

**The AFP View of the
2012/13 Hong Kong Budget**



INTRODUCTION

The Financial Secretary, Mr. John Tsang Chun-Wah, delivered his fifth, and quite possibly last, budget to the Legislative Council on 1 February 2012, which was somewhat earlier than previous years. The AFP Group provides this commentary with the aim of helping clients understand the effects the budget may have on their personal circumstances and business interests, as well as Hong Kong society in general.

Mr. Tsang stated that the aim of his budget was to provide the financial resources for the implementation of measures to relieve people's hardship, improve the quality of life and promote social and economic development that were announced by the Chief Executive in his October policy address. He also said that he would devote resources to all major aspects of Hong Kong society, such as education, medical services, social welfare, housing, infrastructure and various livelihood policy areas, whilst at the same time promoting economic development, so that the "investments" resulting from the budget proposals can help future generations face new challenges.

It has to be said that the budget measures announced included nothing innovative or little that was new by comparison to previous years. Rather, it was much of the same and it therefore remains to be seen if the measures meet the stated aims.

Mr. Tsang observed that the overall aspiration of our society, and therefore a major task of the current administration, was to maintain Hong Kong's steady growth and he implied that this had been achieved despite the challenges faced by the global economy since 2008, from which Hong Kong has not been exempt.

In a somewhat self-congratulatory vein Mr. Tsang noted that despite the worldwide downturn of recent years, Hong Kong had achieved cumulative growth of 19% in real terms in the last five years and that per capita GDP has risen to US\$34,200 in 2011, up from US\$29,900 in 2007.

Hong Kong's unemployment rate is now 3.3%, down from a high of 5.5% in mid-2009, and total employment has increased by more than 180,000 from a low point in 2009, which reflects a return to similar levels of unemployment achieved in 2008. Income from employment for lower-income groups has increased by 12.5% over the last year, which equates to 7% in real terms after adjustments for inflation. There has also been an improvement in the livelihoods of "grass roots" in the last year as the monthly median household income rose by 11.1% to HK\$20,000, from HK\$18,000, a 5.1% increase in real terms.

It is considered that Hong Kong has recovered quickly from the effects of the worldwide downturn of recent years, which was attributed to our flexible economic system and overall competitiveness. Mr. Tsang trumpeted this achievement by citing that Hong Kong had been ranked by the Heritage Foundation as the world's freest economy for 18 consecutive years, had been rated as the world's most open market by the International Chamber of Commerce and the World Bank had rated it as the second easiest place to do business. He also referred to a 2011 report by the IMF that concluded that Hong Kong's policies and strategies to counter financial turmoil contributed to its "vigorous rebound" and to the top triple-A credit rating from Standard & Poor's.

Despite these self-proclaimed achievements, which have most likely been achieved by Hong Kong's entrepreneurial business sector despite the government's bureaucratic meddling in financial and business matters, Mr. Tsang vowed that the government would not "lower its sense of crisis" in the face of continuing turmoil in international financial markets, unresolved economic troubles and the intricate problems of fiscal deficit and debt crisis in Europe and the U.S. as they could have a more serious impact than the 2008 "financial tsunami".

Mr. Tsang announced that to prepare for potential external economic crisis this year, his budget would propose a series of measures to counter the risk of economic slowdown. The measures would be underpinned by the strategy of “supporting enterprises to preserve employment and promoting economic development to protect people’s livelihood” in order to tide enterprises over difficult times, preserve employment and increase peoples disposable cash at hand. He considered that in addition to cushioning the economy, the measures would help reduce the pressure of inflation on people in need so that our economy would move steadily forward.

For 2011/12 Hong Kong is expected to record a budget surplus of HK\$66.7 billion, compared to a forecast HK\$3.9 billion. Material underestimates have been a consistent feature of recent years and cast doubts on the government’s ability to manage the economy. For 2012/13 a deficit of \$3.45 billion is predicted.

Hong Kong’s 2011 exports of goods rose by 3.6% in real terms, following a significant reduction in demand midyear resulting from slowdowns in the U.S. and Europe, compared to 17.3% growth in 2010. Domestic demand remained resilient and as the employment market continued to improve and incomes increased, private consumption expenditure maintained its growth momentum in all four quarters of 2011 to show an annual growth of 8.4% in real terms.

Inflation gathered pace in 2011 with the underlying rate for the year averaging 5.3%, a significant rise from 1.7% for 2010. In last year’s budget speech Mr. Tsang made much of the threats that inflation and asset-price bubbles would pose to the economy and the measures to be introduced to counter them. For a small economy such as Hong Kong that has a currency pegged to the U.S. dollar and which is largely externally driven, it is probably futile for the government to claim that it can do anything material about such risks!

A potential asset-price bubble showed signs of materialising in the real estate market in 2011. On the back of economic recovery and extremely low interest rates (due to Hong Kong’s pegged currency) coupled with a comparatively tight supply of residential units, the property market showed significant price increases during first half of the year, which tapered off during the second half with reductions showing in some areas. Mr. Tsang considered some of the heat had been taken out of the market and attributed this to measures introduced during 2011 to (1) increase the supply of flats; (2) curb property speculation; (3) prevent expansion in mortgage lending; and (4) ensure transparency in the property market.

All in all, Mr. Tsang’s assessment was that he and the government had done a good job in managing the economy during 2011.

In relation to our economic outlook for 2012 Mr. Tsang cautioned about external shocks and was pessimistic about export growth in the second half of the year. He therefore proposed to introduce measures worth nearly HK\$80 billion to prepare for difficult times ahead with the aim of supporting enterprises and people in meeting challenges and to help ease the burden of inflation. Mr. Tsang considers this will help stimulate the economy by 1.5% in 2012.

The average underlying inflation rate for 2012 is predicted to be 4% (2011: 5.3%) and the headline inflation rate is estimated at 3.5% after taking account of the one-off measures proposed.

Hong Kong’s model of taxation and economic operation will continue unchanged. No changes to tax rates were announced, although increased allowances were proposed and a summary of the changes is provided later in this summary.

HIGHLIGHTS

Economic Forecast

- Forecast GDP growth is 1–3%.
- Headline inflation rate is estimated at 3.5%.

Government Expenditure

- Government expenditure is estimated to reach \$393.7 billion for 2012/13, an increase of 7% compared with the revised estimate for 2011/12, and total government revenue is estimated to be \$390.3 billion.

Whilst short-term measures are proposed to stabilise the economy and help the community through the anticipated difficult time, Mr. Tsang said that to prepare for the future “we must also seize this moment when our financial position is sound to invest in our future” and proposed measures to address this in six respects:

- supporting enterprises;
- preserving employment;
- caring for people;
- stabilising our financial system;
- increasing land supply; and
- strengthening our social capital.

Supporting Enterprises

With the aims of helping enterprises reduce operating costs in a difficult external environment and minimising unemployment, the following are proposed:

- Enhancing the SME Financing Guarantee Scheme. The maximum loan guarantee ratio is to be increased to 80%, for which the government will provide HK\$100 billion as a guarantee commitment, and the guarantee fee that is charged will be reduced.
- New policy terms will be offered by the Hong Kong Export Credit Insurance Corporation that will include special concessions for SME policyholders who will be allowed to insure their exports only for places and buyers of their choice, and various premium discounts will be available.
- Business Registration fees will be waived for 2012/13 at a cost to the government of HK\$1.9 billion.
- Profits Tax will be reduced for the 2011/12 tax year by 75%, the reduction being capped at HK\$12,000. This will cost the government HK\$1.12 billion.
- Charges for import and export declarations will be halved.
- Capital Duty will be abolished for Hong Kong companies. This and the previous measure will cost the government HK\$840 million a year.

Preserving Employment

- HK\$220 million is to be earmarked to support the Construction Industry Council in enhancing manpower training in order to bring fresh blood into the industry to meet the demand created by future infrastructure developments.
- The Employees Retraining Board will offer 130,000 training places for the unemployed and people seeking employment. Sufficient resources are to be reserved to provide an additional 30,000 training places to meet contingencies.
- The Vocational Training Council will set up an International Cuisine College, which is expected to admit its first students in the 2014/15 academic year, and will provide over 2,000 places a year.
- HK\$100 million will be injected to the Enhancing Employment of People with Disabilities through Small Enterprises Project. This grants funding to non-government organisations to assist them in setting up small enterprises employing people with disabilities.
- The already established Youth Pre-employment Training Programme and Youth Work Experience and Training Scheme, Employment Programme for the Middle-aged, and Work Orientation and Placement Scheme will continue to be pursued. Such projects benefit about 20,000 job seekers each year and involve an annual expenditure of HK\$175 million.

Caring for People

Education:

- Recurrent expenditure on education will be increased for 2012/13 to HK\$60 billion (up 7%). The increase will be used to implement the four-year undergraduate programmes under the new academic structure of the University Grants Committee-funded institutions, increase university places, introduce small-class teaching in public primary schools, continue the Pre-primary Education Voucher Scheme and increase the value of the vouchers, etc..
- HK\$1 billion will be earmarked to implement a new programme modelled on Project Yi Jin under the new senior secondary academic structure.
- To launch the sixth Matching Grant Scheme, HK\$2.5 billion will be allocated and the scheme will cover all statutory and approved post-secondary institutions.
- Two separate injections of HK\$1 billion each will be made to the HKSAR Government Scholarship Fund and the Self-financing Post-secondary Education Fund to establish more scholarships and award schemes.
- The Research Endowment Fund will be allocated HK\$5 billion to enhance the academic and research development of tertiary institutions.

Medical and Health Services:

- Recurrent government expenditure for 2012/13 will be HK\$45 billion (up 8%).
- The Hospital Authority will be allocated HK\$2.54 billion to meet community demand for medical services, including efforts to attract and retain talent in order to provide quality healthcare services to patients, expand the coverage of the Hospital Authority Drug Formulary, enhance primary medical services, improve mental health services, increase in-patient service capacity and strengthen neonatal intensive care services.
- HK\$2.2 billion will be provided for clinic and hospital projects, which will include expansion of the United Christian Hospital, redevelopment of Yan Chai Hospital, Kwong Wah Hospital and Queen Mary Hospital, and HK\$500 million will be allocated to procure and revamp medical facilities.
- An injection of HK\$10 billion will be made to the Samaritan Fund with the aim of enabling more people to benefit from the subsidy and allowing patients already receiving the assistance to have the burden of drug expenses further eased.

Social Welfare:

- Recurrent government expenditure for 2012/13 will be HK\$44 billion (up 9%).
- The increase in recurrent expenditure will be used to implement provision of public transport concessions for the elderly and eligible people with disabilities, strengthen support for infirm and demented elders, increase the supplements for residential care homes for the demented elderly, provide an additional 1,000 subsidised residential care places and community care services, improve the quality of more than 600 subsidised places in residential care homes for the elderly under the Enhanced Bought Place Scheme.
- An allocation of HK\$900 million will be made to improve the physical settings and facilities of as many as 250 district elderly community centres, neighbourhood elderly centres and social centres for the elderly across the territory.

Relief Measures:

To help ease the pressure on the community brought about by an economic downturn, the following measures will be introduced:

- An extra allowance, equal to one month's payment, will be given to CSSA, Old Age Allowance and Disability Allowance recipients.
 - Two months' rent of public housing tenants will be paid by the government.
 - An allocation of HK\$100 million to extend short-term food assistance services will be made if necessary.
 - Each residential electricity account will be granted a subsidy of HK\$1,800, which will benefit 2.5 million households.
 - Rates for 2012/13 will be waived, subject to a ceiling of HK\$2,500 per quarter for each rateable property, and it is estimated that almost 90% of properties will be subject to no rates in 2012. This proposal will cost the Government HK\$11.7 billion.
 - A one-off reduction of 75%, subject to a cap of HK\$12,000, will be made in liabilities under Salaries Tax and tax under personal assessment for 2011/12. This will benefit 1.5 million taxpayers and will cost HK\$8.9 billion.
 - Various tax measures are proposed:
 - the basic allowance to increase to \$120,000;
 - married person's allowance to increase to \$240,000;
 - increase the allowance for maintaining a dependent parent or grandparent aged 60 or above to \$38,000;
 - raise the child allowance to \$63,000;
 - increase the dependent brother/sister allowance to \$33,000;
 - raise the disabled dependent allowance to \$66,000;
 - extend the entitlement period for relief for home loan interest to 15 years of assessment; and
 - increasing the maximum tax deduction for mandatory contributions to the Mandatory Provident Fund to \$15,000, in line with the increase of mandatory contributions effective in June.
- These measures will cost the Government HK\$3.5 billion a year.
- With the aim of alleviating the financial burden of fresh graduates, all student loan borrowers who complete their studies in 2012 will be given the option to start repaying their loans one year after completion of their studies.

Stabilising the Financial System

- Despite the turmoil in international markets Hong Kong's financial markets have operated in an orderly manner, our financial institutions remain strong and the capital adequacy ratios of our banks have been maintained well above international requirements.
- The resilience of the Hong Kong monetary system has been enhanced by regulatory measures introduced by the Hong Kong Monetary Authority and other regulators. Such measures included the strengthening of banks' credit and liquidity risk management, increasing the level of bank's regulatory reserves and introducing four rounds of prudent regulatory requirements on mortgage loans.
- Mr. Tsang pledged to "work jointly with our regulators to keep a close watch on the development of the global financial markets" and to take appropriate measures to ease strains on our financial system and maintain the stability of monetary and overall financial systems.

Increasing Land Supply

Residential and Business Sites:

- The aggregate housing land it is intended to supply for 2012/13 is estimated to provide around 30,000 private residential flats.
- 47 residential sites are to be included in the Application List in the Land Sale Programme, of which half will be new sites. The sites are predicted to provide some 13,500 units.
- A public consultation will be launched in relation to the two property projects above the West Rail Kam Sheung Road Station and Pat Heung Depot of the Mass Transit Railway Corporation. These projects are predicted to provide about 8,700 flats.
- The supply of business sites will be increased by introducing measures including "Energising Kowloon East", revitalising industrial buildings and relocating government departments from core business districts.

Subsidised Housing:

- In the five-year period starting 2011/12 the total production of public rental housing flats will be 75,000 coupled with an aim to maintain the average waiting time at around three years. Production volumes will be adjusted when necessary.
- Six sites in Shatin, Tsuen Wan, Kwai Tsing and Yuen Long have been initially identified for the first batch of developments under the new Home Ownership Scheme.
- Sites have been earmarked for about 5,000 flats under the My Home Purchase Plan. The first project on Tsing Yi will provide 1,000 flats and should be completed in 2014. Applications for pre-letting will begin in the fourth quarter of 2012. The second development project in Shatin will provide about 700 units.

Urban Renewal:

- The renewal of old industrial areas will be accelerated to release more sites for residential or commercial development.
- The Urban Renewal Authority ("URA") will be invited to launch redevelopment projects for industrial buildings in a pilot scheme. Depending on the results of the pilot scheme, injection will be made to the URA when necessary.

Strengthening Our Social Capital

- The Hong Kong Mortgage Corporation will introduce a three-year pilot scheme of microfinance. An aggregate HK\$100 million will be made available for loans under the scheme and loan repayment periods will be as long as five years.
- HK\$200 million will be injected to the Community Investment and Inclusion Fund to promote social capital development.
- Subject to the views of the Steering Committee on the Community Care Fund (“CCF”), the Government will incorporate the appropriate programmes launched by the CCF into the regular assistance programmes and corresponding financial arrangements will be made when necessary.

Investing in the Future

Promoting Development of Industries:

- To promote development of the retail bond market a further issuance of iBond’s worth not more than HK\$10 billion will be launched.
- An allocation of HK\$150 million will be made to the Mega Events Fund and its operation will be extended for five years.
- The cash rebate under the R&D Cash Rebate Scheme will be increased, the funding ceiling for the Small Entrepreneur Research Assistance Programme will be raised and the monthly allowance of the Internship Programme under the Innovation and Technology Fund will be increased.
- Measures to encourage the use of industrial buildings and industrial lots as data centres will be introduced.
- A fund of HK\$1 billion will be set up to help Hong Kong enterprises tap the Mainland market.

Infrastructural Development:

- The total value of infrastructural projects approved and to be submitted to the Legislative Council is worth \$400 billion, \$62.3 billion of which is the annual actual expenditure on capital works for 2012/13.
- Large-scale projects include the Hong Kong section of the Guangzhou-Shenzhen-Hong Kong Express Rail Link, the Hong Kong-Zhuhai-Macao Bridge, the Central-Wan Chai Bypass, railway construction works of the South Island Line (East) and the West Island Line, and the Shatin to Central Link project.
- Projects of various scales will be taken forward at the district level, including the expansion of Tseung Kwan O Hospital, redevelopment of Caritas Medical Centre, construction of North Lantau Hospital, building the first indoor velodrome in Tseung Kwan O, redeveloping the swimming pools at Victoria Park, Lai Chi Kok Park and Kwun Tong, expansion of Ko Shan Theatre, and building community facilities such as community halls, sports centres, libraries and parks in various districts.
- Building a third runway at Hong Kong International Airport will be considered.

SUMMARY

The measures that will probably be of most interest to our clients and associates are those related to tax and businesses and a summary of them follows:

PROFITS TAX

The budget for the fiscal year 2012/13 proposed no changes to Profits Tax rates or allowances, which reneges on the Chief Executive's pledge to reduce Profits Tax to 15% during his term of office! However, a one-off reduction of 75% of 2011/12 Profits Tax liabilities is proposed. The reduction will be capped at HK\$12,000. Whilst the reduction will be of benefit to and will be welcomed by SME's and sole traders, one must wonder at the wisdom of granting this to all Profits Tax payers, which will include conglomerates such as HSBC, the Swire Group, Jardine's, etc. and international legal and accounting practices, as compared to introducing a lower rate of tax for small businesses.

Below is a summary of the various tax rates and allowances that are still applicable:

Profits Tax Rates	2012/13
For Corporations	16.5%
For Unincorporated businesses	15%

Capital Allowance Rates	2012/13
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Depreciation allowances on plant and machinery:

- initial 60% of qualifying expenditure in the year the expense was incurred.
- annual prescribed rates of 10%, 20% or 30% on reducing value, depending on the type of plant or machinery.

The cost of computer software, hardware and computer systems can be fully written-off in the year the expenditure is incurred.

Industrial building allowances:

- initial 20% available in relation to the cost (excluding the land cost) for buildings occupied for the purpose of a qualifying trade.
- annual 4% of the original qualifying capital expenditure.

Environment friendly equipment and building installations:

- annual 20% of the capital expenditure

Note:

- There is no tax in Hong Kong on capital gains, dividends (whether from Hong Kong sources or otherwise) and foreign-sourced interest or interest from deposits placed with Hong Kong authorised institutions.
- There is no withholding tax on dividends paid to non-resident shareholders.
- Royalties paid to non-resident persons for the use of intellectual property are subject to withholding tax. The prescribed percentage is 4.95% of the gross payment if the payer and the recipient are not related, but 16.5% if the payer and recipient are related.

Other Matters Affecting Businesses

- With effect from 1 August 2011 the standard Business Registration fee reverted to \$2,450 per annum. Mr. Tsang has proposed to waive the fee for one year from 1 April 2012, which means that the employment levy of HK\$450 per annum remains payable.
- Capital Duty levied on Hong Kong companies is to be abolished. Previously Capital Duty was payable at the rate of HK\$1.00 for every HK\$1,000 of authorised share capital created, subject to a maximum payment of HK\$30,000. Consequently, when a Hong Kong company was formed or increased its authorised share capital the duty was payable. The abolition is welcomed but the savings for the majority of companies, which are SME's, will be immaterial because an authorised capital of HK\$10,000 would attract Capital Duty of only HK\$10.

SALARIES TAX

As with Profits Tax, no changes to the rates of tax are proposed but a one-off reduction of 75% of tax payable under Salaries Tax or personal assessment is proposed for 2011/12. The relief will be capped at HK\$12,000. A number of increases in allowances are proposed and the rates, allowances and deductions applicable to Salaries Tax for 2012/13 are as follows:

Salaries Tax	2012/13	(2011/12)
Standard rate of tax	15%	15%
Progressive Rates Of Tax		
<u>Net Chargeable Income</u>	<u>Tax Rate</u>	<u>Tax Rate</u>
First \$40,000	2%	2%
Next \$40,000	7%	7%
Next \$40,000	12%	12%
Remainder	17%	17%

Note: The Salaries Tax charge is the lower of:

- the net assessable income less charitable donations and allowable deductions at the standard rate; or
- the net assessable income less charitable donations, allowable deductions and personal allowances charged at progressive rates.

Allowances	2012/13	(2011/12)
	\$	\$
Personal Allowances:		
Basic	120,000	108,000
Married	240,000	216,000
Single Parent	120,000	108,000
Additional Allowances:		
Child Allowance		
Year of Birth (each)	63,000	60,000
1 st to 9 th child (each)	63,000	60,000
Dependent Parent/Grandparent		
Aged 60 or more		
Basic	38,000	36,000
Additional Allowance	38,000	36,000
Aged 55 to 59		
Basic	19,000	18,000
Additional Allowance	19,000	18,000
Dependent Brother/Sister	33,000	30,000
Disabled Dependent	66,000	60,000
Deduction Ceiling	2012/13	(2011/12)
	\$	\$
Self-education expenses	69,000	60,000
Home loan interest	100,000	100,000
The number of years for which deduction can be claimed is extended to 15 with effect from 2012/13		
Approved charitable donations	35% of income	
Elderly residential care expenses	76,000	72,000
Contributions to recognised retirement scheme	15,000	12,000

OTHER TAXES, RATES, DUTIES AND MEASURES

Property Tax

The rate of Property Tax remains the same. Property owners are taxed on rental income at a standard rate of 15% of the net assessable value.

Government Rates

Government rates are proposed to be waived for 2012/13, subject to a ceiling of \$2,500 per quarter for each rateable property.

Capital Duty

Is abolished.

Stamp Duty

Property Transactions

No changes to stamp duty were proposed, so the rate of duty on transactions of properties valued at more than \$20 million remains at 4.25%, and the rates for stamp duty on property transaction are as follows:

Property Consideration	Rate
Up to \$2,000,000	\$100
\$2,000,001 to \$3,000,000	1.50%
\$3,000,001 to \$4,000,000	2.25%
\$4,000,001 to \$6,000,000	3.00%
\$6,000,001 to \$20,000,000	3.75%
More than \$20,000,000	4.25%

The measures announced on 19 November 2010 to combat speculative activity in the residential property market remain in force. The Special Stamp Duty ("SSD") introduced for any residential property acquired on or after 20 November 2011 which is sold within 24 months of acquisition are unchanged and SSD is payable on the higher of the consideration for the transaction or the market value of the property at the following rates:

15% if the vendor held the property for six months or less;

10% if the vendor held the property for more than six months but for 12 months or less;

5% if the vendor held the property for more than 12 months but for 24 months or less.

Hong Kong Stocks

Stamp Duty on the sale or purchase of any Hong Kong stock is charged at rates that vary with the amount or value of the consideration as follows:

Nature of Document	Tax Rate
Contract Note for sale or purchase of any Hong Kong stock	0.1% of the amount of the consideration or of its value on every sold note and every bough note
Transfer operating as a voluntary disposition inter vivos	\$5 + 0.2% of the value of the stock
Trading of exchange-traded funds (ETFs) that track indices comprising not more than 40% of Hong Kong stocks	
Transfers of any other kind	\$5

Tobacco Duty

The duty on tobacco sold locally has not been increased and remains as follows:

Cigarettes	(per 1,000 sticks) \$1,706
Cigars	(per Kilo) \$2,197
Chinese prepared tobacco	\$419
All other manufactured tobacco except tobacco intended for the manufacture of cigarettes	\$2,067

Others**First Registration Tax on Private Cars**

No changes were proposed and the rates remain as follows:

<i>Tax Bands</i>	<i>Tax duties</i>
(a) On the first \$150,000 of taxable value	40%
(b) On the next \$150,000	75%
(c) On the next \$200,000	100%
(d) On the remainder (i.e. on taxable value over \$500,000)	115%

Other duties and charges remain unchanged.