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The Budgetary Dilemma

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Financial Secretary Hamish Macleod's budget proposals ran into heavy criticism by legislative councillors. Legislators of all persuasions called on the government to provide more tax relief for the sandwich class. This was not unexpected as Hong Kong's new-styled legislature edges towards greater accountability, a development that should be welcomed. However, budgetary debates should not be overly politicized. The distribution of the tax burden among different classes is an important social problem, but one should not lose sight of economic issues.

Hong Kong's highly acclaimed budgetary policy rests on low taxes and limited government expenditures. The great advantage of the income tax system is its enormous simplicity, low tax rate, and high predictability. It is popular to view personal income taxes solely in distribution terms. Low tax rates facilitate economic growth by providing powerful incentives for individuals to improve their situations. When tax rates are low, the tax base will be narrow because it will not be worth the effort to collect taxes from a large sector of the population. Today only half the working population pay income taxes.

Hong Kong's tax regime helps the poor as much as it favors the rich. The experience of the welfare states in the industrialized West shows that the only permanent escape from poverty has to come from self-help and not handouts. The state is not a reliable relief agency in the long run. If the economy slows down due to higher taxes, then the state will sooner or later run out of funds. The middle class in Hong Kong, more than anybody else, knows this. It would be a serious mistake to believe that they prefer higher taxes as a redistributive measure despite its populist appeal. Their concern is to lower the tax burden further for themselves by increasing personal tax allowances.

The personal tax allowance defines the level of income where one begins to pay taxes. Since inflation erodes real income, there is a case for indexing the allowance to inflation. The attached chart plots the real personal tax allowance measured in 1991 dollars over a period of two decades beginning with the budgetary year 1971-72. It shows that although there is no explicit policy to index the tax allowance to inflation, the actual adjustments have left the real tax allowance today at the same level as it was in the 1970s.

Interestingly, in 1981-82 Haddon-Cave, and in 1982-83 Brembridge, allowed the personal tax allowance to rise significantly in real terms. The large budget surpluses in the preceding years probably forced the financial secretaries to reduce tax revenues and increase expenditures. This was a mistake because severe budget deficits emerged as the economy moved into a recession in subsequent years. Brembridge and Jacobs succeeded in gradually reducing the real tax allowance back to the levels in the 1970s. Critics of the government are correct in pointing out the erosion of real tax allowances in the 1980s, but they failed to point out that the real tax allowances at the start of the decade were aberrations from the levels in the 1970s.

Whether real tax allowances should rise with real income growth, as opposed to inflation-induced nominal income increases, is another issue. If real tax allowances are not indexed to real income growth, then a larger fraction of the population will be drawn into the tax net over time. The tax burden will spread down to the middle class as society prospers. Although the proposition that the middle class should bear a larger share of the tax burden as society prospers can be defended on social and moral grounds, practical politics will probably dictate otherwise. Political opposition to a spreading tax net will rise as more people are affected, especially in an environment where the political system becomes more representative over time.

If real tax allowances are fully indexed to real income growth, then the fraction of the population that will be drawn into the tax net will remain largely unchanged as real incomes rise. Income tax revenues will grow more or less in pace with overall economic growth. If other sources of government revenue can grow at the same rate, and public expenditures do not rise faster than economic growth, then there is no problem with balancing the budget over a business cycle.

Unfortunately, the 1980s have been a period of transition for Hong Kong. The traditional sources of tax revenue have been affected in four different ways. First, the tax base for indirect revenues has not expanded over time, and revenues have been maintained through raising tax rates. Second, contributions from corporate profits tax have also lagged behind because of the declining average firm size and the enhanced ability of firms to book profits overseas as production moved offshore. Third, revenue from land sales are subject to restrictions imposed by the Joint Declaration. Fourth, the government has failed to control public expenditure growth. The outcome is a greater reliance on the salaries tax to finance public spending.

There have been a number of proposals to deal with this problem. First, expand the tax base for indirect revenues. This is economically undesirable because it will make available to government an easy source of revenue, making it even more difficult to control public sector growth in the long run. Politically it will also be highly unpopular. Second, increase the corporate profits tax rate or introduce analogous measures to increase the revenue yield. Such measures will be futile because they will only exacerbate the move offshore. Third, the loss of revenue from land sales is temporary, and the situation will improve after 1997 -- unfortunately, five years is not soon enough. Fourth, while reducing public spending is highly desirable it will not be an easy political task. Privatization of government assets is economically desirable but politically sensitive.

The choices for government are few and involve difficult tradeoffs, but unless a solution can be found, it will be difficult to index real tax allowances to real income growth, either partly or in full. The personal income tax allowance will remain a politically contentious issue in the future. This is not a comforting thought for Hong Kong. Politicizing the budget runs the risk of eroding the most attractive features of Hong Kong's budgetary policy. It would be a great irony if Hong Kong's tax system should become more complex, less predictable, and suffer from high tax rates while the rest of the world moves in the other direction.

This is the first part of a two-part commentary. The second part will appear in the next issue of the HKCER Letters.

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