Hong Kong's land system that time forgot

David Pilling

In Hong Kong, the tiny corner of China where it is still permitted to gather freely outside a McDonald's, several thousand people took to the streets last weekend. They were protesting at the contents of the budget. But, unlike their counterparts in Greece and Ireland, they were not lamenting cuts to public services necessitated by big deficits. Rather, they were outraged by what their government was proposing to do with its large surplus: give each and every one of them HK$6,000, or about US$770.

The people of Hong Kong are too savvy to take this bribe lying down. Many worry that the cash handout will stoke inflation, already running at 4.5 per cent and identified by John Tsang, financial secretary, as the most ominous cloud on the economic horizon. The payout, an embarrassing U-turn for Mr Tsang, was meant to placate a public angered at the government's parsimony in the face of a whopping surplus. Revenue exceeded expenditure of HK$304bn by HK$71.3bn, four times the HK$17bn surplus of the previous year. Many wonder if the authorities could not spend the money more wisely, or not collect so much in the first place.

Christine Loh, head of Civic Exchange, a Hong Kong think-tank, calls it the "Scrooge budget". The government's habit of racking up annual surpluses means it has accrued fiscal reserves of HK$592bn, equivalent to 23 months' expenditure or 34 per cent of gross domestic product. Why, asks Ms Loh, is it so allergic to increasing recurring expenditure? Could it not spend even a fraction of the money on cleaning up the city's pollution by introducing greener buses, or improving the wholly inadequate care provided to elderly and disabled people?

There are reasons why the government is reluctant to lift recurring expenditure. The Basic Law, Hong Kong's mini-constitution, mandates a balanced budget. The government has also stuck to a "golden rule" of keeping expenditure below 20 per cent of GDP, a level this year's budget is in danger of breaching narrowly.

But the debate is clouded. The culprit is the policy on land, the allocation and commercialisation of which makes Hong Kong's economy go round. It also creates huge distortions and opacities, making it hard to talk sensibly about levels of tax and expenditure.

The land system is a legacy of British colonialism. London wanted Hong Kong to be self-financing. So the colonial authorities raised money by leasing land, an apparently free source of revenue that persists to this day. The state hives off chunks of land in plots so large that only the biggest developers can bid for it. Developers also pay the government an upfront premium in return for permission to convert its use, say from agriculture to commercial, a hey-presto transformation that releases more value.

Civic Exchange estimates no less than 45 per cent of government revenue comes from land, including land premiums, property rates and taxes on property developers' handsome profits. Hemlock, the *nom de plume* of a business writer with close connections to Hong Kong's tycoons, compares the property cartel that benefits from this arrangement to "feudal lords granted the right to gather tax from the peasants". The tax in question is rent. Hong Kong's is the highest in the world. According to DTZ, the property consultancy, the cost of office space in central Hong Kong pips that of even central London, Tokyo and Zurich.

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Spiriting cash from land creates distortions. The top rate of income tax, at just 17 per cent, is legendarily low. But it turns out to be precisely that: a legend. Taxes are extracted, invisibly, via rent. There are also disguised expenditures. Take the MTR Corporation, which runs Hong Kong's underground train system and airport express line. Such is the extent of the land holdings granted to it that some call MTR a property company with a train running through it. Land allocations require no legislative oversight. Nor are they accounted for as expenditure. By this means, Hong Kong has conjured a cheap and gleaming transport system seemingly out of nothing.

There are physical distortions, too. One is that half of Hong Kong's citizens are herded into cramped government flats. Paying commercial rent or buying an apartment is quite beyond the reach of poor or even middle-class families, leaving them dependent on subsidised housing.

Hong Kong has become a construction state. Money raised from property premiums is allocated to a special account that can only be spent on infrastructure, guaranteeing a building frenzy in perpetuity. So the government, perversely, has an incentive to reclaim land on which to build. That is why so much of Victoria Harbour, once one of the world's most beautiful waterways, has disappeared under concrete. If similar policies were pursued in New York and London, the Hudson and Thames rivers would be long gone.

The system is in need of overhaul. But there is little chance of that. The property tycoons who benefit are deeply entrenched in Hong Kong's undemocratic political system. In return for stability, Beijing has made strange bedfellows with the guardians of this semi-colonial conjuring trick. That leaves Hong Kong's people with few options but to throw the government's bribe back in its face – and demand something better.

david.pilling@ft.com