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Economic Insight

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Hong Kong's 2015/16 Budget: Rebalancing Themes

Research
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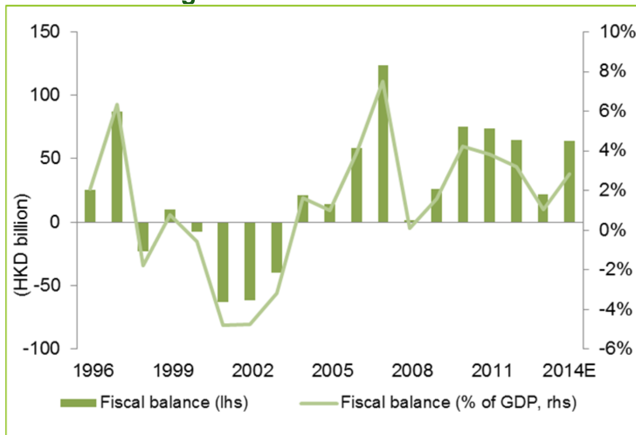
- Hong Kong recorded a provisional surplus of HKD63.8 billion for FY 2014/15. Armed with this hefty fiscal surplus, the Budget included a HKD34.2 billion package of relief measures.
- Compared with previous budgets, however, the handouts were perhaps less generous than some had expected, representing less than 54% of the fiscal surplus, compared with an average of 69% over the past five years. The official rhetoric is indicating a greater tolerance for the idea of a cyclical slowdown and we would not be surprised to see a tightening up of relief measures in the next few fiscal years.
- The priorities of this Budget have expanded beyond addressing immediate social concerns, and there was a clear focus on boosting workforce skills and innovation.
- The government has also taken a bold move in choosing to reduce profits tax for specified treasury activities by 50%. In general, decisions as to where to set up a treasury centre are significantly influenced by tax-related considerations. This is particularly true in deciding between Hong Kong and Singapore, which both offer a sophisticated financial infrastructure and a skilled workforce. The new measure will halve the effective tax rate for treasurers in Hong Kong to 8.25%, giving the city a distinct competitive edge over Singapore as a regional treasury centre.
- Two features of the Budget capture our immediate attention. First, the Financial Secretary communicated the government's desire to expand the labour force as a tool for boosting long-term economic growth. Second, Mr Tsang seems to have put less emphasis on removing supply side bottlenecks via infrastructure improvement. That could reflect the government's stance on 'smart consolidation' and a shift of fiscal resources towards other growth-enhancing policies.

The FY2015/16 Budget details what the government believes needs to be done to help ensure a more prosperous and inclusive future for ordinary citizens. In his speech, Financial Secretary John Tsang Chun-wah delivered two clear messages from the government: 1) it will continue to share the fruits of prudent fiscal management with the people of Hong Kong, and 2) it will push ahead with efforts to enhance the city's medium-term economic prospects. These objectives are not entirely new and have been discussed at length over the past couple of years. But a marked shift in the approach and depth of some of the measures appear to demonstrate a further hardening of the government's resolve to achieve these long-term objectives.

Sizeable fiscal surplus accumulated

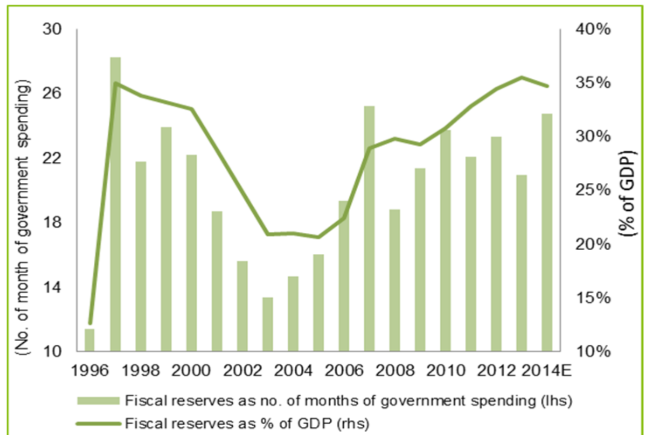
It is important to understand how the fiscal position is expected to look like in the fiscal year that is about to end. In line with expectations, the Hong Kong continues to run a large fiscal surplus. The HKD63.8 billion provisional surplus recorded for FY2014/15 is about seven times the government's earlier stated expectation of HKD9.1 billion, and at 2.8% of GDP, is one of the largest in the developed world (Exhibit 1).

Exhibit 1: Budget Balance



Source: Financial Secretary's Office, Hang Seng Bank

Exhibit 2: Fiscal Reserves



Source: Financial Secretary's Office, Hang Seng Bank

The details of the report are as encouraging as the headline. The unexpectedly large fiscal surplus reflects the combined effect of revenue outperformance and expenditure compression. On the expenditure side, the target for total full-year fiscal outlays was set at HKD411.2 billion. As a reflection the government's fiscal conservatism, the revised estimate for government expenditure is HKD397.2 billion,

only about 97% of planned disbursement. Equally important, unlike in most other advanced economies, the slowdown in government spending has not been caused by a lack of fiscal revenue. Supported by resilient income growth and asset markets, the fiscal fineprint reveals that Hong Kong's major revenue sources — namely, earnings and profits tax, stamp duties, and land premiums – all substantially exceeded their original estimates. Overall, the government's budgetary revenue for FY2014/15 rose by 9.4%[1] to HKD470.7 billion, overshooting the government's original estimate of HKD430.1 billion by more than HKD40 billion.

Slight expansion in relief package

With the recent combination of higher tax buoyancy and a lukewarm macroeconomic environment, questions have been raised about the need to loosen fiscal controls. In response, the government has announced the implementation of measures to relieve the burden of taxpayers. These measures were similar to what we saw in the FY2014/15 Budget. The scope of the one-off handouts is summarised below.

Exhibit 3: One-off Relief Measures and Tax Cuts

	FY2015/16 Budget	FY2014/15 Budget
Property tax waiver	2 quarters, subject to a ceiling of HKD2,500 per quarter (HKD7.7 billion)	2 quarters, subject to a ceiling of HKD1,500 per quarter (HKD6.1 billion)
Salaries tax rebate	75%, subject to a ceiling of HKD20,000 (HKD15.8 billion)	75%, subject to a ceiling of HKD10,000 (HKD9.2 billion)
Extra allowance to CSSA recipients	2 month (HKD5.5 billion)	1 month (HKD2.7 billion)
Public housing rental waiver	1 month (HKD1.1 billion)	1 month (HKD1.0 billion)
License fees waiver	License fees waiver selected sectors (HKD0.2 billion)	-
Profits tax rebate	75%, subject to a ceiling of HKD20,000 (HKD1.9 billion)	75%, subject to a ceiling of HKD10,000 (HKD1.0 billion)
Tax allowances	Increase basic and additional allowances for child to HKD100,000 (HKD2 billion)	Increase allowances for dependent parents/grandparents to HKD40,000 (aged 60 and above) and HKD20,000 (aged 55-59) and raise the deduction ceiling for elderly residential care for parents/grandparents (HKD0.3 billion)
Subtotal	HKD34.2 billion (1.4% of estimated GDP)	HKD20.3 billion (0.9% of GDP)

Source: <<The 2015-16 Budget>>, <<The 2014-15 Budget>>, Hang Seng Bank

[1] Changes in this report are on a year-on-year basis unless otherwise stated.

Not only have most of the measures introduced last year been continued, but the extent of the relief has been increased. The rebates for salaries tax and profits tax will be raised from HKD10,000 to HKD20,000 for personal taxpayers. Other relief measures include: 1) two quarters of rates waivers, 2) two additional months of allowance for recipients of Comprehensive Social Security Assistance, 3) raising the tax allowance for parents from HKD70,000 to HKD100,000 per child, and 4) a one-month public rental housing rent waiver for selected households. If there was any surprise, it was that the package also contained measures to alleviate business cost pressures, with the government offering a six-month license fee waiver to travel agents, hotels and guesthouses, and restaurants.

Overall, we expect the direct impact from the relief package to be mild as consumption has not been significantly influenced by similar initiatives in the past. While not large in absolute terms, it seems to us that the official rhetoric is indicating a greater tolerance for the idea of a cyclical slowdown. Compared with previous Budgets, the package was perhaps less generous than some had expected – representing less than 54% of the fiscal surplus, compared with an annual average of 69% over the past five years (Exhibit 4). Benefits for households remained targeted, focusing on families with children and the underprivileged. Given these factors, we would not be surprised to see a tightening up of relief measures in the next few fiscal years.

Exhibit 4: Size of Relief Package and Fiscal Surplus

	Size of Relief Package (HKD billion)	Fiscal Surplus (HKD billion)	Size of Relief Package (% of fiscal surplus)
FY2010/11	18.5	25.9	71.4%
FY2011/12	60.1	75.1	80.0%
FY2012/13	35.6	73.7	48.3%
FY2013/14	33.0	64.8	50.9%
FY2014/15	20.3	21.8	93.1%
FY2015/16	34.2	63.8	53.6%

Source: Hang Seng Bank

Investing for the future

While cyclical improvements in the fiscal position seem to have delayed an immediate need for extensive fiscal reform, it is important not to get carried away. The latest projections from the Working Group on Long-Term Fiscal Planning suggest a structural fiscal deficit balance will emerge within the next decade, due mainly to higher healthcare costs and rising welfare spending.

The real security behind any public finance system is a healthy economy. To us, the key issue is how the government will deploy the current additional fiscal headroom to boost Hong Kong's longer-term competitiveness and productivity growth. The Budget has built upon earlier broad-based measures to address the most pressing concern for the Hong Kong economy, namely, the need for growth:

- Inject HKD1.5 billion and HKD5 billion into the SME Export Marketing and Development Funds and the Innovation and Technology Fund respectively;
- Launch a HKD300 million Art Development Matching Grants Pilot Scheme to sponsor eligible local arts groups;
- Earmark HKD650 million to support talent development in the retail, construction, insurance and asset management services industries;
- Allocate HKD130 million to improve childcare services;
- Remove stamp duty on the transfer of all exchange-traded funds; and
- Strengthen trade ties with countries under China's 'One Belt One Road' economic development policy.

Among these measures, the proposal to offer preferential tax treatment for certain treasury activities is of primary interest. The government proposes to amend the Inland Revenue Ordinance to allow interest deductions under profits tax for corporate treasury centres and to reduce profits tax for specified treasury activities by 50%. In general, decisions as to where to set up a treasury centre are significantly influenced by tax-related considerations. The Singapore government has set a 10% corporation tax levy on corporate treasury centres. Once the Hong Kong government's announced measure is implemented, the effective tax rate for treasurers in Hong Kong will be halved to 8.25%. We believe the preferential tax treatment will give Hong Kong a distinct competitive edge over Singapore as a regional treasury centre.

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Two other features of the FY 2015/16 Budget capture our immediate attention. First, the Financial Secretary communicated the government's desire to expand the labour force. We interpret this as a shift in emphasis towards labour input playing bigger role in growth, rather than the ever-expanding use of capital. Second, Mr Tsang seems to have put less emphasis on removing supply side bottlenecks via infrastructure improvement. That could reflect the government's stance on 'smart consolidation' and a shift of fiscal resources towards other growth-enhancing policies.

Rising expenditures and budgeting for the future

Besides the items that routinely receive attention in the Budget – fiscal projections and the relief package – Budget 2015 gave special focus to healthcare and social retirement programmes. The government is continuing with its drive to increase social spending. Operating expenditure in FY2019/20 will exceed HKD410.4 billion, up from HKD317.7 billion in FY2014/15.

Bearing in mind Hong Kong's aging population and a lower growth rate as the return of capital declines, it is encouraging to see that the government has made a good start in working to address future financing needs. A Future Fund, comprising the Land Fund and a proportion of future budget surpluses, has been established to tackle future challenges.

That said, as we have previously noted, pre-funding in and of itself does not generate additional revenue. For pre-funding to have a significant influence on the security of welfare spending, one of the following three requirements has to be satisfied: 1) the Fund will increase gross national savings; 2) the Fund will produce higher levels of wealth creation compared with the long-established Exchange Fund; and/or 3) such savings can be invested so as to boost worker productivity.

The government has thus far shed little light on how the Future Fund will meet such requirements and we expect more information on how it plans to finance the proposed welfare programmes.

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Economy hit soft patch towards end of 2014

In spite of impressive job creation and robust personal spending, the Hong Kong economy is still struggling to achieve lift-off, with full-year growth retreating from 2.9% in 2013 to 2.3% in 2014. Fourth-quarter GDP came in at 2.2% last year, compared to 2.7% in the third quarter.

In line with our expectations, the most prominent feature of the fourth-quarter economic activity report was lingering weakness in external demand. The net external balance subtracted 2 percentage points off headline GDP growth, though contribution from consumption and investment was stronger than expected at 3.4 percentage points. Late-year weakness in exports was related to the drag from lower shipments to the EU and Asia, cancelling out strong US exports over the period. Investment registered a surprising growth of 4% in the fourth quarter last year compared to -3.3% in the third quarter, benefiting from a more stable economic outlook in mainland China.

Overall, fourth-quarter data was in line with our expectations that that the macroeconomic climate is unlikely to improve markedly this year. Given the uncertainties relating to the external environment and monetary conditions, we remain cautious as regards Hong Kong's potential growth momentum this year despite the positive tailwind provided by lower oil prices[2]. We are forecasting full-year GDP growth of 2.6% for 2015, similar to 2014. The Financial Secretary also began the Budget speech with a cautious assessment of the prevailing risks and challenges, with the official growth forecast corridor fixed at between 1% and 3%. Given these projections, demand-pull inflationary pressures are likely to be absent and we expect headline inflation to stay around 3.5% this year.

[2] *Sliding Oil Prices and Its Implications*, Hang Seng Hong Kong Economic Monthly, January 2015

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