

## The Political Economy of Hong Kong SAR's Fiscal Policy

Professor Lok Sang Ho

Director

Centre for Public Policy Studies, Lingnan University

### I. Introduction

For decades the government of Hong Kong had enjoyed huge fiscal surpluses (Table 1). Only rarely did Hong Kong register a fiscal deficit. The natural question to ask, following this observation, is where did the surging revenues come from, and whether such huge revenues can be expected to continue indefinitely.

**Table 1: Fiscal History of Hong Kong**

\$ million

Fiscal Year	Fiscal Balance	% of GDP	Fiscal Year	Fiscal Balance	As % of GDP
46-47	-4	n.a.	73-74	72	<b>0.2</b>
47-48	36	n.a.	74-75	-380	<b>-0.8</b>
48-49	35	n.a.	75-76	488	<b>1.0</b>
49-50	82	n.a.	76-77	903	<b>1.4</b>
50-51	40	n.a.	77-78	1236	<b>1.7</b>
51-52	33	n.a.	78-79	1467	<b>1.7</b>
52-53	73	n.a.	79-80	2924	<b>2.6</b>
53-54	42	n.a.	80-81	6696	<b>4.7</b>
54-55	62	n.a.	81-82	5039	<b>3.0</b>
55-56	52	n.a.	82-83	-792	<b>-0.4</b>
56-57	40	n.a.	83-84	-2533	<b>-1.2</b>
57-58	51	n.a.	84-85	24424	<b>9.5</b>
58-59	39	n.a.	85-86	2850	<b>1.0</b>
59-60	-45	n.a.	86-87	5899	<b>1.9</b>
60-61	14	n.a.	87-88	12502	<b>3.3</b>
61-62	78	<b>1.0</b>	88-89	16066	<b>3.5</b>
62-63	140	<b>1.6</b>	89-90	11063	<b>2.1</b>
63-64	99	<b>1.0</b>	90-91	3967	<b>0.7</b>
64-65	77	<b>0.6</b>	91-92	22509	<b>3.4</b>
65-66	137	<b>1.0</b>	92-93	21979	<b>2.8</b>
66-67	12	<b>0.1</b>	93-94	19164	<b>2.1</b>
67-68	134	<b>0.9</b>	94-95	10843	<b>1.1</b>

68-69	208	1.3	95-96	-3113	-0.3
69-70	449	2.3	96-97	25678	2.2
70-71	619	2.7	97-98	80866	6.6
71-72	640	2.4	98-99	-23241*	-1.8
72-73	636	2.0	99-00	+9952*	0.8

Source: Dictionary of Hong Kong citing the Annual Digest of Statistics, & the Annual Digest of Statistics

Note: \*These are provisional figures. Percentages of fiscal balance in GDP should be interpreted with caution, as GDP for year t is for calendar year t, while fiscal balance for year t is for fiscal year t to t+1. Fiscal year runs from April 1 to March 31 of the following year.

It is the thesis of this chapter to argue that the Hong Kong government during the last decade immediately preceding the hand-over had raised much of its revenue through land rent and inflation. The land rent was collected as land premiums collected through land auctions, rates, and other land-related revenues. The inflation tax is also raised directly by imposing higher fees and charges, and indirectly by fueling inflation expectations, the Government had increased Hong Kong people's demand for property investment to serve as a hedge against inflation. This has contributed to higher proceeds in land auctions and high amounts of land premiums collected. While I would not say that the Government has a "high land price policy" as many commentators claim, I have criticized time and again the Government's inflationary ways as highly dangerous and ultimately unsustainable.

In this paper I also argue that the Hong Kong SAR Government's mishandling of its housing policy has aggravated the inevitable fiscal crisis deeply and has left a trail of bankruptcies and bad debt that will take years to clean out.

## II. Prelude to the Fiscal Crisis

Hong Kong is well known to be a land of low tax rates. Its profit tax currently stands at 16 per cent and the "standard tax rate" for salaries, which caps the maximum tax load of a person regardless of the tax amount calculated from the tax rates applicable to various incremental changes in income, stands at 15 per cent. The top marginal tax rate for personal incomes stands at 17 per cent, well below the 25 per cent rate which had applied for decades until fiscal 1993-94 and the 20 per cent rate which applied from 1994-95 to 1997-98. The achievement of secular budget surpluses with low tax rates is a feat that has never failed to impress. Unfortunately, many people in Hong Kong have taken things for granted and have failed to realize that to enjoy this performance we must put up with high land prices.

It is not a coincidence that Hong Kong has about the lowest tax rates and the highest land

prices in the world. As long as Hong Kong has low tax rates, as long as Hong Kong has a stable society, a regime of stable and laissez-faire policy, free and open markets, respect for the rule of law, and good infrastructure, then Hong Kong can expect to have a vibrant economy and with a vibrant and growing economy and secularly rising land prices. Of course land prices, particularly housing prices, can momentarily rise excessively and will be subject to corrections, which may be prompted by some random shocks that are bound to occur from time to time. Yet the long term trend should be up, up, and up. This has been so for at least forty years and can be expected to continue indefinitely, if we continue to have those conditions as listed above.

It is now a well known fact that Hong Kong has gone into a deep recession, and that this unprecedented recession has something to do with the Asian financial crisis which was triggered by the devaluation of the Thai baht on July 2 1997. It is, however, not recognized that the Government of Hong Kong—both that of the colonial times and the Special Administrative Region--is really very much the crux of the problem.

It is true that the colonial Hong Kong Government, by its inflationary policy, has contributed to excessive asset price inflation in Hong Kong and escalating business costs. There are several theories about Hong Kong's inflation. Some attributed it to the large inflow of capital and profit repatriation associated with outward processing activities. Some attributed it to labour shortage and excessive demand. But no matter how we look at it, the fact is that the Hong Kong Government has been accumulating large fiscal surpluses while at the same time the public sector as a whole has been boosting fees and charges in the name of the "user pays principle." There is no escape from the simple and plain conclusion that the entire public sector could have charged less by way of public transit fares, sewage charges, gasoline taxes, rates on properties, services rendered by such departments as the Electrical and Mechanical Services Department, the Lands Department, etc. and still maintain budget balance. It is also generally recognized that civil service pay has over the years gone increasingly out of line with private sector wages and salaries, to the extent that the total compensation package could be as much as double the private sector levels. Had the government exercised some restraint on the fees and charges and the wages and salaries on which it had discretion, Hong Kong's inflation would have been considerably lower, and with lower inflation expectations, the enthusiasm to buy homes as a hedge against inflation would have been less. The asset price bubble would certainly have been much less serious.

Quite apart from inflation expectations pushing home prices up, three important factors must be recognized as key explanations for the dramatic run-up of property prices prior to the hand-over.

The first explanation is the very successful public housing programme in Hong Kong. It sheltered some fifty per cent of Hong Kong's population from the very large rent increases which were caused in part by rising inflation expectations. As of March 31, 1998 there were about 700,000 public rental units and about 260,000 Home Ownership Scheme or Private Sector Participation Scheme (PSPS) units. Together they house over fifty per cent of Hong Kong's population. Because the households living in these units, particularly those living in public rental units, enjoyed relatively low cost of housing, they have been able to, over the years, accumulate a lot of savings, ready to plow into the housing market.

The second explanation is the determination by the Housing Authority to adopt a policy of "rational allocation of public housing resources," which is tantamount to forcing the richer tenants to pay higher rent and even market rent. This policy had been proposed as early as 1984 but was first implemented in 1987 with some eight thousand households starting paying double rent in 1988/89 and was modified in 1993/94 and 1996/97 with minor alterations (Table 2). This policy was effective in pushing public housing tenants with means to buy HOS housing as well as private residential properties. From 1993/94 to 1997/98, the number of public housing units surrendered by public housing tenants who purchased HOS housing were respectively: 8406, 7676, 7462, 9963, and 9414. Compared to the annual production target of about 35000 units of public housing these are very large figures and are on top of those who surrendered their units without buying HOS housing. TPS has destroyed this ongoing stream of up-movers.

Table 2: Implementation of the "Rational Allocation" Policy since 1987/88

Year of Implementation	Year of Payment	1.5 x regular rent	2 x Regular Rent	Market Rent
87/88	88/89	n.a.	8789	n.a.
88/89	89/90	n.a.	24772	n.a.
89/90	90/91	n.a.	44710	n.a.
90/91	91/92	n.a.	58802	n.a.
91/92	92/93	n.a.	63058	n.a.
92/93	93/94	n.a.	60903	n.a.
93/94	94/95	13901	34979	n.a.
94/95	95/96	20738	32516	n.a.
95/96	96/97	26778	29519	n.a.
96/97	97/98	21157	9898	3606
97/98	98/99	15160	5863	1590

Source: Housing Authority; units are number of households paying the respective rents.

The third explanation is the surge in confidence. There was widespread belief that “tomorrow will be better” under the SAR, and that there would be an influx of Chinese capital boosting the prices of properties.

It was against this background that the prices of homes surged in the early 90s. But three things should be noted about this price surge:

- 1 it is not due to an excess of demand over supply;
- 1 short-term speculators were not the driving force behind the price surge;
- 1 the price surge was accompanied by a surge in the dwelling unit turnover, and many Hong Kong families were moving to better quality housing.

It may seem paradoxical that housing prices could surge without an excess of demand over supply. To some people a rise in price is equivalent to an excess of demand over supply. This belief, however, is inaccurate. What we had was a case of everybody putting a higher value on homes, but if you count the number of households and the number of dwelling units, you will find that the two sides essentially balance. To put this in another way, we can say that while the demand for housing units matched with the number of housing units available, the demand for housing quality, which was backed by rising incomes and aspirations, was unsatisfied, prompting a surge in prices. More specifically, as the well-to-do public housing tenants bid up the prices of HOS units and other housing units in preparation for the day when they might be forced to leave public housing, the owners of HOS units found that their equity had increased. They could then sell their units and with the enhanced purchasing power they could in turn bid up the prices of higher quality housing.

According to figures supplied by the Commissioner of Inland Revenue, Mr. Wong Ho Sang, the number of short-term purchase and resale of housing units totaled no more than 5 per cent of the total market turnover from 1992 to 1996. Since short-term speculators are usually multiple-unit traders the presence of speculators by head-count must be considerably less than 5 per cent. I conclude that short-term speculators were not the driving force of the price surge. Although they certainly had helped fuel market sentiments and to a certain extent had boosted prices, they were essentially taking a free ride.

The fact that so many people had changed their dwelling units in the past five years means that many Hong Kong people were badly hit by the housing market collapse. When people trade up they usually take out a larger loan. When the housing market collapsed they could, under some unfortunate circumstances, face a situation of negative equity. That is, they could lose all the equity they had accumulated in the first home and more.

All this is background. Now we turn to the making of the crisis.

It all appeared to start with the devaluation of the Thai baht on July 2 1997. The contagion effect led to a siege on the Hong Kong dollar, as the financial market was convinced that Hong Kong had to devalue given its high costs. The siege on the Hong Kong dollar led to very high interest rates, indeed a 280 per cent HIBOR (Hong Kong Inter-bank Offer Rate) in October 1997 and a plunge in the stock market. Housing prices also plunged in the wake of the storm.

One could argue that the Hong Kong Monetary Authority could have done something to avoid a surge in interest rates and that would have helped stabilize the markets. But that is a moot point. Let it be known that property prices had to fall and that the fall in property prices was part of the adjustment process required under the currency board system of Hong Kong in order to restore Hong Kong's competitiveness. Let it be known that property prices had risen far too much. The rental yield on residential properties had fallen to 3 per cent and to expect that rents could rise rapidly to bring the rental yield up to more normal levels was unrealistic. So a major correction was unavoidable.

However, a major correction does not imply a hard collapse. The housing market was hard hit, with dire consequences on Hong Kong's fiscal health, by misguided government policy based on misguided readings of the developments in the housing market and bad economics.

The SAR government read the housing market wrong. It thought the surge in housing prices was due to an excess demand for dwelling units and sought to redress the problem by increasing supply. Actually the surge in housing prices was due to a surge in the demand for quality, which was triggered by the "rational allocation of public housing resources policy," by the perception that the value of money would be eroded by inflation if not "protected" by some tangible investment.

The SAR government responded to public opinion without cool analysis. Public opinion held that housing had become prohibitively high and must be brought down. Increasing supply dramatically seemed logical.

The SAR government thought that boosting housing ownership would produce a more stable society and that the demand for housing ownership had been stifled by excessively high housing prices. Mr. Tung Chi-wah, the Chief Executive of the SAR Government, pledged to increase housing ownership from 50 per cent to 70 per cent in ten years, in the first Policy Address delivered in October 1997. All this is poor economics as the demand for home-

ownership is fleeting and elusive. Seeing that other people who had bought homes had enjoyed a huge capital gain most people would regret that they had not bought a home. Yet seeing that others who had bought homes had suffered a huge capital loss most people would congratulate themselves for not having bought a home. There is no intrinsic demand for home-ownership as such.

Acting on the political pressures to bring down housing prices and to make home-ownership a “realizable dream,” and lured by the prospective benefits of free market economics and private ownership the SAR government got very serious about selling public housing. On December 8, 1997 the Housing Authority announced the Tenant Purchase Scheme(TPS), which was the true beginning of the fiscal nightmare that Hong Kong must now face.

The TPS allowed public housing tenants to buy their own units at very deep discounts. Prices ranged from less than \$100,000 to just over \$300,000. Such prices are comparable to homes sold on the Mainland. To those people who can find the money to buy, the deal appears irresistible. From the point of view of the society, achieving efficiency seems far more important than achieving a narrow sense of equity. Let us not envy those people who benefit. If the Housing Authority benefits over the long term by unloading the responsibility for maintenance and management and the buying household benefits from becoming a proud owner of a flat, and if no one gets hurt, the proposition seems highly desirable. As far as equity is concerned there will always be no agreement as to what is fair and what is not.

Unfortunately the economic system is perforce an ecological system and is subject to the laws governing the fine balances required of any such system. The very attractive prices of TPS flats have rendered the prevailing prices of HOS flats very unattractive. Even though the number of flats open to sale in the first phase of TPS sale was rather limited all potential buyers of HOS housing have reason to demand much lower prices. Overnight the prices of HOS and PPS flats plunged. Since these flats housed roughly a quarter of a million families, the effect on the entire housing market is quite significant. When HOS housing owners suffered a huge decline in the equity embodied in their homes their ability to trade up was undercut severely. Other homeowners who depend on HOS owners as buyers for their own flats also could not trade up. Table 3 shows clearly that there was a discrete drop in transactions in existing homes starting in December 1997.

**Table 3: Transactions in Existing Homes**

	97 Oct	97 Nov.	97 Dec.	98 Jan.	98 Feb.	98 Mar.	98 Apr.	98 May	98 Jun.	98 Jul.	98 Aug.	98 Sep.	98 Oct
No.	9069	9546	<b>4198</b>	<b>4016</b>	<b>3217</b>	<b>6063</b>	<b>5102</b>	<b>4816</b>	<b>3750</b>	<b>3690</b>	<b>3848</b>	<b>3564</b>	<b>2993</b>
Value	36.0	34.5	<b>15.3</b>	<b>14.9</b>	<b>11.0</b>	<b>19.8</b>	<b>17.8</b>	<b>15.4</b>	<b>11.5</b>	<b>9.6</b>	<b>9.4</b>	<b>9.0</b>	<b>7.0</b>

Source: Mingpao, November 10, 1998; Housing Authority

What followed was a trail of unhappy events. Most important and noticeable of all, however, was that the turnover in existing homes fell like a stone. Sellers of existing homes did not realize it and waited patiently, but the developers of new housing sensed something strange had happened. The developers of new housing used to depend on homeowners trading up for their sales. As this source dried up they found that they had to reduce their prices dramatically to draw buyers. Those buyers who had never owned a home could only pay very low prices. So the prices of new homes fell so drastically that they could be 20 per cent below the asking prices of old and far inferior homes.

The Housing Authority found that several thousand formerly happy bidders for its HOS homes had to forfeit their deposits and simply walked away. This had never happened in all of the Housing Authority's history. The HA had to sharply reduce its prices.

The HA thought this was all due to the Asian financial market turmoil. But no one can describe the "transmission mechanism" whereby the currency market turmoil affected the Hong Kong housing market to the extent as witnessed.

In a single quarter, Hong Kong's GDP fell 11.8 per cent in real terms in the first quarter of 1998(quarter to quarter; this compares with 2.6 per cent decline year-on-year). This performance was unprecedented. In all of Hong Kong's history, the years of the Cultural Revolution, the years of the oil price embargo, the years of world recession, the year of the June 4 incident, and the years of very high interest rates(reaching about 20 per cent in 1981-82), Hong Kong has never undergone such an ordeal. Mysterious to those who did not understand the effect of the TPS, Hong Kong's economic performance suddenly was reduced to that of Malaysia and South Korea. Notwithstanding "the Hong Kong advantage," Hong Kong's economic performance in 1998 was far inferior to that of Singapore and Taiwan, despite the fact that Hong Kong's main trading partners, the Mainland and the U.S., were still expanding at a brisk pace. Unemployment, bankruptcies, and bad debt followed, notwithstanding an unprecedented stimulative budget announced on 18 February 1998.

### **III. The Most Stimulative Budget in Hong Kong's History**

By all accounts the budget of February 1998 was the most stimulative in Hong Kong's history. According to a leaflet published by the Government, the tax concessions totaled \$13.6 billion (cf. \$3.1 billion for fiscal 1997-98) for 1998-99 and close to \$100 billion by 2001-02. This was achieved by raising existing tax allowances and introducing new ones (most noticeably a mortgage interest allowance at up to \$100,000 per year for five years), reducing the top marginal tax rate from 20% to 17%, reducing the profits tax rate from 16.5% to 16%, reducing the percentage charge for rates from 5 % to 4.5%, freezing most government fees and charges, halving the air passenger departure tax to \$50, cutting the hotel accommodation tax from 5% to 3%, as well as reducing the estates duty, among others. The tax reductions were expected to benefit 99% of salaries taxpayers, investors in the stock market (who pay a lower stamp duty), businesses, and home-buyers. At the same time total public expenditures were to increase by 11.2 %. Notwithstanding these changes, the Financial Secretary forecast a small budget surplus and promised to keep the overall growth in government spending within the rate of growth of the economy.

As it happened, at the time the Financial Secretary read his budget speech in the Legislative Council, the economy had already fallen firmly into recession. Despite the stimulative budget, Hong Kong was to suffer the first ever yearly decline in the GDP, and to decline at the shocking rate of about 5 per cent. The earlier forecast of a small budget surplus was to turn into a major, unprecedented budget deficit in excess of \$30 billion.

### **IV. Genesis of the Fiscal Crisis: the TPS**

Without realizing it, by announcing the TPS on that portentous day of 8 December 1997 the Housing Authority had sealed the fate for the fiscal health of Hong Kong. Intended to realize the full potential wealth embodied in the existing public housing stock and to improve the financial health of the HA through unloading the long term burden of the cost of maintenance, the TPS actually destroyed wealth on a massive scale and worsened both its own financial health and the fiscal health of the government of SAR. The collapse of GITIC and the problems faced by many "red chip" companies can also be linked to it. To some people this account seems far-fetched, but that is only because they do not realize the fact that the economy is subject to a delicate ecological balance much like other ecological systems. The failure of one component in the system can quickly result in a general collapse of the whole system.

The sharp decline in transactions in existing homes in the wake of the December 8 1997

announcement effectively meant that home developers must sharply reduce their prices to levels within the reach of first-time home-buyers. The rules of the game had changed. It used to be the case that first time home buyers buy existing homes, HOS homes, and particularly homes in less accessible areas. When the traditional buyers from among the public housing tenants disappeared, HOS owners would not fully realize the implications and did not accept that they had to lower their prices tremendously in order to sell them. If they could not sell, they also could not trade up. As they could not trade up, other homeowners who depend on them as buyers of their homes also could not trade up. As this happened, all those businesses which make their living on housing market transactions discover that their business volume has fallen tremendously. They had to lay off staff and even to close down. These businesses include real estate brokers, movers, decorators, lawyers, furniture and appliance sellers, etc.

The HA found that the number of potential buyers had fallen sharply. They had to reduce the prices of HOS housing. Similarly the Housing Society also found that it had to reduce sharply their prices. Thousands of buyers of HOS and Housing Society housing lost their deposits. Those home-buyers who had bought a new home before selling their old homes were particularly hard hit. As the housing market collapsed, tens of thousands of owners of small businesses who had used their homes as collateral to obtain financing faced a credit squeeze. The credit squeeze made them more reluctant to invest. The banks were forced into greater caution. The government had no choice but to announce a moratorium on land auctions, as well as various other measures, to help boost confidence.

Most noteworthy among these measures are the various loan schemes available to first time home-buyers. The first such initiative had been announced in the Chief Executive's first policy address in 1997, when a quota of 6000 was announced. On June 22 1998 this quota was doubled to 12,000. Called the "Home Starter Loan Scheme," it provides low interest loans of up to \$600,000, or 30% of the purchase price of property, for households earning no more than \$70,000 a month. In addition to this scheme, which was administered by the Housing Society, the Housing Authority also raised the quota for the "Home Purchase Loan Scheme"(HLPS) from 4,500 to 10,000. The Government hoped that these schemes would "help will help create an additional demand for 11,500 flats in 1998-99 in the private market."

It is amazing that notwithstanding these efforts, notwithstanding the unprecedented mortgage interest deductibility, notwithstanding the moratorium on land auctions, and notwithstanding that home prices had fallen by some 40 per cent from the historical peak, home prices continued to slide, and trading in second-hand market homes continued to be very inactive. Meanwhile the unemployment rate continued to climb. It took Japan ten years to double its unemployment rate since the "asset bubble" burst. It took Hong Kong nine months to do the same. Hong Kong's unemployment stood at 2.5 per cent in the last quarter of 1997.

By June-August 1998 it had gone up to 5 per cent. It was to reach 5.8 per cent by the last quarter of 1998.

Magically but tragically, one serious policy blunder had led to the evaporation of hundreds of billion dollars of wealth and a fiscal crisis. The Housing Authority continued to be unpenitent. The Government continued to blame the Asian financial crisis. The tragedy continued in full force.

## **V. Compartmentalized Policy: an Extreme Case**

The Housing Authority has been making a handsome profit in its consolidated income-expenditure account and has been accumulating a sizable reserve. Its operational deficit on rental public housing has been increasing rapidly. At 1.7 billion dollars in 1997/98, however, it is very small compared to the operational profit of 14.2 billion for commercial and HOS operations. Selling public housing to tenants would reduce the deficit for public housing operations, but to take such a narrow, compartmentalized view of fiscal health is extremely unwise. What it gains by way of unloading the maintenance burden and income, it loses by hundreds of times through reduced pricing of HOS housing and roll-backs on rents on commercial premises. Moreover, the general government revenue suffers. Private sector business incomes suffer. Household incomes suffer. Job losses result. Bad debts form. People and businesses go into bankruptcy.

In economics there is a clear distinction between general equilibrium and partial equilibrium analyses. If only one public housing tenant was given the opportunity to buy his flat at a discounted price and no one else has the opportunity he certainly would enjoy a huge capital gain, and there would not be a noticeable effect on the rest of the housing market. However, if public housing tenants were told that they could now all have such an opportunity, the prices of other kinds of housing would certainly be affected. Those who recommend selling public housing cheaply and allowing the sold units to trade in the free market have made a serious logical error. They have applied partial equilibrium analysis where general equilibrium analysis is more appropriate.

## **VI. “Shell-less Snails,” the Monetary Authority, and the Fiscal Crisis**

Of course we should not hold the Housing Authority fully responsible for the collapse of the housing market and the recession. The Asian financial crisis had its role to play. Those who called themselves “shell-less snails” and implored the Government to make housing accessible to them also should take some of the blame, and so should the Monetary Authority. As a matter of fact, the “shell-less snails” were far from homeless. They had only missed the

boat as housing prices went up, up and away, and beyond their reach. But they could afford to rent; indeed many of them were enjoying housing benefits from their employers. Because they looked upon home-ownership as a big issue and took it to the streets, the Government felt compelled to do something about it. TPS promised to bring Mr. Tung's dream of 70% home-ownership into reality; a housing production target of 85,000 yearly also promised to bring home prices back to more reasonable levels.

The Monetary Authority also has its share of the responsibility. For months it had relied on higher interest rates to increase the cost of those speculators who bet that the Hong Kong dollar was to depreciate. It had hoped that this would increase the cost of speculators who had to borrow Hong Kong dollars in order to short-sell it. Thus it refused to supply liquidity into the banking system. During the height of the financial market turmoil, in October 1997, the inter-bank rate had gone up to 280 per cent and the prime rate kept climbing. Not until late February 1998 did interest rates register their first decline since the Asian Financial Crisis began, and not until October 1998 did interest rates in Hong Kong start on a downward path. After a series of cuts, however, Hong Kong's prime rate continued to be 0.75 per cent above its American counterpart. A tight monetary policy has always been associated with large budget deficits because it depresses private sector business activities and thus depresses tax revenues<sup>1</sup>. The failure of the Monetary Authority to bring interest rates closer to US levels must take part of the blame for the large fiscal deficit which has emerged.

## **VII. What can be done**

The most important thing for the Government to do to save itself from the crisis is *to rescind the TPS*. Such a move will not cost the Government anything but will be the first step to a true and sustainable recovery. Another step that the Government can take is to issue inflation-indexed bonds to finance the deficit. Apart from these moves, I would propose that the Government reduce the salaries of civil servants by about 5 per cent, which is roughly the rate of decline of the economy in 1998, and reduce the benefit amount under the Comprehensive Social Security Assistance. Still another step that the Government can take is to re-link the Hong Kong dollar to a basket of currencies rather than to the US dollar and reduce Hong Kong's interest rates. Finally the Government can sell some of its assets, particularly the currently fully-owned MTR and the KCR.

We shall take up the last first. Privatizing the MTR and the KCR through the flotation of shares has two advantages. Not only will it at once bring in a sizable revenue, but by attracting

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<sup>1</sup> Both United States under Paul Volcker and Canada under John Crow had fast rising budget deficits and tight money.

foreign acquisition of these shares it will help bring in foreign capital and indirectly bring down Hong Kong's interest rates. Any inflow of capital will reduce the need for higher interest rates to preserve the link. Lower interest rates will improve the business environment and help boost the Government's revenues.

The current currency board system with the Hong Kong dollar linked at HK\$7.8 to US\$1 is for the SAR Government as well as China a sacrosanct matter. In order to ward off speculative attack on the HK dollar which would put pressure on Hong Kong interest rates, the HK Monetary Authority has made every effort to dispel any suspicion that the linked exchange rate system would be modified in any way. It is true that if a re-linking is one of devaluation it would call forth speculation that further devaluation might take place. For this reason I do not propose that we re-link the HK dollar to the US dollar at a stipulated rate. However, if we link the HK dollar to the US dollar at \$7.8(or \$7.75 for that matter since the latter is what actually prevails) now announcing that this link will be changed upwards or downwards to offset any movement of the US dollar so as to stabilize the effective exchange rate, we will have a much more viable and defensible situation than if we hold on to a fixed US-HK dollar link. Under such a system we will be in a position to lower our interest rates. Once again, with lower interest rates and avoiding unintended appreciation of the HK dollar, business activities in Hong Kong will be healthier, thus contributing to a healthier fiscal outlook.

*A cut in civil servants' pay* would allow the Government to hire needed people to improve its services. While some Departments and agencies are no doubt over-staffed and should face a cut in staffing, other Departments and agencies are currently understaffed so that citizens have to wait in long queues to get things done. Because the economy has shrunk by some 5 per cent in 1998, assuming a fair distribution of the pain of the recession everyone should be prepared to take a 5 per cent real decline in wages. As the price level has actually fallen, maintaining nominal incomes would imply a real increase in wages. That can only take place at the expense of others. Without cutting civil servants' pay it will be difficult to come up with the revenue to hire more people. As a matter of fact, the premium of civil servants' wages over private sector employees' has been documented to be very high, particularly at the lower end. Actually, not only civil servants, but also many workers in the subvented sector and in education, are paid with tax revenues. Another very sizable group, comprising workers of statutory bodies and government-owned corporations, such as the Hospital Authority, the Airport Authority, the Trade Development Council, the Mass Transit Corporation, and the Kowloon-Canton Railway Corporation, are also paid lucratively relative to the private sector. Together they form the bulk of the middle class people who pay the bulk of salaries tax. It has often been said that Hong Kong's tax burden is too narrowly concentrated on a small group of taxpayers. It is estimated that some two million of the 3.15 million workforce in 1998/99 do not have to pay taxes while 100,000 of the top salaries earners shoulder 62.5 per cent of the

total salaries tax burden. About 0.3 per cent of the workforce paid the standard tax rate of 15 per cent and they account for 19.5 per cent of the total salaries tax burden. Concern over this observation is misplaced if we assume that the greater majority of these workers are in the “public sector” and are overpaid by, say, 15 per cent. Someone who is overpaid by 15 per cent and who pays taxes equal to 15 per cent of the overpaid salaries actually pays no tax from his adjusted income. From this perspective we can see more clearly the importance of land-based revenues in Hong Kong. *Not counting the salaries tax paid by the overpaid middle class as Government revenue*, certainly land based revenue, comprising direct proceeds from land sales, land premiums collected when extra development is approved, the profit tax from land-developers and from the banks which profit from mortgage lending, rates, stamp duties, etc., must be very significant, and could amount to as much as 50 per cent of the *adjusted revenue*.

CSSA(Comprehensive Social Security Assistance) payments has been rising at a rapid rate in recent years. The figure was \$3.4 billion in 1994/95. By 1997/98 it had gone up to \$9.4 billion and in 1998/99 it topped \$13 billion. The Government issued a Report on Review of the Comprehensive Social Security Assistance Scheme in December 1998 and recommended a cut in the benefits given able-bodied recipients. As benefit levels are quite attractive relative to the going wage rate the proposed move has received much public support. Yet it would at most slow down the rate of increase in expenditures but is unlikely to reverse the trend of increase, and would also undercut consumption spending.

In recent history, Canada is a notable example of a country that has reversed its fiscal deficit very quickly through currency depreciation and interest rate reduction. The Hong Kong SAR Government’s fiscal position would certainly benefit from a more lax monetary policy, but in the short term a fiscal deficit is inevitable. To finance this deficit one option is to draw down the fiscal reserve. Another option is to issue bonds. While I will not object to the Government drawing down the fiscal reserve it also makes sense to issue bonds, particularly inflation-indexed bonds, as this will help the development of the underdeveloped bond market and provide a valuable investment vehicle for the \$15 billion a year to be collected under the Mandatory Provident Fund, starting in December 2000. For retirees, preserving the real value of the deposits is important, and it is likely that because savers appreciate it, the indexation feature would reduce the cost of financing the government debt.

Finally, since the Tenant Purchase Scheme is under my analysis really the crux of the fiscal crisis and a major contributory factor to the economic downturn, it only makes sense to scrap it altogether.

## VIII. Conclusions

Despite the dramatic gyrations in prices, Hong Kong's housing market has never suffered a gross imbalance between supply and demand. If the dramatic price surges of the last few years were due to an excess of demand over supply it would be difficult to explain the sudden and dramatic reversal. Just as there was no significant excess of demand over supply when property prices surged so there was no significant excess of supply over demand when property prices crumbled. Unlike Thailand, unlike Singapore, unlike the Mainland, there was no overbuilding of homes, although there was obviously a serious overbuilding of offices. Hong Kong's fiscal crisis was home-grown. Hong Kong's deep recession was home-grown. It was in part due to the failure of some bureaucrats to look at the general equilibrium effects of a major policy shift, and in part due to the inability of the Hong Kong monetary system to bring about interest rates that are appropriate to Hong Kong's situation<sup>2</sup>. The experience of Hong Kong 1997-98 demonstrates the ecological nature of the economy.

Failing to address the crux of the problem, Hong Kong's recovery had been painfully slow. In 1999 the Hong Kong economy did bounce back 3 per cent, but that did not make up for the 5.1 per cent decline in 1998. This compares with a 10 per cent clip for South Korea in the same year. While the first quarter of 2000 did show a very strong growth in excess of 14 per cent year-on-year, property values continued to decline and retail sales were still weak. Even if the Government mends its mistakes the medicine will have come too late. So the Government is going to face a prolonged fiscal crisis. The prolonged fiscal crisis will inevitably lead to more confrontations, more social strife, more political haggling.

Preparing the budget for 1999-2000 had been difficult, but that for 2000-2001 will be even more difficult. Because the Basic Law requires that the SAR government run a balanced budget, Hong Kong cannot have several years of deficits in a row. Because the Basic Law also requires that the SAR government maintain a low tax rate regime, the equation seems impossible to balance, unless bold steps are taken to reduce government expenditures. A reduction in government expenditures will inevitably lead to increasing confrontation between the government and the groups who will be affected.

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<sup>2</sup> In sharp contrast, the Singapore Monetary Authority aggressively reduced interest rates. Despite the fact that Singapore has close ties with Indonesia and Malaysia Singapore has been able to achieve a much less severe downturn than Hong Kong.

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