Hong Kong: budget deficit sparks tax reform debate

Economic downturn has forced debate on the former British colony's land and tax policies into the open

Tony Vickers reports from Hong Kong

DESPITE having far more of its public revenue arising from land values than anywhere else on earth, Hong Kong has suffered from the recent economic crisis in Asia. Following its staggering 50-year growth in population, per capita wealth and gross capital formation, debate on economic and fiscal policy in what is now a Special Administrative Region (SAR) of the People's Republic of China has been almost non-existent. That seems to be changing.

For the first time in decades, the government is facing at least several years of budget deficit. Direct capital receipts from land, almost all of which is state-owned, had run at around 30-40% of total revenue but with economic slow-down now stand at only 11%. With a huge capital funding programme needed to sustain its massive urban infrastructure, including the largest public housing programme in the world, government itself has been first to recognize that it needs to broaden and stabilize its tax base.

The problem lies in the way land revenues arise. Leases of new development land are sold at auction. The purchaser then enters into negotiation with the Lands Department over the potential development value. 15% of this capital sum is then due as a "Land Premium", to be paid "up front" before development commences. Then follows a 3% annual tax (on rental value, not capital) over the remaining 50 years of the lease.

More importantly re-development of existing sites where, subsequent to original sale, re-zoning to a higher and better use has occurred, requires the issue of a new lease containing the new development covenants. This is also subject to land premium, levied as being the entire difference between existing use and proposed use value of the site. Developments for sale are also subject to a profits tax and an occupation rate is levied on subsequent occupiers, based on rental values.

Financial Secretary Donald Tsang has floated the idea of a sales tax, to help plug the gap in land revenue that has been apparent because of the down turn in the real estate market in 1998. This has alerted all sides, in a society where the earnings of over half the working population are untaxed and the top rate of income tax is 15%, to the threat to earned income and profits.

In the SAR's fledgling democracy, less than half the members of its Legislative Council (LegCo) are elected. This has led to a "politics of permanent opposition" with no incentive for political parties to prepare for government since the members appointed by the executive themselves (or elected indirectly by various "functional" interest groups) will always outnumber any group of politicians. LegCo is - more than most legislatures - known for negative comment rather than sensible ideas.

One Party and especially its sole LegCo member stands out. Christine Loh's Citizens Party has been the only one to produce an annual Alternative Address for the Chief Executive and a coherent alternative budget statement. In last year's budget, Loh called for a Development Land Tax (DLT) and reform of land laws imposing restrictive covenants on leaseholders. Copies of her party's documents were sent to me, citing several Georgist web-sites as sources of these ideas.

Conditioned to think of DLT as a form of betterment levy, I was puzzled why Loh and her economic adviser Stephen Brown claimed they were working towards a progressive tax policy as advocated by Henry George. Land Premium is a betterment levy, but a very capital intensive one. The DLT proposed would be an interim measure. Its aim would be to provide a half-way house, freeing the market from the constraints of the current regime; eventually it would then be possible to introduce a land use value tax, but this would only be meaningful when the majority of leases were freed from micro-development covenants.

One leading property consultant, Nicholas Brooke, who is on a number of Government bodies related to land issues, has argued for a "rentalisation" (or phased payment) of Land Premium. This would smooth out the peaks and troughs in HK's public revenue and remove the disincentive to bid for development land. However this proposal does not address the issue of there being conflicting policy between lease restrictions and district zoning plans.

As Brooke and Brown both say in their different ways, DLT is not intended to make life more comfortable for developers (although it should do that), but rather to bring down the

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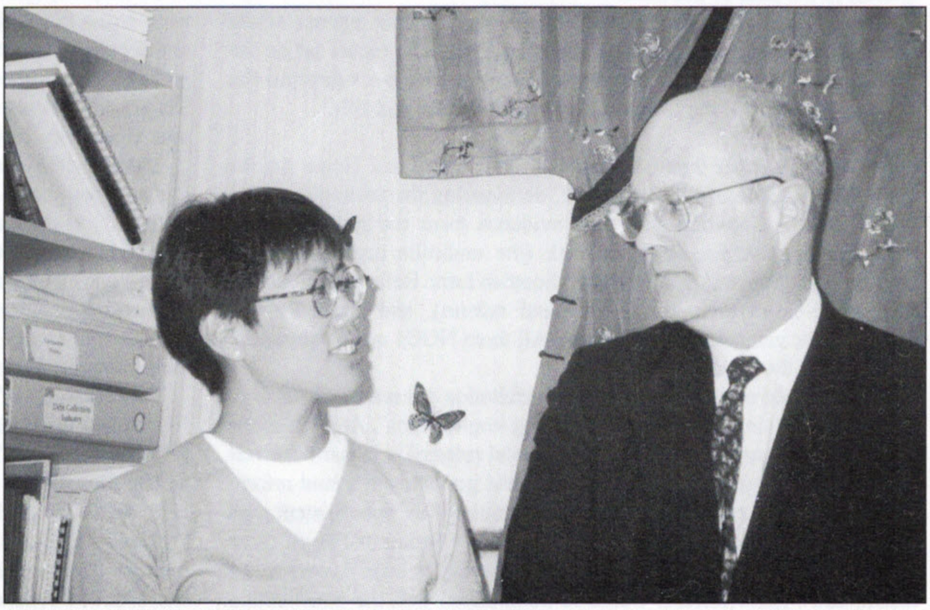

Christine Loh (left), Citizens Party member of the HK Legislative Council, confers with her fiscal and property adviser Stephen Brown

■ Hoarding promoting the new Hong Kong International Airport

Hong Kong: will pragmatism win?

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price of real estate, especially for residential property, without causing chaos in financial markets. Nobody seems to dispute (says Brooke) that the development value of land ought to be retained by the community, as it is (generally) now.

I met Brown and Loh in her office to explore the prospects for their ideas. "Government here is very segmented," explained Loh. "Nobody is looking at the whole impact of land policies - or at alternatives to current HK land policy that might have wide public benefits." The government still has large reserves, so that concern over a short-term budget situation is dulled by the knowledge that these reserves will see it through to the next boom.

Loh's reputation is built upon a concern that economic prosperity should be widely shared, that it must be sustainable and that it can only continue if markets are free. In the case of land, she realizes that a "free" market means one that puts the natural monopoly powers over land in the hands of the community - through ownership of land rent and open, democratic planning laws - rather than lease-holders: those who own 19th century leases of 999 years are, in effect, exempt all contributions to revenue from the huge unearned gains received from occupation of some of the most valuable sites on the planet.

But in political terms it may not be these "hongs" who will cause land reform to fail. A recent but little known government-funded report indicated that

- 13% of those in public housing ought not to be;
- many households earn far more than they declare on their tax forms;
- market prices for rented housing are affordable for many who now benefit unfairly while contributing to the massive distortion of the land market that public housing creates.

These not-so-poor voters could block any plans to remove subsidies.

Brown thinks that pragmatism will win. "Income and profits are only taxable here when they derive from economic activity in our territorial area. With so much of our wealth coming from offshore activity and with the internet inevitably going to increase this massively, we have to look to land values more - not less - in the future. Luckily we only need a restructuring of our land revenue system, not a massive tax shift like other places. I look to a convergence of our land markets - rented housing and all forms of leasehold - over a 50-year period. Anything too quick could wipe out the banking system here."

The new airport development has lifted the lid - literally in the case of Kowloon - on development values in large areas where height restrictions due to flight safety are no longer needed. Yet, says Loh: "Look at properties around any subway station, where you'd expect to see redevelopment beginning. The present system is holding back redevelopment where it's needed, creating slums where we should have prosperity."

Proof that the debate started by Loh and Brown has reached main-stream in Hong Kong came with a feature article by Brown himself, a week after Brooke's but in the main section of the same leading English language daily. "A fluid and flexible land market is the key to curing economic and social ills, argues Stephen Brown" ran the front-page box.

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