within the range of 3% to 28% of the total government revenue, while investment income varied from 0.5% to 18%.

12. Over the past decade, government revenue has fluctuated between \$170 billion and \$280 billion. In line with our goal of “keeping expenditure within the limits of revenues”, the extent to which the Government can increase spending in the future depends on how much revenue it can generate. There is a degree of rigidity in government spending, and it is difficult to cut expenditure even in deflationary settings. Therefore, while our economy is recovering and the Government’s financial position improving, we must continue to observe a strict fiscal discipline and should not substantially increase expenditure or reduce taxes.

13. In addition, we must explore ways of bringing in new sources of revenue to yield a sizeable and steady revenue in order to protect our revenue and meet our expenditure needs. The Government has completed its study on the implementation of a Goods and Services Tax and will consult the public on whether and how best it should be implemented.

Current financial position

14. The Financial Secretary has just announced the 2006-07 Budget. With Government’s efforts to rein in our expenditure combined with strong economic growth, we shall be able to achieve, three years ahead of schedule (i.e. in 2005-06), all the three fiscal targets previously set:

- operating expenditure reduced to less than \$200 billion in 2004-05 and 2005-06;

- fiscal balance restored in the Operating and Consolidated Accounts starting from 2005-06: the first time since 1997-98 that both accounts have recorded a surplus; and
- public expenditure as a proportion of GDP lowered to and remaining below 20% from 2004-05.

15. The Financial Secretary has made it clear that, taking our forecast economic growth into account, we will increase operating expenditure moderately over the next few years to enhance the quality of government services and cater for inflation. However, Hong Kong will face many challenges, such as the impact of increased oil prices and successive interest rate hikes on the economy. Having regard to prevailing circumstances in the next five years, we will review our expenditure guidelines annually to ensure that we continue to manage our public finances prudently and keep expenditures within revenue limits.

“Big Market, Small Government”

16. The Government has been observing the principle of “Big Market, Small Government”. The forecast public expenditure as a proportion of GDP for 2006/07 is 18.2% (of which Government expenditure accounts for 16.9%), while the forecast Government revenue as a proportion of GDP is 17.7% (of which tax revenue accounts for 11.5% and land premium and other income account of 6.2%). As compared to other developed economies, HKSAR Government’s expenditure as a proportion of GDP is relatively lower. Take the year 2004 as an example, Government expenditure as a proportion of GDP of OECD member jurisdictions is 40.8% on average. However, these economies are more highly taxed than Hong Kong, and their tax bases are broader. Hence, their Government revenue as a proportion of GDP (37.3% on average in 2004) is also higher than that of Hong Kong.

17. A comparison of Hong Kong’s expenditure and revenue as a proportion of GDP with those of selected developed economies is provided below for reference.

**Government expenditure and revenue as a proportion of GDP
(2004 as reference year)**

	Government Expenditure	Government Revenue		
		Tax Revenue	Non-tax revenue	Total Revenue
	%	%	%	%
Hong Kong	18.3	11.7	8.7 [*]	20.4 [*]
United States	36.4	19.0	12.7	31.7
United Kingdom	43.9	29.0 ^{**}	11.0 ^{**}	40.0 ^{**}
Germany	47.0	22.0	21.3	43.3
Japan	37.5	16.0 ^{**}	14.0 ^{**}	30.0 ^{**}
South Korea	30.9	19.8 ^{***}	10.4 ^{***}	30.2 ^{***}
OECD members' average	40.8	-	-	37.3

* Excluding the proceeds from issuance of bonds and notes (\$ 25.4 billion), the non-tax revenue and total revenue is 6.7 % and 18.4% respectively.

** Figures for 2003.

*** Figures for 2002.

Conclusion

18. Regarding how we could ensure that the principle of “facilitating the development of the capitalist economy” could be implemented in the process of Hong Kong’s constitutional development, public views received by the Constitutional Development Task Force during the consultation period for the 2007/08 electoral arrangements had touched on this issue. There were views that as Hong Kong had a narrow tax base, if universal suffrage were implemented or functional constituencies were abolished hastily, Hong Kong might become a “welfare state”. In turn, this might affect the investment and economic environment of Hong Kong. On the other hand, there were views that in other economies practising democratic elections, although they provide higher level of welfare protection, they are also capitalist societies. Members may consider these views when exploring how we could ensure that the Basic Law provisions concerning the capitalist economy could be implemented when attaining the ultimate aim of universal suffrage as provided for in the Basic Law.

Financial Services and Treasury Bureau
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