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The New Budgetary Challenge

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Misplaced Emphasis on Taxes

Sir Piers has for many years warned the public of the danger of a narrow tax base, which would expose government spending to the vicissitudes of the economy. Popular opposition to tax increases has kept the controversial wholesale tax proposal on the backburner. But it has not prevented the Financial Secretary from imposing ever higher indirect taxes on selected products, making Hong Kong less and less a free port. The 200 percent increase in tobacco taxes this years is particularly offensive for being both hypocritical and condescending at the same time. More significantly, Sir Piers has succeeded in expanding the individual salary tax base without attracting a similar public outcry. In the 1987 budget, the number of taxpayers who had to pay salary taxes was about 517,500. This year, the number is estimated to be one million.

Sir Piers will also be remembered for allowing government expenditures to accelerate during his five-year tenure as Financial Secretary. In 1986 to 87, before he came into office, the share of consolidated public sector expenditure as a share of gross domestic product was 11 percent. The forecast for 1991 to 92 when he leaves office, will be 19.3 percent. This is a significant departure from the practice of previous Financial Secretaries. Sir Piers has silently shifted the focus of our budget from controlling expenditures to raising taxes. He has not only broadened the direct tax base but has tried to persuade the public of the necessity of broadening the indirect tax base as well. This is quite ironic for someone who has acquired a reputation for being conservative and cautious.

It has never been clear why Hong Kong's tax base should be broadened. Hong Kong's low tax rates and accompanying narrow tax base has been one of the pillars of her highly acclaimed free enterprise economy and limited government, acting as an effective constraint on the size of the government. The very fact that Hong Kong's tax base was narrow has made it difficult for the government to raise taxes. A broad tax base would make it much easier for the government to raise more revenue.

A well-known dictum in political economy is that it is easier to ask large numbers of people to contribute a small amount each than to get a small number of people to each contribute a large sum. Indeed, the relative ease with which Sir Piers has been able to broaden the base for direct taxes in the past five years has demonstrated the correctness of such a dictum. It should sound a warning bell to all those who are opposed to big government that further broadening should be resisted and the current scope should be rolled back. The sales tax should be resisted for it would make available to government an easy source of revenue that would, over time, erode the foundation of Hong Kong's free enterprise system and limited government.

The fear that a narrow tax base will lead to large swings in the budget, generating huge deficits in bad years and surpluses in good years is more rhetoric than a real economic concern. So long as the government seeks to balance the budget over the business cycle rather than from year to year there is really no cause for alarm. Even Sir Piers recognizes this point at the beginning of his Budget Speech this year. Yet,oddly enough, he repeated again his concern about the vulnerability of Hong Kong's budget to external shocks. History has shown that the best budgetary policy is to contain spending, not to increase revenue. Small government budgets survive external shocks better. Taxes should be cut during good years and spending reduced during bad years to keep governments small.

Focus on Expenditures

The real purpose for broadening the tax base probably comes from the concern that the demand for better provisions of infrastructure, social services, and civil service pay may well rise in the future, and therefore, adequate revenue arrangements have to be made now. For a variety of reasons the demand for such services will accelerate. But raising revenues is not the appropriate response in general, and a broad-based wholesale tax is the wrong solution to this specific problem.

On the revenue side, the Financial Secretary has significantly expanded the salary tax base so that further expansion is not likely to bring in much additional revenue without increasing the tax rate. About 50 percent of the working population is already in the tax net. The vast majority of these taxpayers contribute very little to the total share of revenue derived from salary tax. A broad-based wholesale tax is not likely to add significantly more revenue since it will not be all that broad-based. Such a tax will be difficult to collect on services, which are becoming an increasingly important component of Hong Kong's economy. It is also highly likely that certain "necessities" will be exempted from taxation. Expanding the tax base will not satisfy the demand for more expenditure. Unless expenditure is controlled, tax rates would have to be raised before long.

The provision of public services through general tax revenues is now well recognized as being inefficient. Bureaucrats whose incomes are not tied to their performance do not have adequate incentives to perform well. The collapse of the socialist economies and state enterprises proves the point. The use of such a system can only be justified if the cost of collecting fees for the services are too high and if the tax system works to the advantage of the poor. A broad-based sales tax will not work to the advantage of the poor. It will force them to pay for services which they might not utilize.

Attempts to contain government spending by applying administrative pressure in Star Chamber sessions can only have a limited effect. It will not be popular among civil servants whose morale is faltering. Civil service pay, which constitutes the single most important item of government spending, is highly inelastic given government civil service regulations. Furthermore, the rapid expansion of Hong Kong's service sector in a tight labor market will continue to fuel civil service pay rises. The demand for better health, education, and other services will accelerate simply because these are highly income-elastic items. The government is simply caught between rising demand and meager resources. Any attempt to shift the burden onto users without providing better services will precipitate a public outcry.

More radical reforms in the provision of public services have to be contemplated. There is still, fortunately, considerable scope for reducing government spending. Privatization of many government services can save tax money and improve quality. Parking meters, car parks, tunnels, airports, postal services, urban services, water supply, housing, education, and health care are some such examples. These measures can be combined with an adequate provision of financial subsidies to the needy so that the poor will not be hurt. A properly devised privatization scheme would obviate the need to increase taxes and to broaden the tax base, and is far more likely to lead to an efficient and equitable solution. This is nothing new. Former British Prime Minister Margaret Thatcher and former U.S. President Ronald Reagan did it for years, as have the rest of the world, capitalist and communist. The real focus of the budget should not be on raising revenue but controlling expenditure.

Better Economic Policies

Hong Kong’s economy faces a number of problems that demand solutions: emigration, inflation, labor shortage, and economic restructuring. These issues are related and should be properly addressed in a budget speech. Sir Piers' presentation left much to be desired.

There is an erroneous belief that a narrow tax base is particularly vulnerable for Hong Kong because those who pay most of the taxes may well be those who will emigrate in view of 1997. But their places surely will be taken by others. The problem of an emigration-induced economic slowdown is best handled by a more aggressive policy to attract immigrants rather than a policy to insulate the budget from its effects. Indeed, Hong Kong's economic growth is being jeopardized by the restrictions on immigration. They also contribute to keeping Hong Kong's inflation rate above that of the United States.

The current inflation has two causes. By linking the Hong Kong dollar to the U.S. currency, we import U.S. inflation. The excess inflation above the U.S. rate is structural inflation and results from the tightness of the labor market. The latter cannot be resolved except through a continuous program to increase the supply of labor. Adjusting the link, whether it is pegged to the U.S. dollar or to a basket of currencies, will not solve structural inflation. At best, it will generate deflationary pressures through an unending series of revaluations to offset structural inflation, and worse, it will subject our currency to speculative attacks and increase the overall uncertainties of doing business. Also, in Hong Kong's open economy, tight interest rates will have a limited effect on curbing inflation.

The current inflation is very damaging for the economy. To begin with, Hong Kong's economy is rapidly shifting towards the service sector because manufacturing wages are no longer cheap. Unfortunately, inflation is most severe in this sector. This shift will undoubtedly hurt our overall competitiveness. By default, the natural evolution of our economic system towards services is making our economy less laissez-faire than it used to be. Since our manufactured products contain a larger service component now, their competitiveness will also be affected. The effect is worsened by the fact that important areas in the service sector, like air services, telecommunications, banking, professional services, and others, are far more cartelized and protectionist than manufacturing. Government policies to increase competition in this area are clearly called for.

The rapid decline of manufactures and their relocation into China is a logical response to cheaper labor there. Hong Kong manufacturing workers are naturally unhappy with their present state. Their wages are not only lagging behind, but many are not working as many hours as they wish. Given the fact that many of these workers are married women who started working in the factories during their teens and have now returned to the labor force after their child-bearing years, they have little comparative advantage in relocating to the service sector and little incentive to acquire new skills because their anticipated working life is relatively short. Retraining such workers may not yield a high rate of return.

The community is keen to request government support for research and development and manpower programs as a solution to what is seen as the need for economic restructuring and to the problem of a labor market with the wrong mix of skills. Investment in technological know-how and skills is clearly important in the long run, but will not be cheap. A better solution is to bring in more immigrants, which will also relieve tightness in the labor market and reduce inflationary pressures. Even our tertiary institutions can benefit from an infusion of immigrant talent, not only among teachers but also students. If one has to invest money in human capital, it should be put where it can earn the highest yield.

What is to be done?

What is required is a renewed commitment to strengthen the system of free enterprise and limited government in Hong Kong. This would require large-scale privatization of government services, increased competition in the service sector, and a more liberal immigration policy. It will not be an easy task, but such is the challenge of leadership.

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