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The Budget, Inflation, and Housing

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The failure to control public expenditures effectively in the 1980s and the erosion of traditional sources of government revenue meant that the salaries tax was becoming an increasingly important component of recurrent revenue. In ten years, the tax net has expanded and the number of taxpayers has risen from less than a quarter of the labor force to more than a half. Not only have real tax allowances been unable to rise with real income growth -- in fact, they have been reduced to levels prevailing in the 1970s.

Rising inflation and the emergence of an elected legislature were the main reasons for the severe opposition to Macleod's maiden budget. Attention was focused on the plight of the so-called sandwich class. This group has been defined in many ways. One popular current definition includes households with monthly incomes between $18,000 and $40,000. The lower limit denotes the level of income above which a family is not eligible to apply for subsidized public housing and homeownership scheme units, and the upper limit denotes the level of income necessary to support mortgage payments for a small unit in the private sector. According to the 1991 Census figures, the distribution of households according to their monthly income is as follows:

Monthly Income	**below $18000**	**$18000-$40000**	**above $40000**
Households	1,241,382	257,540	81,150
Percentage	78.6%	16.3%	5.1%

Note that only 16.3% of the households are in the sandwich class, and they are in the top quintile of the household income distribution. In 1991, a family with two children having a monthly income of $30,000 would have to pay the standard tax rate of 15% of total assessable income. If the same family had an income above $13,800, it would have to pay taxes at the maximum 25% marginal rate until it reached the standard tax rate level.

The people in the sandwich class are clearly those at the bottom of the high tax bracket, whose interests have been hurt by inflation in two major ways. It is important to distinguish between the effects of inflation on real incomes and on real savings. Inflation can erode after-tax real incomes, not because nominal incomes do not rise fast enough, but because of inflation-induced changes in real tax allowances and real tax brackets. This problem can be solved simply by indexing tax allowances and tax brackets to inflation. Another benefit of indexing is that it removes one element in the annual exercise of political posturing that surrounds the budget debate. If legislators and the government could agree to such an arrangement, then taxpayers can have greater certainty about their anticipated tax liabilities. It would be even better if they could agree not only to index tax liabilities to inflation but also to real income growth. This would effectively limit public expenditure growth to the rate of economic growth. The establishment of tax rules would institutionalize the successful budgetary policies of the past and reduce the scope of arbitrary decisions in an evolving political system.

These tax effects of inflation on the economic well-being of households in the sandwich class are usually small when compared to the effects of inflation on real savings. With double-digit inflation, real savings fall rapidly over time. The flight to property as an inflation hedge is a natural response. Households who do not own property will find their lifetime wealth position declining rapidly both in absolute and relative terms.

In 1991, domestic property prices surged as families rushed to purchase homes in order to hedge against inflation. Tenants in the private sector who were not eligible for subsidized public housing and homeownership schemes discovered that their hopes of acquiring a unit had vanished within the span of a few weeks. They could no longer afford to buy a unit at current prices and probably not in the near future either because the gap between accumulated savings and property prices was growing.

The government effort to intervene in the housing market by forcing banks to reduce their mortgage loans so as to curb the demand for property cannot help the sandwich class to acquire property. There is much talk about devising other means of extending direct help to these households. One cannot be optimistic about the feasibility and desirability of further interventions into a market which is dominated by public housing programs, private sector participation schemes, and homeownership schemes.

The effect of inflation on real savings can only be addressed by increasing the supply of assets that can serve as a hedge against inflation. In Hong Kong and elsewhere, the single most important asset that serves such a purpose for most households is property. Other assets like stocks and foreign currency are not equivalent alternatives. If every household were to become a property owner, then the problem would be largely resolved. The magnitude of the problem can be estimated on the basis of the number of households who are not homeowners. The figures below indicate that 42.6% of the households are homeowners, 36.3% live in public rental housing, and 16.7% live in private rental housing. Among private renters, 213,092 have incomes below $18,000, whereas only 31,092 are in the sandwich class. Whether government should spend resources to help the top quintile of the income distribution at the expense of the rest can always be debated, but surely the case cannot be based on equity grounds.

Monthly Income	below $18000	$18000-$40000	above $40000
Owner Occupier	467,539	156,345	49,183
Tenant:	726,197	89,023	22,131
Public housing	513,105	58,002	3,142
Private housing	213,092	31,021	18,989
Employer Provided	32,575	10,849	9,261
Rent Free	15,071	1,323	575
Total	1,241,382	257,540	81,150

A staggering 574,249 households live in public rental housing. While these tenants do not have a housing problem, they do not own the units they live in. As a consequence,the tenants do not have a hedge against inflation. Although the government is the landlord to over 2.2 million individuals, it cannot exercise most of the rights other landlords possess. It is inconceivable that the tenants can be evicted. Therefore, the units and the land on which public housing estates are erected have, for all practical purposes, no alternative use. This means that the market value of vast amounts of resources has been artificially obliterated by maintaining the public housing program.

If these public housing units could be sold to the tenants with unrestricted transfer rights, then it will liberate those resources and create enormous wealth immediately for society. Tenants would obviously welcome them if the prices for these were set at a discount to the market value. It will make available to the Housing Authority vast resources through the sale of public housing units so that private tenants, including those in the sandwich class, can look forward to faster provision of both public housing and homeownership scheme units. The dilemmas of managing the budget in an age of limited revenues and growing expenditures would also be reduced.

With the privatization of over half a million public housing units, one can look forward to creating a society of genuine homeowners within a realistic time span. Privatization would at one stroke create an asset that can serve as a hedge against the effects of inflation for more than one-third of the population. What policy can be more genuinely equitable at so little cost? The government has nothing to lose by privatizing public housing. Land on which these massive estates sits has no alternative use; it is merely a matter of allowing the estates to realize their full market worth. Society, on the other hand, has much to gain from acquiring such vast amounts of wealth.

Macleod's maiden budget has focused attention on the sandwich class. The issue of tax allowances and tax brackets are important issues in their own right and should not be debated on the grounds of providing tax relief for the middle class. The real issue is to index tax allowances and tax brackets to inflation and income growth. This would help preserve the essential features of Hong Kong's successful budgetary policy in an age of political change.

The large-scale privatization of public housing with unrestricted transfer rights provides the best long-term solution for society as a whole, and the people in the sandwich class in particular, who would like to have their own home but do not wish to pay more taxes. A society of homeowners contributes enormously to social stability. Unlike public housing tenants who lobby incessantly for transfers in their favor by robbing others in the name of social justice, homeowners have a stake in defending and striving to strengthen the integrity of private property rights. This privitization would also help shape future debates on the budget in a healthy direction.

This is the second half of a two-part commentary. The first half appeared in the previous issue of the HKCER Letters.

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