

**For discussion
on 25 October 2002**

LEGISLATIVE COUNCIL PANEL ON FINANCIAL AFFAIRS

Fiscal Deficits and the Budgeting of Government Expenditure for Years from 2003-04 to 2006-07

PURPOSE

Members asked for information on –

- (a) the deficit situation which the Government faces and the measures we will take to address the deficit problem;
- (b) the overall budgeting strategy in respect of both the revenue and expenditure aspects for 2003-04 to 2006-07; and
- (c) in respect of the policy portfolio of Secretary for Financial Services and the Treasury, how will the efficiency savings for 2003-04 and 2004-05 to 2006-07 be achieved, how such savings will be spread out among the various programmes, and how the planning and implementation of existing and new or improved services would be affected.

2. This paper seeks to provide the requested information as far as possible. Members will note that since we are currently making preparations for the 2003-04 Budget, we are not in a position to provide firm details on some questions raised by Members. A key part of our preparation for the 2003-04 Budget is the consultations with the public and LegCo Members on the expenditure and revenue sides of the Budget. The Director of

Administration's letter of 24 July 2002 to the Chairman of the House Committee enclosed a consultation timetable of the Policy Address and the Budget. We now enclose at **Annex A** a timetable which focuses on the Budget process, and which is updated and more detailed.

DEFICIT SITUATION AND MEASURES TO ADDRESS THE PROBLEM in 2003-04 TO 2006-07

2002-2003 Deficit

3. The 2002 Budget forecast that the consolidated deficit for 2002-03 would be \$45.2 billion, or 3.6% of GDP. At this point we do not have a revised estimate. The 2002-03 budget is slightly counter-cyclical. In real terms, government expenditure was planned to grow by 2% over the original estimate for 2001-02, or 7.7% over the revised estimate, higher than the economic growth of 1% in real terms for 2002 forecast in March 2002. In money terms, on the assumption there would be a pay cut of 4.75% for the civil service to take effect from 1 October, government expenditure was planned to increase by 0.6% over the original estimate, or 6.2% over the revised estimate. On the revenue side, we introduced two moderate revenue proposals, one on duty on wine and one relating to the quantities of duty-free tobacco and still wine that Hong Kong residents may bring back. They were forecast to generate total additional revenue of \$400 million in a full year. At the same time, to help the community ride out of the storm, we introduced a package of one-off revenue concessions costing \$6.4 billion.

4. The Government accounts for the first five months to end-August 2002 recorded a cumulative deficit of \$56 billion. It is not appropriate to simply base on these results to draw any conclusion on the deficit outturn for the full year, given that among other things the bulk of our salaries and profits tax receipts occur in the last four to five months of our financial year. We are

monitoring the performance of our various revenue sources, for the purpose of finalising our revised revenue estimate for 2002-03. However, there are two major uncertainties, namely land premium and sale of the second tranche of the MTR shares. On land premium, we have received \$6 billion up to end-August as against the original estimate of \$25 billion. On the budgeted proceeds of \$15 billion from the sale of the MTR shares, whether the sale will take place in this financial year will depend on the outcome of our study underway on a possible merger of our two railways.

Strategy in 2003-04 to 2006-07

5. The 2002 Budget Speech sets three targets for our public finances in 2006-07 –

- first, restore balance in the Consolidated Account;
- second, attain a balanced Operating Account; and
- third, reduce public expenditure to 20% of GDP or below.

The Speech says we aim to achieve these targets step by step through reducing the growth of government expenditure and modestly raising revenue, and that we believe this is a practical strategy commensurate with our economic condition.

6. The Medium Range Forecast published as Appendix A to the Budget Speech (the 2002 MRF) also covers the years 2003-04 to 2006-07 and the Financial Secretary's overall budgeting strategy in respect of both revenue and expenditure aspects for these years. Assuming a trend GDP growth rate of 3% in real terms and a trend GDP deflator of 0.4%, the 2002 MRF shows that we will continue to see budget deficits in the next two years, i.e. \$38.7 billion or 3% of GDP in 2003-04 and \$15.9 billion or 1.2% of GDP in 2004-05, before returning to balanced budgets in 2005-06 and 2006-07. This forecast is reproduced at **Annex B** for easy reference.

The operating expenditure planned for 2003-04 to 2006-07

7. To achieve the above-mentioned targets in 2006-07, on the expenditure front we need to control growth of government expenditure. According to the 2002 MRF, total government expenditure in 2003-04 is estimated to be \$253.3 billion, which includes \$210.4 billion of operating expenditure. We are working on the basis of these expenditure guidelines at this stage of our preparation of the 2003-04 Budget.

8. On capital works the 2002 MRF estimates a total expenditure of \$147 billion for the five years up to 2006-07, or an average of \$29 billion per annum. This is more than the average actual expenditure of \$27 billion for the past five years. We are sticking to this provision and have no plan to cut capital works expenditure in the coming five years.

9. On operating expenditure, taking into account planned additional or improved services, natural increases in such expenditure as pensions, and the fact that the civil service pay has not been adjusted downwards by the percentage assumed by us, total operating expenditure for 2003-04 will exceed the amount stated in the 2002 MRF. To contain Government's operating expenditure at the level set out in the 2002 MRF, Directors of Bureaux are required to achieve savings of 1.8% in operating expenditure on existing and new or improved services for 2003-04 and an additional indicative 1% each year from 2004-05 to 2006-07. The savings targets after 2003-04 are provisional and subject to review in future. Further details of this arrangement are provided in the Financial Secretary's reply to the oral question by the Hon. Yeung Sum on 9 October. We should emphasise that we are at the early stage of preparation of the 2003-04 Budget. The Expenditure Estimates would not be finalised until we have gone through the consultations. A copy of the reply is at **Annex C** for Members' easy reference.

Secretary for Financial Services and the Treasury (SFST)

10. Like other Directors of Bureaux SFST is considering how to re-deploy resources in his operating expenditure envelope so that notwithstanding the efficiency savings the Bureau's services will continue to meet the priority needs of the society and those of other bureaux/departments. We are looking at various possibilities in 3Rs and 1M : Re-prioritisation, Re-organisation, and Re-engineering; and better use of the Market in the delivery of our services. In this connection we would be grateful for any comments or proposals that the public or Members of the Legislative Council may have.

Budget Consultations

11. Indeed we would be grateful for comments or proposals on how we should re-prioritise the use of resources in other policy areas, and on how we should budget for expenditure and revenue in 2003-04 and thereafter. We will very soon start the next important stage of work for next year's budget. The Financial Secretary will be consulting Members of the Legislative Council, relevant organisations and the public on the 2003-04 Budget.

12. In the process leading to the 2002 Budget Speech on 6 March 2002, we made one change so that we published the 2002-03 Expenditure Estimates on the same day, instead of publishing them on the Friday before the Budget Day as we had done in some past years. In our letter of 21 February 2002 (a copy at **Annex D**) we explained that under the previous arrangement when we announced the Expenditure Estimates for the year we did not at the same time provide other essential information such as revenue forecasts, forecast of our fiscal position, and our Medium Range Forecast. Without such other information, some LegCo Members and members of the public might find it difficult to analyse our Expenditure Estimates, and there had been occasions where Members' questions on the Estimates could not be answered until after the Budget Day. We therefore believed that it would be useful to try an

alternative arrangement for the 2002-03 Budget with a view to facilitating Members' consideration of the Budget. To give Members and the public a complete picture in which to understand the relationships among expenditure, revenue, fiscal balance and other relevant dimensions, the then Secretary for the Treasury and FS attended a special Finance Committee meeting in the morning of 7 March 2002 to brief Members on the key points on the Budget and answer Members' questions. Having reviewed the experience our plan is to continue this arrangement for the 2003-04 Budget by publishing the Expenditure Estimates on the same day as the Budget Day on 5 March 2003. The timetable at Annex A reflects our plan and gives Members the same number of working days as this year for giving us their questions.

Financial Services and the Treasury Bureau (Treasury)
22 October 2002

2003-04 Budget

Timetable of Consultation/Processes

| Target Date | Event |
|--------------------------------|---|
| 25 Oct 2002 | FS to issue information pack to LegCo Members as background information for consultations on the 2003-04 Budget and brief LegCo Panel on Financial Affairs on fiscal deficits and the budgeting of Government expenditure for years from 2003-04 to 2006-07 |
| November 2002 | FS to consult LegCo Members on their proposals for both expenditure and revenue for the 2003-04 Budget |
| 8 Nov 2002 | Briefing of Finance Committee Members on budget process |
| December 2002/ January 2003 | Bureaux to finalise their estimates submissions for the 2003-04 Estimates taking into account views received from consultations. |
| January 2003 | Treasury Branch to finalise Estimates on Expenditure (including Controlling Officer's Report, Subhead Estimates, Details of Expenditure by Subheads and Capital Account Commitments) in consultation with bureaux |
| February 2003 | Final proof and printing of Estimates of Expenditure and Revenue |
| 5 Mar 2003 | Budget Day: FS to deliver Budget Speech at LegCo – 1st Budget Sitting |
| 6 Mar 2003 | FS/SFST to brief Finance Committee Members on the Budget. |
| 24-28 Mar 2003 | Special Finance Committee Meetings to examine draft Estimates of Expenditure |
| 2-3 Apr 2003 | 2nd Budget sitting – LegCo Members to debate on Budget Speech |
| 9 Apr 2003 | 3rd Budget sitting – LegCo Members to vote on the Appropriation Bill |
| | FS to deliver Concluding Speech |
| 30 Apr 2003 | SFST to introduce Revenue Bills, if required |

Financial Services and the Treasury Bureau (Treasury)**October 2002**

APPENDIX A

MEDIUM RANGE FORECAST

2001-2002 TO 2006-2007

MEDIUM RANGE FORECAST 2001-2002 TO 2006-2007

INTRODUCTION

The *Medium Range Forecast* (MRF) is a projection of expenditure and revenue for the forecast period based on the forecasting assumptions and budgetary criteria outlined in Section I of this Appendix.

2 The MRF is presented in three sections:

(I) Forecasting assumptions and budgetary criteria.

(II) The MRF for 2001-2002 to 2006-2007.

(III) Relationship between Government Expenditure, Public Expenditure and GDP in the MRF.

3 Government's contingent liabilities at 31 March 2001 and an estimate at 31 March 2002 and 31 March 2003 respectively are provided in Section IV of this Appendix as supplementary information to the MRF.

SECTION I - FORECASTING ASSUMPTIONS AND BUDGETARY CRITERIA

4 A number of computer based models are used to derive the MRF. These models reflect a wide range of assumptions about the factors determining each of the components of Government's revenue and expenditure. Some are economic in nature (the general economic assumptions) while others deal with specific areas of Government's activity (the detailed assumptions). These are supported by studies of historical and anticipated trends.

General Economic Assumptions

Growth in Gross Domestic Product (GDP)

5 There is a clear link between many of Government's major revenue sources and economic growth. For planning purposes the medium range assumption as to *trend* annual GDP growth for 2002 to 2006 has been set at 3% in real terms.

Inflation

6 Over the forecast period of 2002 to 2006, the *trend* annual inflation in the economy, measured by the GDP deflator, is assumed to be 0.4%. The *trend* annual inflation in local consumption terms, measured by the Composite Consumer Price Index, is assumed to be 0.3%.

Methodology

7 In arriving at the yearly forecasts, account is taken of short-term fluctuations from the trend forecasts.

Detailed Assumptions

8 A wide range of detailed assumptions relating to developing expenditure and revenue patterns over the forecast period are taken into account. These include:

- estimated cash flow of capital projects.
- forecast completion dates of these capital projects and their related recurrent consequences in terms of staffing and running costs.
- estimated cash flow arising from new commitments resulting from policy initiatives.
- the expected pattern of demand for individual services.
- the trend in yield from individual revenue sources.
- new revenue measures in the 2002 Budget.

Budgetary Criteria

9 In addition to the above forecasting assumptions there are a number of criteria against which the results of forecasts are tested for overall acceptability in terms of budgetary policy. Any significant breach of important budgetary criteria results in a review and adjustments, where necessary, of the expenditure and revenue projections.

10 The following are the more important budgetary criteria:

—Budget surplus/deficit

The Government aims to achieve balance in consolidated and operating accounts by 2006-2007. In the longer term, the Government needs to achieve an operating surplus to partially finance capital expenditure.

—Fiscal reserves

The Government aims to maintain the level of reserves at around 12 months of total government expenditure.

—Total expenditure growth

The general principle is that, over time, expenditure growth should not exceed the growth of the economy, taking into account both real and nominal terms. The Government aims to keep public expenditure at or below 20% of GDP by 2006-2007.

—Capital expenditure growth

By its nature some fluctuations in the level of capital expenditure are to be expected. However, over a period the aim is to contain capital expenditure growth within overall expenditure guidelines.

—Revenue policy

Account is taken of the need to maintain over time the real yield from fees and charges, fixed duties etc. and to review periodically the various tax thresholds in the light of inflation.

SECTION II - THE MRF FOR 2001-2002 TO 2006-2007

11 The current MRF (*Note a*) is summarised in the following three tables which indicate the forecast operating position, capital financing position and consolidated reserves position.

Operating Account

Table 1

| | Revised Estimate | Forecast | | | | |
|---|------------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| | | 2001-2002 | 2002-2003 | 2003-2004 | 2004-2005 | 2005-2006 |
| | \$m | \$m | \$m | \$m | \$m | \$m |
| Operating revenue (<i>Note b</i>) | 150,660 | 149,400 | 167,920 | 180,580 | 196,580 | 208,940 |
| Less : Operating expenditure (<i>Note c</i>) | 201,530 | 211,360 | 210,440 | 212,790 | 215,550 | 219,760 |
| Operating surplus/(deficit) before investment income | (50,870) | (61,960) | (42,520) | (32,210) | (18,970) | (10,820) |
| Investment income (<i>Note b</i>) | 180 | 12,640 | 15,650 | 14,190 | 13,660 | 13,610 |
| Operating surplus/(deficit) after investment income | (50,690) | (49,320) | (26,870) | (18,020) | (5,310) | 2,790 |

Capital Financing Statement

Table 2

| | Revised Estimate | Forecast | | | | |
|---|------------------|--------------|-----------------|--------------|--------------|----------------|
| | | 2001-2002 | 2002-2003 | 2003-2004 | 2004-2005 | 2005-2006 |
| | \$m | \$m | \$m | \$m | \$m | \$m |
| Capital revenue other than MTR share offer (<i>Note d</i>) | 22,780 | 36,440 | 38,470 | 39,460 | 40,680 | 41,860 |
| MTR share offer and sale of other government assets (<i>Note d</i>) | — | 15,000 | — | 10,000 | 10,000 | — |
| Less : General Revenue Account capital expenditure (<i>Note e</i>) | 2,160 | 4,160 | 3,680 | 3,770 | 3,860 | 3,970 |
| : Expenditure on capital projects (<i>Note f</i>) | 29,620 | 34,360 | 34,570 | 35,120 | 35,680 | 36,260 |
| : Loans and investments (<i>Notes g</i>) | 6,010 | 9,370 | 12,620 | 8,860 | 6,240 | 4,850 |
| : Aid for disaster relief (<i>Note h</i>) | 10 | — | — | — | — | — |
| : Expenditure for innovation and technology (<i>Note i</i>) | 360 | 560 | 580 | 690 | 720 | 720 |
| Capital financing surplus/(deficit) before investment income | (15,380) | 2,990 | (12,980) | 1,020 | 4,180 | (3,940) |
| Investment income (<i>Note d</i>) | 440 | 1,120 | 1,180 | 1,130 | 1,190 | 1,200 |
| Capital financing surplus/(deficit) after investment income | (14,940) | 4,110 | (11,800) | 2,150 | 5,370 | (2,740) |

Consolidated Reserves

Table 3

| | Revised Estimate | Forecast | | | | |
|--|------------------|-----------------|-----------------|-----------------|----------------|----------------|
| | | 2001-2002 | 2002-2003 | 2003-2004 | 2004-2005 | 2005-2006 |
| | \$m | \$m | \$m | \$m | \$m | \$m |
| Fiscal Reserves at 1 April | 430,280 | 369,760 | 325,580 | 286,910 | 271,040 | 271,100 |
| Operating surplus/(deficit) (per Table 1) | (50,690) | (49,320) | (26,870) | (18,020) | (5,310) | 2,790 |
| Capital financing surplus/(deficit) (per Table 2) | (14,940) | 4,110 | (11,800) | 2,150 | 5,370 | (2,740) |
| Consolidated surplus/(deficit) | (65,630) | (45,210) | (38,670) | (15,870) | 60 | 50 |
| Write-back of provision for loss in investments with the Exchange Fund | 5,110 | 1,030 | — | — | — | — |
| Fiscal Reserves at 31 March (<i>Note j</i>) | 369,760 | 325,580 | 286,910 | 271,040 | 271,100 | 271,150 |
| As number of months of Government Expenditure | 19 | 15 | 14 | 13 | 13 | 12 |

Notes on the Medium Range Forecast

(a) Accounting policies

- (i) The Medium Range Forecast, like Government's Accounts, is prepared on a cash basis and reflects forecast receipts and payments, whether or not they relate to recurrent or capital transactions.
- (ii) The Medium Range Forecast includes the General Revenue Account and the Funds (the Capital Works Reserve Fund, the Loan Fund, the Capital Investment Fund, the Disaster Relief Fund, the Civil Service Pension Reserve Fund, the Land Fund and the Innovation and Technology Fund).

(b) Operating revenue

- (i) Operating revenue is defined in Appendix C.
- (ii) For the purpose of the Medium Range Forecast, the investment earnings of the balance of the General Revenue Account which is credited to revenue head Properties and Investments and the investment earnings of the Land Fund are consolidated and shown separately under Investment Income in Table 1. The rate of return on investment earnings is assumed at 4% in 2002-2003 and 5.5% in 2003-2004 to 2006-2007.
- (iii) The level of operating revenue in 2002-2003 has taken into account the revenue concession and revenue-raising measures in the 2002 Budget.

(c) Operating expenditure

- (i) Operating expenditure is defined in Appendix C.
- (ii) The operating expenditure in 2001-2002 to 2006-2007 includes provision for some major expenditure items which are one-off in nature. They include compensatory payments and commuted pension gratuity payments under the Voluntary Retirement Scheme and the Voluntary Departure Scheme introduced in 2000-2001 and forecast to amount to \$12.5 billion (\$5.8 billion in 2001-2002, \$3.3 billion in 2002-2003, \$1.3 billion in 2003-2004, \$0.7 billion in 2004-2005, \$0.7 billion in 2005-2006 and \$0.7 billion in 2006-2007), and total commitments of \$7.1 billion for funding the various funds/schemes announced in the 2001 Policy Address (the \$5 billion Continuing Education Fund, the \$1.9 billion funds to support small and medium enterprises, the \$0.1 billion Community Investment and Inclusion Fund, and the \$0.1 billion fund for supporting the comprehensive development of professional services).
- (iii) The level of operating expenditure in 2002-2003 to 2006-2007 has assumed a 4.75% reduction in the salaries of the civil service and the salary-related portion of recurrent subventions to take effect from 1 October 2002. This assumed salary reduction, if implemented, will save about \$3 billion in 2002-2003 and \$6 billion in a full year in subsequent years.

(d) Capital revenue

- (i) The breakdown of capital revenue to the various General Revenue Account and the Funds is —

| | 2001-2002 | 2002-2003 | 2003-2004 | 2004-2005 | 2005-2006 | 2006-2007 |
|------------------------------------|---------------|---------------|---------------|---------------|---------------|---------------|
| | \$m | \$m | \$m | \$m | \$m | \$m |
| General Revenue Account | 4,830 | 19,720 | 4,960 | 14,470 | 14,460 | 4,380 |
| Capital Works Reserve Fund | 10,080 | 25,650 | 26,560 | 27,620 | 28,820 | 30,080 |
| Capital Investment Fund | 2,820 | 2,200 | 2,150 | 2,200 | 2,220 | 2,220 |
| Civil Service Pension Reserve Fund | 0 | 480 | 690 | 730 | 770 | 810 |
| Loan Fund | 5,470 | 4,330 | 5,060 | 5,370 | 5,430 | 5,430 |
| Innovation and Technology Fund | 20 | 180 | 230 | 200 | 170 | 140 |
| Total | 23,220 | 52,560 | 39,650 | 50,590 | 51,870 | 43,060 |

- (ii) For the purpose of the Medium Range Forecast, the investment earnings on the balances of the Funds other than the Land Fund are shown separately under Investment Income in Table 2. The forecast receipts of \$15 billion in 2002-2003 from the second tranche of MTR Corporation Limited share offer, and the assumed receipts of \$10 billion each in 2004-2005 and 2005-2006 from sale of government assets, which are to be credited as capital revenue to the General Revenue Account, are also shown separately in Table 2.
- (iii) For the purpose of the Medium Range Forecast, the annual land premia included under the Capital Works Reserve Fund for 2002-2003 to 2006-2007 are assumed at 2% of GDP.

Notes on the Medium Range Forecast —Contd.

(e) *General Revenue Account capital expenditure*

This comprises expenditure chargeable to the General Revenue Account in respect of purchase of equipment and works of a minor nature.

(f) *Expenditure on capital projects*

This comprises expenditure chargeable to the Capital Works Reserve Fund in respect of the Public Works Programme, land acquisition, capital subventions, major systems and equipment and computerisation.

(g) *Loans and investments*

(i) These comprise loans made from the Loan Fund, including loans to schools, teachers, students, housing loans, and loans under the special finance scheme for small and medium enterprises, and advances and equity investments made from the Capital Investment Fund mainly to Trading Funds and statutory bodies.

(ii) The forecast of payments from the Loan Fund is —

| 2001-2002 | 2002-2003 | 2003-2004 | 2004-2005 | 2005-2006 | 2006-2007 |
|-----------|-----------|-----------|-----------|-----------|-----------|
| \$m | \$m | \$m | \$m | \$m | \$m |
| 5,670 | 3,810 | 4,030 | 3,270 | 3,290 | 3,300 |

(iii) The forecast of payments from the Capital Investment Fund is —

| 2001-2002 | 2002-2003 | 2003-2004 | 2004-2005 | 2005-2006 | 2006-2007 |
|-----------|-----------|-----------|-----------|-----------|-----------|
| \$m | \$m | \$m | \$m | \$m | \$m |
| 340 | 5,560 | 8,590 | 5,590 | 2,950 | 1,550 |

(h) *Aid for disaster relief*

This is actual expenditure made from the Disaster Relief Fund for providing relief to disasters that occur outside Hong Kong. Because of the unpredictable nature of disasters, no estimate of future expenditure is made for the forecast period.

(i) *Expenditure for Innovation and Technology*

This comprises expenditure chargeable to the Innovation and Technology Fund to finance projects to help promote innovation and technology upgrading in manufacturing and service industries.

(j) *Fiscal reserves*

The fiscal reserves represent the accumulated balances of the General Revenue Account and the Funds.

SECTION III - RELATIONSHIP BETWEEN GOVERNMENT EXPENDITURE, PUBLIC EXPENDITURE AND GDP IN THE MRF

12 For monitoring purposes, the Government's own expenditure is consolidated with the expenditure of some other public bodies such as the Housing Authority in order to compare total public expenditure with the size of the economy. The results are set out in Table 4.

Government Expenditure and Public Expenditure in the Context of the Economy

Table 4

| | Revised Estimate | Forecast | | | | |
|---|------------------|------------------|------------------|------------------|------------------|------------------|
| | 2001-2002 | 2002-2003 | 2003-2004 | 2004-2005 | 2005-2006 | 2006-2007 |
| | \$m | \$m | \$m | \$m | \$m | \$m |
| Operating expenditure | 201,530 | 211,360 | 210,440 | 212,790 | 215,550 | 219,760 |
| Capital expenditure | 37,820 | 42,890 | 42,860 | 42,850 | 43,550 | 44,250 |
| Total government expenditure | 239,350 | 254,250 | 253,300 | 255,640 | 259,100 | 264,010 |
| Add: Other public bodies | 33,800 | 32,930 | 38,540 | 34,590 | 33,510 | 34,990 |
| Total public expenditure (Note 1) | 273,150 | 287,180 | 291,840 | 290,230 | 292,610 | 299,000 |
| Gross Domestic Product (calendar year) | 1,262,590 | 1,256,210 | 1,311,480 | 1,369,190 | 1,429,430 | 1,492,330 |
| Growth in GDP (Note 2) | | | | | | |
| Money terms | -0.3% | -0.5% | 4.4% | 4.4% | 4.4% | 4.4% |
| Real terms | 0.1% | 1.0% | 3.5% | 3.5% | 3.5% | 3.5% |
| Growth in government expenditure | | | | | | |
| Money terms | +6.5% | +6.2% | -0.4% | +0.9% | +1.4% | +1.9% |
| Real terms | +5.7% | +7.7% | +0.4% | +0.5% | +0.9% | +1.5% |
| Growth in public expenditure | | | | | | |
| Money terms | +2.1% | +5.1% | +1.6% | -0.6% | +0.8% | +2.2% |
| Real terms | +1.7% | +6.5% | +2.2% | -0.9% | +0.4% | +1.8% |
| Government expenditure as a percentage of GDP (Note 3) | 19.0% | 20.2% | 19.3% | 18.7% | 18.1% | 17.7% |
| Public expenditure as a percentage of GDP (Note 3) | 21.6% | 22.9% | 22.3% | 21.2% | 20.5% | 20.0% |

Note 1 Public expenditure comprises government expenditure (i.e. all expenditure charged to the General Revenue Account and financed by the Government's statutory funds excluding Capital Investment Fund), and expenditure by the Trading Funds, the Housing Authority and the Lotteries Fund. But *not* included is expenditure by those organisations, including statutory organisations, in which the Government has only an equity position, such as the Airport Authority, the MTR Corp Ltd and the Kowloon-Canton Railway Corporation. Similarly, advances and equity investments from the Capital Investment Fund are excluded as they do not reflect the actual consumption of resources by the Government.

Note 2 Over the period 2002 to 2006, the forecast trend nominal growth in GDP is 3.4% and the trend real growth in GDP is 3%.

Note 3 Caution should be exercised in interpreting these percentages as government expenditure and public expenditure are estimated on a fiscal year basis while the GDP is estimated on a calendar year basis.

13 Table 5 shows the sum to be appropriated in the 2002 Budget analysed between operating and capital expenditure and after including expenditure from the Funds and other public bodies. It also shows the derivation of public expenditure for 2002-2003 given in Table 4.

14 Table 5 also illustrates the effect of the Budget revenue measures on the overall surplus/deficit position for 2002-2003.

Relationship between Government Expenditure and Public Expenditure in 2002-2003

Table 5

| Components of expenditure and revenue | Appropriation | Government expenditure and revenue | | | Public expenditure |
|---|---------------|------------------------------------|---------|----------|--------------------|
| | | Operating | Capital | Total | |
| | \$m | \$m | \$m | \$m | \$m |
| Expenditure | | | | | |
| General Revenue Account: | | | | | |
| Recurrent account | 207,830 | 207,830 | — | 207,830 | 207,830 |
| Capital account | | | | | |
| Plant, equipment and works | 2,760 | — | 2,760 | 2,760 | 2,760 |
| Other non-recurrent | 6,480 | 6,480 | — | 6,480 | 6,480 |
| Subventions | 1,400 | — | 1,400 | 1,400 | 1,400 |
| | 218,470 | 214,310 | 4,160 | 218,470 | 218,470 |
| Transfer to Funds | 21,020 | — | — | — | — |
| Capital Works Reserve Fund | — | — | 34,360 | 34,360 | 34,360 |
| Loan Fund | — | — | 3,810 | 3,810 | 3,810 |
| Innovation and Technology Fund | — | — | 560 | 560 | 560 |
| Trading Funds | — | — | — | — | 3,570 |
| Lotteries Fund | — | — | — | — | 1,370 |
| Housing Authority | — | — | — | — | 28,150 |
| | 239,490 | 214,310 | 42,890 | 257,200 | 290,290 |
| <i>Less: Assumed salary reduction</i> | — | (2,950) | — | (2,950) | (3,110) |
| | 239,490 | 211,360 | 42,890 | 254,250 | 287,180 |
| Revenue (before Budget revenue measures) | | | | | |
| General Revenue Account: | | | | | |
| Taxation | | 127,100 | 1,610 | 128,710 | |
| Other revenue | | 30,950 | 3,110 | 34,060 | |
| | | 158,050 | 4,720 | 162,770 | |
| MTR share offer | | — | 15,000 | 15,000 | |
| Land Fund | | 10,090 | — | 10,090 | |
| | | 168,140 | 19,720 | 187,860 | |
| Capital Works Reserve Fund | | — | 25,650 | 25,650 | |
| Capital Investment Fund | | — | 2,200 | 2,200 | |
| Civil Service Pension Reserve Fund | | — | 480 | 480 | |
| Disaster Relief Fund | | — | — | — | |
| Loan Fund | | — | 4,330 | 4,330 | |
| Innovation and Technology Fund | | — | 180 | 180 | |
| | | 168,140 | 52,560 | 220,700 | |
| Surplus/(deficit) before Budget revenue measures | | (43,220) | 9,670 | (33,550) | |
| <i>Less: Effect of Budget revenue measures</i> | | (6,100) | — | (6,100) | |
| Surplus/(deficit) after Budget revenue measures | | (49,320) | 9,670 | (39,650) | |
| <i>Less: Advances and equity investments from the Capital Investment Fund⁽¹⁾</i> | | — | (5,560) | (5,560) | |
| Consolidated surplus/(deficit) | | (49,320) | 4,110 | (45,210) | |

(1) Advances and equity investments from the Capital Investment Fund are excluded from government expenditure (see also Note 1 to Table 4).

SECTION IV - ESTIMATES OF CONTINGENT LIABILITIES

15 The Government's contingent liabilities are \$20,045 million at 31 March 2001 and estimated to be \$18,600 million at 31 March 2002 and \$24,000 million at 31 March 2003, comprising —

| | 2000-2001 \$m | Estimate 2001-2002 \$m | Estimate 2002-2003 \$m |
|---|------------------|------------------------------|------------------------------|
| Guarantee to the Hong Kong Export Credit Insurance Corporation for liabilities under contracts of insurance | 8,889 | 9,500 | 11,000 |
| Litigation | 4,788 | 4,800 | 4,700 |
| Possible capital subscriptions to the Asian Development Bank | 1,763 | 1,800 | 1,800 |
| Guarantees provided under the Special Finance Scheme, the Self-employment Business Start-up Assistance Scheme and the SME Business Installations and Equipment Loan Guarantee Scheme for Small and Medium Enterprises | 4,605 | 2,500 | 6,500 |
| Total | <u>20,045</u> | <u>18,600</u> | <u>24,000</u> |

TRANSLATION (DRAFT)

LegCo Question No. 2 (Oral Reply)

Date of sitting: 9.10.2002

Asked by:
Dr Hon Yeung Sum

Replied by:
Financial Secretary

Question:

It was reported that, in a letter to all directors of bureaux in August this year, the Financial Secretary had demanded that they reduce the original estimates of operating expenditure for 2003-04 of the government departments under their portfolios by a uniform 1.8%, and a further reduction of 1% in each of the following three financial years. In this connection, will the Government inform this Council:

- (a) of the original estimates of expenditure and the revised ones after the 1.8% reduction in respect of each government department, and of the impact on the projection of revenue and expenditure contained in the Medium Range Forecast 2003-04 to 2006-07 in Appendix A to the 2002-03 Budget;
- (b) why the Financial Secretary has made such a demand, and the basis on which the above two rates of reduction has been determined; and why such expenditure reductions were not mentioned in the above Budget; and
- (c) why the Financial Secretary has neither consulted this Council before making the above demand nor explained the matter to this Council afterwards?

Reply:

Madam President,

As the question raised by Dr Hon YEUNG Sum covers three points which are interrelated, I hereby incorporate all of them in my reply :

In my 2002-03 Budget Speech, I set three targets for our public finances in 2006-07 –

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- (a) restore balance in the Consolidated Account;
- (b) attain a balanced Operating Account; and
- (c) reduce public expenditure to 20% of GDP or below.

If we are to achieve the above targets, on the expenditure front, we have to control the growth of government expenditure. According to the Medium Range Forecast of Revenue and Expenditure at Appendix A to my Budget Speech, total government expenditure in 2003-04 will amount to \$253.3 billion, which includes \$210.4 billion of operating expenditure. We will continue to base our preparations for the 2003-04 Budget on these forecast expenditure figures at this stage.

2. As regards operating expenditure, if the additional or improved services as planned, the natural increases in such expenditure as on pension, and the fact that the civil service pay cannot be adjusted by the original assumed percentage, are taken into account, the total of operating expenditure to be incurred in 2003-04 will exceed the amount estimated in the Medium Range Forecast. In order to ensure that the Government's overall operating expenditure does not go beyond the total amount estimated in the Medium Range Forecast, Directors of Bureaux are required to achieve a saving of 1.8% in the operating expenditure on the existing and new or improved services as planned in 2003-04, and an additional saving of 1% each year from 2004-05 to 2006-07. As to how these savings are to be achieved and spread out among the various programmes under their respective policy portfolios, it is for Directors of Bureaux to decide.

3. In practice, several processes are involved leading to the submission to the Legislative Council of the annual estimates of the revenue and expenditure of the Government, which include the internal Resource Allocation Exercise through which we make tentative allocation of resources to Directors of Bureaux and the consultations that we conduct in parallel with Members of the Legislative Council and the public on expenditure and revenue proposals. We follow this broad procedure every year, although we make adjustments to suit changing needs. This year, we tentatively allocate to each Director of Bureau an envelope of operating expenditure to give the Director a provisional limit on operating expenditure to be used as a guideline for preparing the 2003-04 Estimates of Expenditure under his / her respective policy areas. The "envelope of operating expenditure" states the total amount of resources available after deducting the savings required. Operating expenditure subject to the limit on overall expenditure stated in the envelope includes all recurrent expenditure and the "other non-recurrent" part of the capital expenditure in the General Revenue Account. There are, however, three kinds of operating expenditure that are not included in the envelope, namely the Comprehensive Social Security Assistance and Social Security Allowance Schemes, and civil

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servants' pension and benefits. The purpose of the "envelope" arrangement in the tentative internal resource allocation exercise is to allow Directors of Bureaux greater flexibility in the overall deployment of resources among the various policy areas under their purview.

4. As I have just explained, we are now in the early stage of preparing for the 2003-04 Budget. On the basis of our preparations, we will commence another important stage of work later on, i.e. consultation with the public and Members of this Council. In the next few months, Directors of Bureaux and I will consult Members of the Legislative Council, related organizations and the public on the priority and deployment of government services.

5. Before the formulation of the 2003-04 draft Estimates, I will further consider individual cases in all areas, the views collected and other factors to ensure fiscal sustainability for the Government and that the expectations of the public are met as far as possible.

中國人民共和國
香港特別行政區政府
財政司司長
梁錦松



Antony Leung
Finance Secretary
Government of the Hong Kong
Special Administrative Region
of the People's Republic of China

(Translation)

The Honourable Mrs Selina Chow Liang Shuk-ye, JP
Chairman, House Committee
Legislative Council
8 Jackson Road
Central
Hong Kong

Dear Mrs Chow,

I understand that the House Committee will discuss the Administration's plan to try out a new arrangement for presentation of the Expenditure Estimates for financial year 2002-03. In the light of concerns expressed by some Members on the matter, I would like to explain more clearly the rationale behind this change to facilitate your discussion.

The practice has been for Secretary for the Treasury to announce our Expenditure Estimates and brief the Finance Committee on the Estimates, on the Friday before the Budget Speech.

Under this arrangement, when we announce the Expenditure Estimates for the year, we do not at the same time provide other essential information such as revenue forecasts, forecast of our fiscal position, and our Medium Range Forecast. Without such other information, some LegCo Members and members of the public may find it difficult to analyse our Expenditure Estimates, and there have been occasions where Members' questions on the Estimates could not be answered until after the Budget Day. We therefore believe it would be useful to try an alternative arrangement this year with a view to facilitating Members' consideration of the Budget.

(Translation)

Our plan to announce the 2002-03 Estimates at the same time as the Budget Speech on 6 March aims to give Members and the public a complete picture in which to understand the relationships among expenditure, revenue, fiscal balance and other relevant dimensions. Secretary for the Treasury and I have proposed to attend a special Finance Committee meeting in the morning of 7 March to brief Members on the key points on the Budget and answer Members' questions.

We are conscious of the importance to give Members sufficient time to study the Budget and prepare their questions for the series of Special FC meetings to be held later in the month. We have therefore proposed to the Finance Committee that the Special FC meetings be held on 25 to 27 March. This will give Members the same number of working days as last year for giving us their questions.

I believe the new arrangement would enable Members to consider the Budget in a more comprehensive manner. My colleagues and I look forward to exchanging views with Members during the special Finance Committee meetings.

I am copying this letter to the Chairman and Vice-Chairman of the Finance Committee. I should be grateful if you could draw the content of this letter to the attention of Members of the House Committee.

Yours sincerely,

signed
(Antony Leung)
Financial Secretary

c.c./...

(Translation)

c.c. Dr the Honourable Philip Wong Yu-hong
The Honourable Ng Leung-sing, JP