Asia Viewpoint

Hong Kong: FY24-25 Budget Preview: Between a rock and a hard place

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GEM Economics
Asia

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Fiscal principles increasingly stand in contrast to reality

Since the return to Chinese sovereignty in 1997, the HKSAR has followed several guiding principles on public financing, including "keeping the expenditure within the limits of revenues" and a "low tax policy". However, such principles have been contrasted with the reality in the post-COVID period. For the past three out of four fiscal years, the HK government has run fiscal deficits. We estimate the **final FY 23-24 deficit to be HK$ 130bn**, given the current fiscal year-to-date trends of revenue and expenditures. As a result, fiscal reserves are down 44% from their January 2019 peak.

Persistent headwinds on medium term fiscal outlook

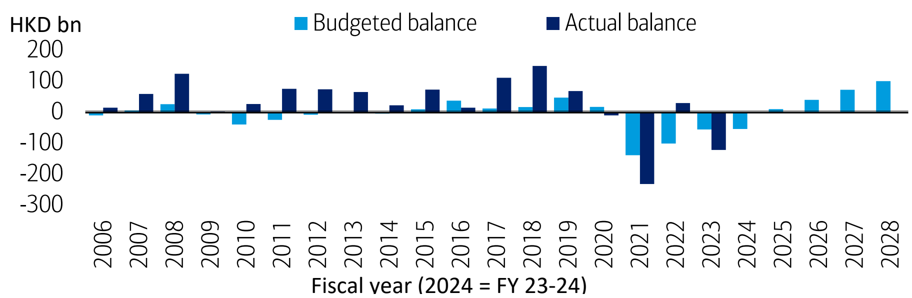
The fiscal outlook will likely remain weak for the next 2-3 fiscal years. The shortfall in land sales is the biggest reason for why we believe Hong Kong's fiscal position will further deteriorate. Moreover, with the inventory of unsold housing at its highest since 2006, we think the digestion of this inventory will first need to occur before property developers would be incentivized to bid for land again. On the other hand, the government has penciled in for an acceleration of infrastructure expenditure.

Choosing between a rock and a hard place

To maintain a balanced budget in the near term, the government must sacrifice at least one of the below: **1)** keeping the current expenditure plan, **2)** maintaining a low tax regime, **3**) avoiding financing for general spending through bond issuances, **4)** avoiding significant drawdowns in the Capital Works Reserve Fund (CWRF), and **5)** refraining from using the Land Fund to cover for the fiscal shortfall.

The Budget, to be announced on 28th Feb, will likely reveal which path the government will take. **We believe a combination of transfer from funds and/or bond issuance will be the most plausible options under the current circumstances**. Either way, with revenue structurally weak from the decline of land premium, we expect Hong Kong's fiscal reserves to remain on a path of decline for the next 2-3 fiscal years.

Exhibit 1: Budgeted and actual fiscal balance
The government is likely to revise down its fiscal projection in the upcoming FY24-25 Budget



Source: The Treasury, BofA Global Research. Note: Budgeted balance for 2025-2028 are forecasts in FY23/24 Budget
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Introduction

Fiscal principles increasingly stand in contrast to reality

Since the return of Chinese sovereignty in 1997, the Hong Kong Special Administrative Region (HKSAR) has followed several guiding principles on public financing which are enshrined in the Basic Law, Hong Kong's constitution.

- **Article 107:** "The Hong Kong Special Administrative Region shall follow the principle of **keeping the 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:** "The Hong Kong Special Administrative Region shall, taking the **low tax policy** previously pursued in Hong Kong as reference, enact laws on its own concerning types of taxes…"

However, in the post COVID period, the principles of low taxes and striving to achieve fiscal balance (i.e. no fiscal deficit) is contrasted with the reality of falling land premium, growing recurrent expenditure stemming from an aging population and ambitious infrastructure projects. For the past three out of four fiscal years, the HK government have run fiscal deficits (**Exhibit 1**). **We estimate the final FY 23-24 deficit to be HK$ 130bn**[1], given the current fiscal year-to-date trends of revenue and expenditures. This stands in contrast with the HK$54.4bn fiscal deficit the Finance Secretary presented in the FY 23-24 budget.

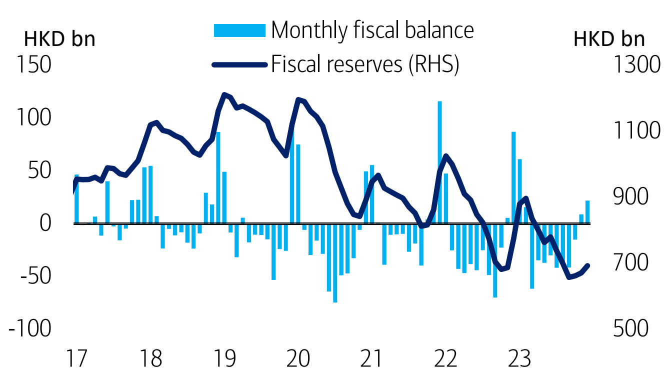
Low cash level in GRA despite ample fiscal reserves

The net trend of expenditures exceeding revenue for the past four fiscal years has resulted in a gradual reduction in Hong Kong's fiscal reserves. Peaking at HK$1.2tn in Jan 2019, the fiscal reserves have fallen to HK$692bn by Dec 2023, a decline of 40% (**Exhibit 2**). Although reduced, Hong Kong's fiscal space remains ample and the HKSAR government has among the strongest fiscal positions in the world. The current issues with Hong Kong's finances have nothing to do with solvency but likely with liquidity.

That said, cash levels at the GRA are running low. As we had emphasized in our Asia FI & FX Strategy Viewpoint: A deep dive into Hong Kong's finances 02 January 2024, the quarterly disclosure provided by the HK Treasury for 3Q23 shows cash levels at the General Revenue Account (GRA) are running low and towards HK$100bn, despite total fiscal reserves remains massive, at close to HK$690bn (**Exhibit 3**).

Exhibit 2: Fiscal reserves and monthly fiscal balance

Hong Kong's fiscal reserves are down 40% from their peak in January 2019



Source: CEIC, The Treasury, BofA Global Research

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Exhibit 3: 3Q23 breakdown of Hong Kong's fiscal reserves

As of 3Q23, only 16% of Hong Kong's fiscal reserves are available to use to fund recurrent expenditures

	Current Assets (as of 3Q23, HK$ Bn)	As %
Land Fund	307.54	45%
Capital Works Reserve Fund	138.78	20%
General Revenue Account	111.98	16%
Civil Service Pension Reserve Fund	53.86	8%
Innovation and Technology Fund	29.76	4%
Lottery Fund	22.91	3%
Capital Investment Fund	17.23	3%
Loan Fund	7.01	1%
Disaster Relief Fund	0.13	0%
Total	**689.20**	**100%**

Source: HK Treasury

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[1] Our projection includes the proceeds from green bond issuance, which has been HK$67bn in FY23-24

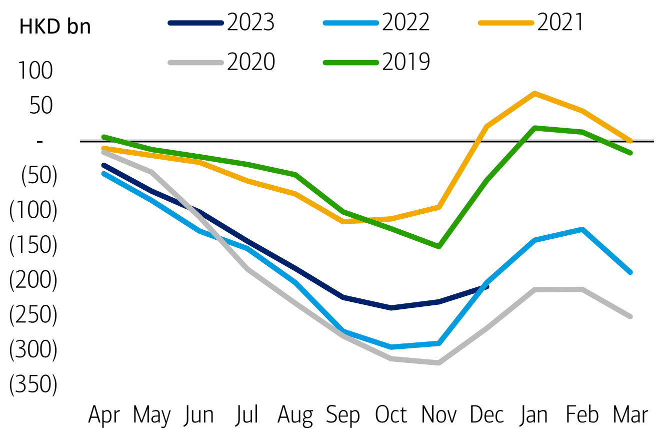
Dissecting the fiscal shortfall

Currently, the HK government runs a fiscal deficit at a size similar to that seen in 2020 and 2022 (**Exhibit 4**). As of Dec 2023, cumulative consolidated fiscal deficit reached HK$209bn before repayment/proceeds, the second largest on record in the same month (only behind HK$269bn in 2020). As a result, fiscal reserves cover around 12 months of fiscal expenditure (**Exhibit 5**).

We believe **the falling revenue from land premium and stamp duties have been the major driver of the fiscal shortfall**, amid relatively the stable paths of expenditure and other tax collections.

Exhibit 4: Cumulative running fiscal deficit (without proceeds from bond issuance)

HK government is running a fiscal deficit similar to those seen in 2020 and 2022



Source: CEIC, The Treasury, BofA Global Research

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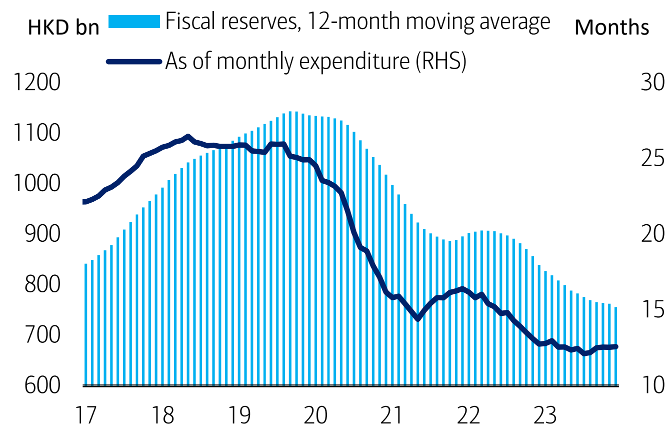
Exhibit 5: Fiscal reserves' coverage of monthly expenditure

Fiscal reserves now cover around 12 months of fiscal expenditure



Source: CEIC, The Treasury, BofA Global Research

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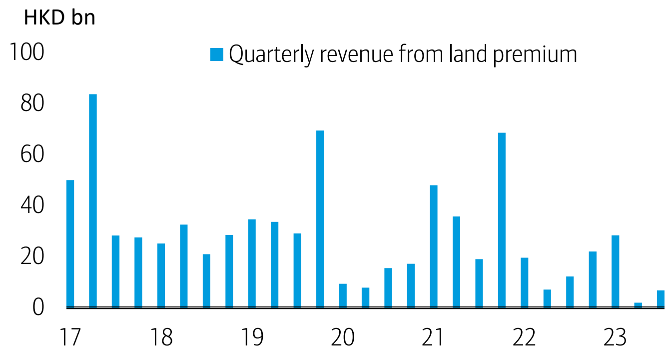
Record-low land premium collected since FY09/10

Revenue from land premium is on the worst record since FY09/10 (**Exhibit 6**). As of November 2023, the revenue only reached HK$12.1bn fiscal-year-to-date, around 15% of the initial target set for FY23-24 (HK$85bn). The muted revenue was not only due to low prices transacted, but also the record-high number of failed land tenders. As of Jan 2024, there were already six failed residential and commercial land auctions, the highest on record.

Following the poor response to land auctions, sluggish market sentiment and high commercial vacancy rate, the government announced in early Jan not to sell any residential or commercial land in the first three months of 2024. This implies the total land premium collected in FY23-24 will be capped at a very depressed level. With the inventory of unsold housing at its highest since 2006, we believe the digestion of this inventory will first need to occur before property developers would be incentivized to bid for land again.

Exhibit 6: Land premium collected
The revenue from land premium in FY23/24 is expected to be the lowest number since FY09/10



Source: CEIC, The Treasury, BofA Global Research

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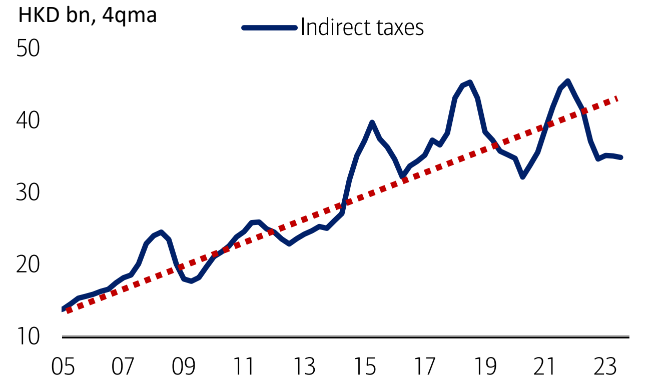
Exhibit 7: Indirect taxes collected
Indirect taxes collected in FY23/24 have been below trend



Source: CEIC, The Treasury, BofA Global Research

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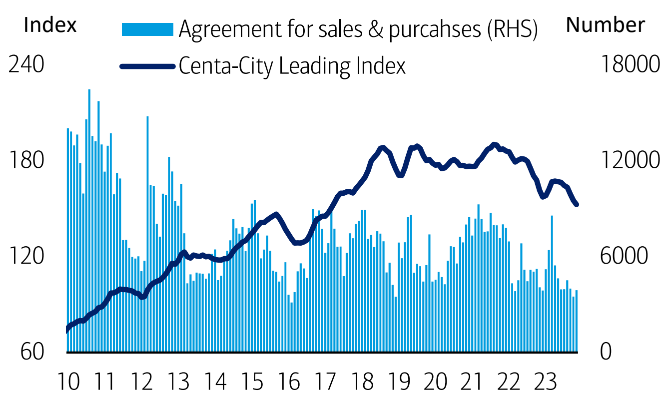
Falling stamp duties from property & equity markets

The additional drag to fiscal position has been the falling indirect taxes collected (**Exhibit 7**), mostly driven by fall in stamp duties in property transaction and equity market transaction (which accounted for ~15% of total operating revenue historically). Although there is no monthly data available for detailed tax collection, the sluggish sentiment and transaction are evident in the two markets.

In property market, sentiment only briefly improved in early 2023 before further deteriorating since late 2Q23, in spite of some marginal property tax reductions announced in latest Policy Address (see more in our Policy Address review). For the whole year 2023, prices and transaction volume dropped by 5% and 2% respectively compared with 2022, or by 20% and 40% compared to 2021 (**Exhibit 8**). We do not expect a material improvement in 2024, as our property analysts expect a further 5% drop in home prices in 1H before stabilization in 2H, meaning limited upside to stamp duties collection from property transactions.

On the other hand, the Hang Seng Index has been the worst performer compared with global equity markets, dropping by 14% in 2023 vs bull markets in most global equity indices (**Exhibit 9**). Despite the government's effort to lower stamp duty on stock transactions from the current 0.13% to 0.10% in the latest Policy Address, there seems to be limited impact on stock turnover so far.

Exhibit 8: Property price and transaction
Property transactions have been tepid amid price correction



Source: CEIC, BofA Global Research

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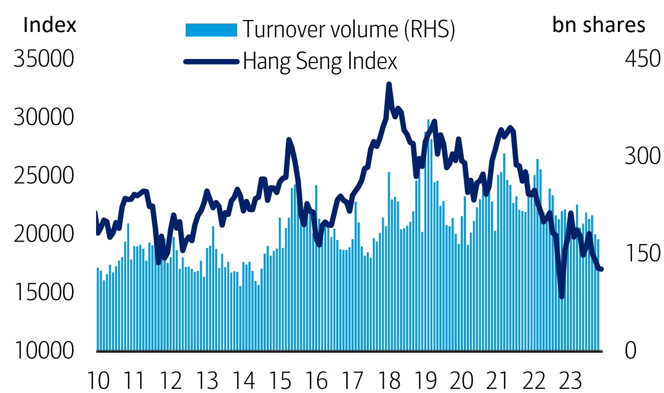
Exhibit 9: Equity index and turnover volume (daily avg)
Similar trend in the shock market



Source: CEIC, BofA Global Research

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Between a rock and a hard place

As discussed before, we do not expect immediate solutions to these lingering headwinds on revenue. As such, fiscal balance could record consecutive years of deficit If land premium and stamp duties (historically account for >30% of total revenue) remain at such depressed levels.

To maintain a balanced budget in the near term, the government must sacrifice at least one of the following options:

1) Keeping the current expenditure plan;

2) Maintaining a low tax regime;

3) Avoiding financing for general spending through bond issuances;

4) Avoiding significant drawdowns in the Capital Works Reserve Fund (CWRF);

5) Refraining from using the Land Fund to cover for the fiscal shortfall.

In our views, options 1 and 2 are practically difficult to be sacrificed. **We believe a combination of transfer from funds (CWRF/Land Fund) and/or bond issuance will be the most plausible options under the current circumstances.**

1) Limited room for massive spending cut

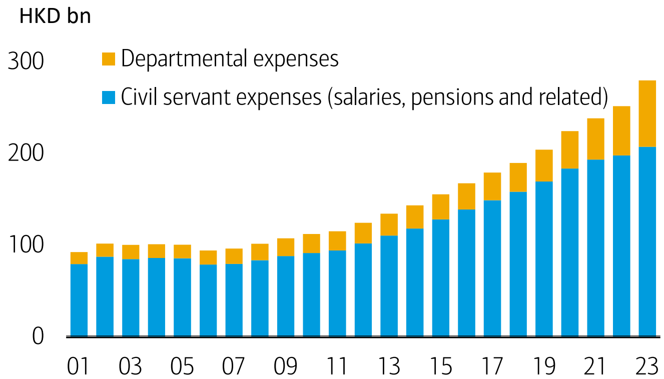
In our view, there is no easy way to dial back both operating and capital expenditure (which are mostly infrastructure spending).

Downward rigidities in operating spending

Most operating expenses are rigid in nature and are not subjected to meaningful downward revision. For example, there are very limited rooms to cut the civil servants as well as departmental-related expenditure, which have been growing steadily at around 8% CAGR in most of fiscal years (**Exhibit 10**). Although the government vows to strictly control the growth of the civil service establishment, the expected wage inflation would continue to push up spending in this category.

The same kind of rigidity exists in social spending too (**Exhibit 11**). Looking at the three major components of social expenditure (including education, health and social welfare), they have not fallen in size since FY06/07. On average, they have been growing at 5% annually. While it is possible to keep education spending in check amid lower birth rate, the aging population will put spending on health and social welfare on a perennial upward trend.

Exhibit 10: Operating expenditure: Civil servant & department expenses
Strong downward rigidity in civil servant/departmental expenses...



Source: CEIC, C&SD, BofA Global Research

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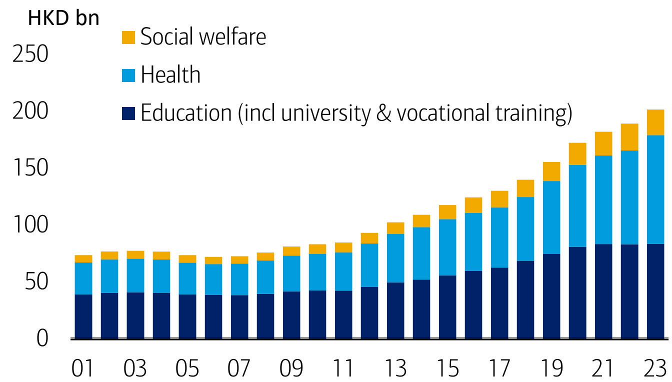
Exhibit 11: Operating expenditure: Social related expenses
...as well as in social-related expenses



Source: CEIC, C&SD, BofA Global Research

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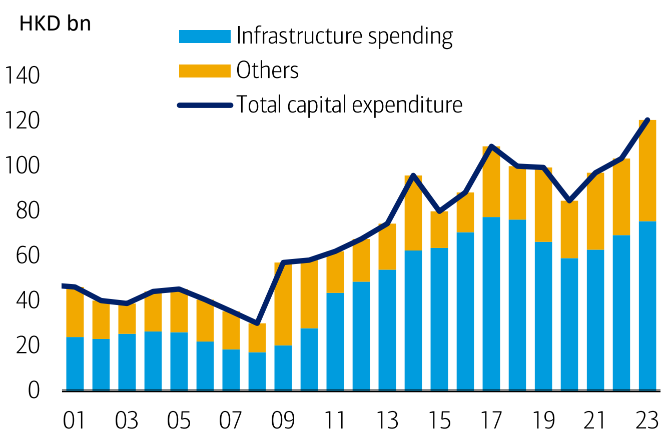
Future infrastructure spending is already penciled in

We do not think there is much space to cut the upcoming infrastructure spending either[2]. Despite being a more volatile components in fiscal spending, it has trended up over the years since the Global Financial Crisis (**Exhibit 12**). In the medium-term projection, the government estimates a 7.5% CAGR during 2023-2027, higher than the 0.2% in 2013-17 and 2.7% in 2018-22 (**Exhibit 13**), driven by projects on housing supply, transport, recreational facilities, etc.

Specifically, there are already several strategic infrastructure projects that are under way (including Kai Tak Development, The Northern Metropolis project, LoK Ma Chau Loop), as well as projects with funding that approved by the Legislative Council. We expect limited chance of halting these projects for the sake of a more balanced budget. Note that the acceleration in capital works does not include the mega project of Lantau Tomorrow which is supposed to be self-financed through the sale of new land created.

Exhibit 12: Capital and infrastructure expenditure
Infrastructure spending over the years has trended up



Source: CEIC, C&SD, BofA Global Research

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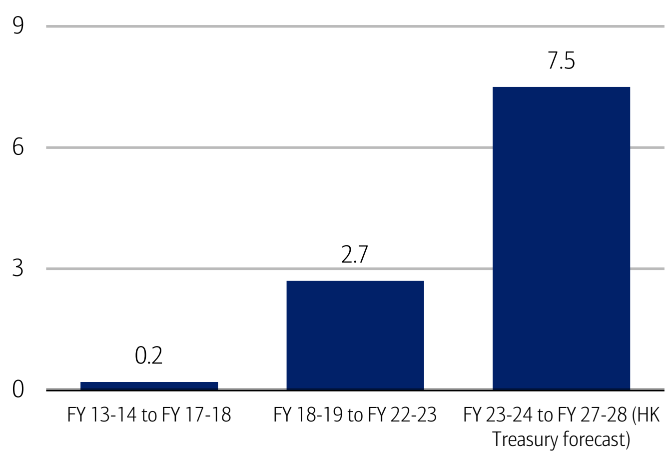
Exhibit 13: Trend growth (% annualized) of capital works expenditure
In the next four fiscal year, the HK government plans to significantly accelerate the pace of capital works in Hong Kong



Source: HK Treasury, 24/25 budget consultation document

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[2] We categorize public works program (PWP) expenditure under Capital Works Reserve Fund as infrastructure spending.

2) Heightened concerns on new taxes/higher tax rate

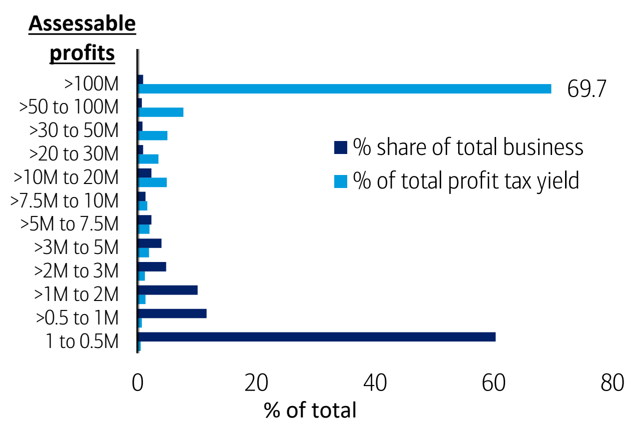
At the same time, it seems to be an inappropriate time to consider introducing new taxes and/or raising tax rate (for existing taxes).

Low tax regime crucial for retaining talents and corporations

Traditionally, HK has been known for its low and simple tax regime. The government only levies profit tax on business profits, property tax on rental income and salaries tax on employment income. The salaries tax rate is capped at 15.0% whereas profits tax rate for corporations is 16.5%, one of the lowest in developed economies.

In our view, the government could risk the loss of top talent and corporations shall it consider notable tax rate hike, especially with such a skewed tax base. In 2021/2022, the top 5% businesses (in terms of assessable profits) bear about 90% of profits tax revenue (**Exhibit 14**), while top-5% taxpayers bear more than 58% of salaries tax revenue (**Exhibit 15**).

Exhibit 14: Distribution of profit tax contribution
Top-5% taxpaying firms bear about 90% of profit tax revenue...



Source: 24/25 budget consultation document, BofA Global Research

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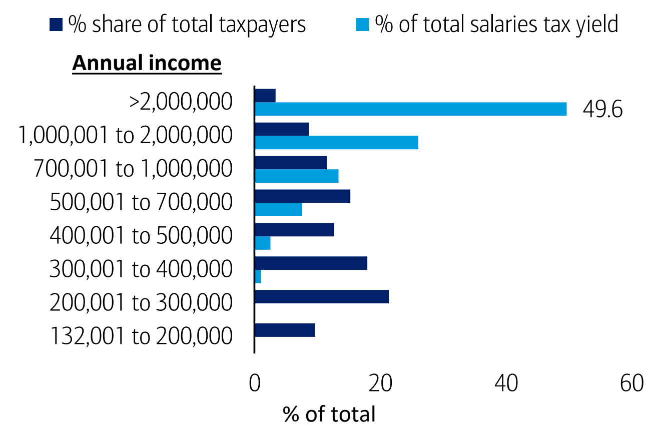
Exhibit 15: Distribution of salaries tax contribution
While top-5% taxpayer bear more than 58% of salaries tax revenue



Source: 24/25 budget consultation document, BofA Global Research

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Inappropriate timing for new taxes amid other concerns

With the relatively narrow tax base, there has been growing discussion on the introduction of new taxes, with the **land/sea departure tax** and the **capital gains tax** receiving the most attention.

The departure tax is proposed to be levied on HK residents who leave the city by land/sea given the rising cross-border consumption (especially to mainland China), as a short-term measure to boost revenue[3]. In fact, the same tax was proposed in 1999 and 2003 when the HK government faced similar pressure on fiscal coffers, although they were all rejected. On the other hand, the capital gains tax is also proposed to be levied on profits via disposal of assets, including stocks and properties.

We believe both proposals are impractical under the current socioeconomic circumstances. For the departure tax, first, the introduction of a land/departure tax would be inconsistent with the ongoing integration of the Greater-Bay-Area. Second, there is a substantial group of HK/mainland residents travelling between borders for daily lives (e.g. education, work), not just for consumption. There are few reasons to impose additional burden on them. For the capital gains tax, such introduction could disrupt stock and property markets without proper consultation and forward guidance, in

[3] www.scmp.com/news/hong-kong/hong-kong-economy/article/3248332/hong-kong-liberal-partys-departure-tax-proposal-those-crossing-border-land-and-sea-slammed

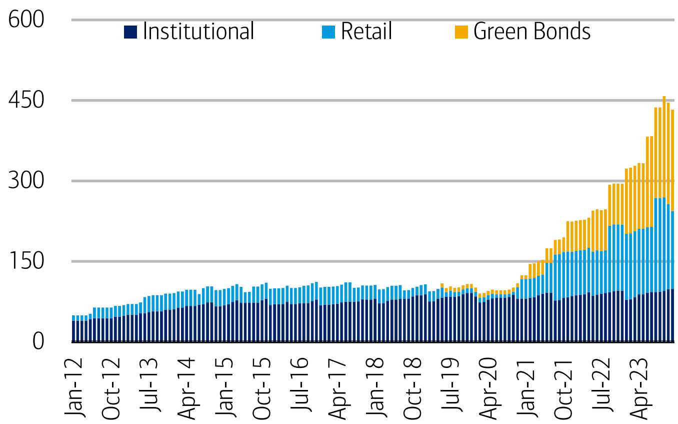
our view. In the long run, this could severely impair the competitiveness of the HK economy and lure capital away.

3) Financing spending through bond issuance

Hong Kong's 'true' debt ratio is lower than what it appears on paper. On the balance sheet of the HK government, total outstanding bonds stand at HK$ 433bn or about 15% of GDP (**Exhibit 16**). However, the 'true' debt of the Hong Kong government is much lower. The bonds issued under the institutional and retail program amounts to HK$ 244bn, and the proceeds of which are invested with the HKMA to be held in foreign assets. This is consistent with the principle outlined in the Article 107 of the Basic Law to achieve fiscal balance and avoid deficit financing.

Green Bonds are the only true debt of the Hong Kong government. The true debt of the Hong Kong government only includes Green Bonds which are issued to invest in environmental projects and amounts to HK$ 189bn. Green Bonds are counted as a revenue inflow for the Hong Kong government as the amount raised impacts Hong Kong's fiscal reserves. Still, it has not been used to finance for recurrent spending.

Exhibit 16: Outstanding bonds of the Hong Kong government (HK$ Bn)
Total outstanding bonds of the Hong Kong government stands at HK$ 433bn, of which HK$ 189bn is 'true' debt



Source: HK Treasury

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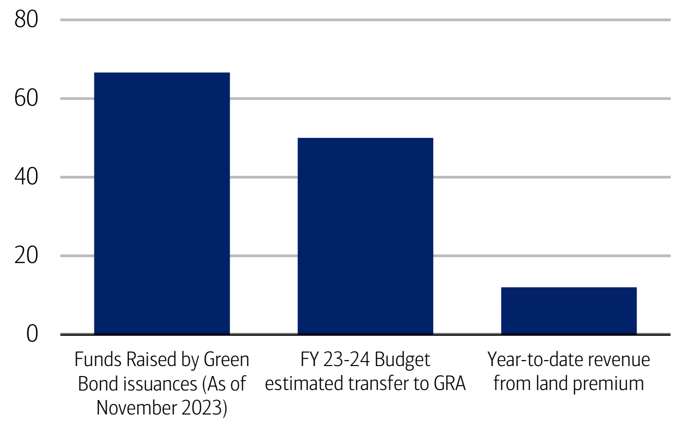
Exhibit 17: Transfer between CWRF and GRA
The FY 23-24 budget estimated for HK$ 50bn of transfer from the CWRF to the GRA to support general spending



Source: HK Treasury

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Land premium paid for Hong Kong's infrastructure development. Historically, the strong land sales resulted in land premium raised that goes into the Capital Works Reserve Fund. A longstanding philosophy of the HK government is that the infrastructure should be paid for the monies raised from land sales. Extra money raised from land sales that is not used in infrastructure building would be remitted to the General Revenue Account to cover for recurrent and general spending. However, proceeds from Green Bond issuances also enters the CWRF as those proceeds are meant to finance the development of green infrastructure (**Exhibit 17**).

CWRF has to remit HK$ 50bn back to the GRA amid weak land premium. From what we can track in FY 23-24, year-to-date revenue raised from land premium is HK 12bn while the government is on track to remit HK$ 50bn back to the GRA for general spending. As the original estimates for land premium was HK$ 85bn, the shortfall in land premium and the necessarily large transfer back to the GRA means, on average, the level of fiscal reserves in the CWRF is on path of general decline. This decline has been somewhat offset by the issuance of HK$ 67bn issuance in Green Bonds. However, the money raised from Green Bonds should have a transitory impact on Hong Kong's level of fiscal reserves as that money is meant to be spent on earmarked projects.

Hong Kong has large fiscal buffers to deficit finance. The Hong Kong government has enormous fiscal space to engage in deficit financing should it choose to as Hong Kong's true debt-to-GDP ratio stands at only 6%. HKGB remains to trade at a heavy premium to US Treasuries reflecting the lack of duration supply in the market. For a structurally aging society and strong demand for HKD duration from both local and international real money accounts, we believe it is natural for the Hong Kong to increase its local currency debt supply over time.

4) Drawing funding from Capital Works Reserve Fund

The CWRF may say still provide financial support to the GRA, but not at a level similar to that in previous years. In itself, this is not a constraint as the CWRF has regularly remits money to the government's general operations under the GRA (**Exhibit 18**). However, the CWRF represents the savings meant to develop Hong Kong's future infrastructure. With the aggressive infrastructure plan outlined, it is likely that the government could only transfer a fraction of surplus in CWRF (to finance current recurrent spending) so that the future infrastructure plan would not be jeopardized. Specifically, the FY 23-24 Budget estimates HK$633bn outstanding spending commitment for CWRF, 4 times more than the existing funding within CWRF (**Exhibit 19**). Such substantial commitment will prevent the government from draining the fund too much.

At current level, CWFR can cover its own expenditure for around a year. In the FY 23/24 budget, it is estimated that the total spending needs of the CWRF was penciled to be HK$ 157bn, of which HK$ 50bn represents transfer to the GRA. As of 3Q23, the CWFR was still HK$ 137bn. Even assuming continued weak income from Land Premium for next 2-3 fiscal, if it not unforeseeable to see levels in the CWFR significantly decline, especially should it need to support the spending of the GRA.

Exhibit 18: Net transfer between fiscal funds (HKD bn)
In previous years, the CWRF can provide strong support to the GRA to support general spending

	2019	2020	2021	2022	2023
General Revenue Account	57.40	47.93	58.52	23.64	95.23
Capital Works Reserve Fund	-80	-55	-84	-35	-100
Capital Investment Fund	-	6.00	20.14	-	-
Civil Service Pension Reserve Fund	1.53	0.00	1.84	3.02	-
Disaster Relief Fund	0.07	0.07	0.06	0.07	0.02
Innovation and Technology Fund	20.00	0.00	2.00	5.18	4.75
Land Fund	-	-	-	-	-
Loan Fund	1.00	1.00	1.44	2.00	-
Lotteries Fund	-	-	-	1.10	-

Source: The Treasury, BofA Global Research

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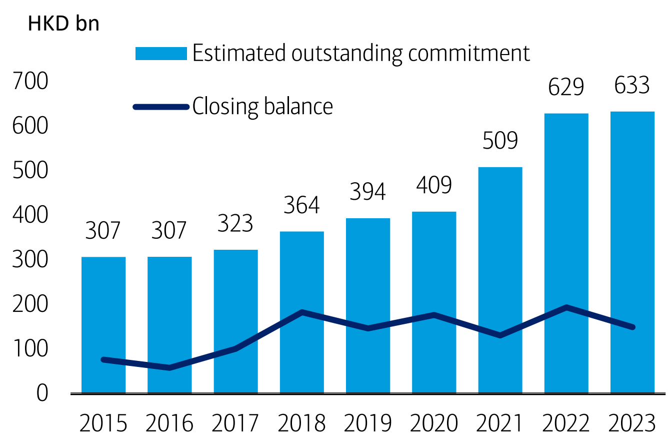
Exhibit 19: CWRF: Balance and outstanding commitment
Outstanding commitment on spending for CWRF has grown relative to its own size



Source: Previous Budgets, BofA Global Research

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5) Revenue transfer from the Land Fund

The Land Fund is the single largest resource of the Hong Kong government. As shown in **Exhibit 3**, almost half of Hong Kong's fiscal reserves are held by the Land Fund. At HK$ 307bn, this is an ample resource for Hong Kong to ride out of the current period of economic downturn and weak land premium. (For those that are interested in the historical origin and the purpose of the Land Fund, please see Asia FI & FX Strategy Viewpoint: A deep dive into Hong Kong's finances 02 January 2024). Currently, around HK$ 286bn of the Land Fund's monies are invested with the HKMA while HK$ 21bn is invested in strategic incentives such as Hong Kong Growth Portfolio.

The current plan for the Land Fund is not to be withdrawn and used until 2030. The base case is for Land Fund resources to remain at the HKMA until 2030. Of the portion of the Land Fund invested in the HKMA, in 2022 HKMA Annual Report disclosed "the repayment date of placements by Future Fund and the interest thereon (note 30) was extended from 31 December 2025 to 31 December 2030 unless otherwise directed by the Financial Secretary according to the terms of the placements".

However, emergency measures can allow the Financial Secretary to draw on the Land Fund to fund current expenditures. The Resolution which established the Land Fund states the Land Fund can be used only for investment and not for the provision of any government services. The Resolution does not allow the government to freely transfer resources from the Land Fund to the General Revenue Account or other government funds. However, in practice, the Financial Secretary, with consent from the Legislative Council, has previously used Land Fund resources to cover for shortfall in revenue, as was the case in FY 03-04 and FY 04-05.

Conclusion

After close examination of the above options, we believe **transfer from funds** (including CWRF and Land Fund), with **additional support from bond issuance**, will be the most plausible options to fund the needs of the GRA under the current circumstances.

The FY24-25 Budget, to be announced on 28th Feb, will likely reveal which path the government will take. Either way, with revenue structurally weak from the decline of land premium, we expect Hong Kong's fiscal reserves to remain on the path of decline for the next 2-3 fiscal year.

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