The 2002/03 Budget: A Critical Review

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Introduction

In 2000, the then Financial Secretary, Mr Donald Tsang, set up a Task Force to review Hong Kong’s public finances. The Task Force completed the study early this year and released a report in February. Their findings are alarming. They estimated a fiscal deficit of HK$65.6 billion — that is, 5.2 per cent of GDP — for 2001/02, and that the fiscal reserves would be depleted by 2008/09 if the prevailing revenue and expenditure policies were to continue. They concluded that the Government of the Hong Kong Special Administrative Region (HKSAR) was facing a fundamental structural deficit problem. This conclusion has some credibility. It was made after the negative (cyclical) impacts on public finances of the existing economic downturn had been accounted for. Nevertheless, it is important to make clear that one should not take their quantitative projection too seriously. Projection is, by definition, inexact and inevitably involves (big) assumptions.

The (structural) deficit problem clearly needs to be addressed. In his 2002/03 Budget Speech, the current Financial Secretary, Mr Antony Leung, in his maiden Budget, announced that the depletion of the fiscal reserves was unacceptable. He outlined a plan to restore fiscal balance and set three specific targets for public finances in 2006/07:

- Restore balance in the Consolidation Account
- Attain a balanced Operating Account
- Reduce public expenditure to 20 per cent of GDP or below

These three targets were set after a number of factors had been considered: 1) the guiding principle of prudent management of public finances, which is indeed stipulated by Article 107 of the Basic Law of the HKSAR; 2) the current state of the economy; and 3) a reasonable economic forecast over the medium term. It is hard to imagine that one would dispute these targets. However, making the objectives right is only the first, and perhaps a small, step in formulating a desirable policy. It calls for a review...
of the measures, however preliminary, raised by the 2002/03 Budget.

Review of Measures

The measures in the Budget were devised either to control public expenditure or to increase revenue. To accomplish all the three targets set by the Budget, controlling expenditure is more important than raising revenue. The latter one, per sec, has no bite in the third target: reducing the share of public expenditure in the economy, which can only be done by keeping the growth of public expenditure below economic growth.

In 2001/02, the share of public expenditure in the economy was 22 per cent. It was significantly higher than the average in the past two decades, which was about 17 per cent in the mid-1990s and around 16 per cent in the mid-1980s. The Budget attributed the recent jump to two facts. First, the Government, facing economic downturn, has adopted a counter-cyclical fiscal policy since 1998 to consciously keep the growth of government expenditure above the growth of the economy. Second, rigidity in the prices of public expenditure has made it continue to rise despite deflation in the economy.

To illustrate the second fact, the Budget cited the following figure: From 1989/99 to 2001/02, government expenditure recorded a cumulative growth of 17 per cent in money terms, while GDP registered a cumulative fall of 5 per cent. Interestingly, the Budget, in the same paragraph, also made available another statistic: Over the past decade, the government expenditure price level has risen by 72 per cent, but the general price level has only risen by 29 per cent. What this statistic shows is that the prices of public expenditure, ceteris paribus, are sufficient to drive up the share of public expenditure, regardless of whether there is a counter-cyclical policy and/or inflation in the economy. This implies that the two facts in the preceding paragraph play only a marginal role in explaining the increasing share of public expenditure, revealing that the analysis in the Budget is incomplete.

Pay Cut

The most significant measure in the Budget, an expenditure-controlling measure, is an assumed 4.75 per cent pay cut in the civil service and the subventions. According to the Budget, personnel-related expenses accounted for 70 per cent of government operating expenditure. The assumed pay cut would save the Government HK$3 billion in 2002/03 if it took effect from 1 October this year. The Budget emphasised that the 4.75 per cent pay cut was a hypothetical number and the Government would decide the final pay adjustment based on the existing policy and system. Our analysis shows that the increasing share of public expenditure is a fundamental problem which cannot be solved by maintaining the status quo. Hence, the proposed pay cut is at best an ad hoc measure. To effectively contain the share of public expenditure, the Government should overhaul the existing civil service pay policy and system.

In fact, the Government started to review the existing civil service pay policy and system in January of this year and has just completed Phase One of the review. While it is too early to make specific comments on the review, one general piece of advice can be offered. There are numerous non-cash allowances in the civil service. However, employees generally prefer cash to an equivalent amount of non-cash allowances, even though they cost the same to the employer. By converting all the non-cash allowances to cash at a discount,
the Government can cut personnel-related expenses without compromising the well-being of civil servants. In addition, the Government can also save the resources from administering the associated tedious procedures. The point is that controlling personnel-related expenses does not have to be win-lose. It can be win-win if done wisely.

**Other Expenditure-Controlling Measures**

The Budget stated that growth of the civil service would be contained, and the target to reduce the establishment to around 181,000 would be achieved in 2002/03. It is believed that there is still room to further trim the establishment. *A new target should be set to further reduce the establishment in the future, especially when the unemployment problem lessens.*

The Budget also vaguely mentioned that the Government would make use of market forces and strengthen the co-operation with the private sector. Along this direction, the most effective measure is privatisation. *The Government should start to work out a plan for privatising some of its services.* We now turn to the revenue proposal raised by the Budget.

**Revenue Proposal**

The Budget proposed to: 1) raise the duty rate on wine from 60 per cent to 80 per cent; 2) cut by 40 per cent and 25 per cent respectively the quantities of duty-free tobacco and still wine that Hong Kong residents may bring back; and 3) introduce a Boundary Facilities Improvement Tax of HK$18. These are concrete, but minor, changes. On the whole, the revenue proposal is quite sketchy. For the two most important, but controversial items, the *Goods and Services Tax* and *Soccer Betting Duty*, the Budget merely indicated that the Government would keep considering them as options.

**Goods and Services Tax**

Technically speaking, the Goods and Services Tax was recommended by the Advisory Committee on New Broad-based Taxes. The Committee was established by the then Financial Secretary at the same time the Task Force (the one mentioned in the Introduction) was set up. It is common knowledge that a Goods and Services Tax has the broadest tax base among all existing taxes in operation in the world. The Government first appointed the Committee to investigate new types of broad-based taxes for introduction in Hong Kong. The Committee, after hiring a team of consultants and consulting the public, then recommended a Goods and Services Tax to the Government as the leading candidate to broaden the tax base of Hong Kong. It is hard to come up with a better example to illustrate that the Government is inefficient.

It is unclear whether a system with a broader tax base is a better taxation system. One known problem of a broad-based taxation system is that it provides convenient sources of finance to a government, making the government have less incentive to control public expenditure. Ironically, the opposite of it is needed to achieve the three targets, especially the third one, set in the Budget. *A Goods and Services Tax should not be introduced in Hong Kong.*

**Soccer Betting Duty**

There has been a relatively long debate on legalising soccer betting in Hong Kong. Views were mixed until the deficit problem was publicised, which has steered people toward supporting legalisation. First of all, this controversy has to
be resolved by practical considerations. Betting, probably, can never be ethically correct. The question is whether soccer betting is morally acceptable or not. Gambling on horse racing has been legal in Hong Kong for a long time. The Jockey Club of Hong Kong, the monopoly of legal betting, is known as one of the biggest charity donors in Hong Kong. It is believed that soccer betting will be managed to play a similar role if legalised.

*Ipsos factot* soccer betting is much more globalised than gambling on horses. Stopping illegal soccer betting effectively is already a daunting task, and the Internet makes it virtually impossible. *Soccer betting should be legalised.* In terms of generating revenue, soccer betting is not expected to be as effective as gambling on horses. Unlike gambling on horses, soccer betting needs to face fierce international competition, which also prevents a duty rate from being set too high, while a low duty rate may steal punters away from horse racing. The duty rate should be set to balance these two effects.

**Other Recommendations**

A review of the Budgets of the past few years shows that there were significant reductions in salaries tax and profits tax in 1997/98 and 1998/99. These reductions were made when the Government was in great “fiscal shape” and should be reversed when it deteriorates. *The personal allowances should be lowered and the profits tax rate should be raised from 16 per cent to 16.5 per cent.\(^4\)*

**Concessions**

To show concern over the current community’s hardship, the Budget provided a number of one-off concessions: 1) reduce rates payments; 2) reduce water and sewage charges and trade effluent surcharges; 3) waive business registration fees; 4) extend duty concessions for ultra-low sulphur diesel; and 5) freeze government fees and charges. These concessions were made under political considerations and are believed to have few economic consequences.

**Conclusion**

The three targets set by the Budget are commendable. To achieve all of them, controlling public expenditure is more important than raising revenue. Recommendations made in this article are summarised below:

**Controlling Expenditure**

- Overhaul the existing civil service pay policy and system
- Convert all non-cash allowances to cash at a discount
- Set a new target to further reduce the civil service establishment
- Work out a plan to privatise some of the services provided by the Government

**Raising Revenue**

1. Legalise soccer betting
   - Consider international competition and the impact on gambling on horses when setting the duty rate
2. Lower personal allowances
3. Raise the profits tax rate to 16.5 per cent
4. *Do not* introduce a Goods and Services Tax

When preparing this article, I came across the
consultancy report prepared for the Advisory Committee on New Broad-based Taxes. The report reviewed the tax systems of other countries extensively and compared them to the Hong Kong system comprehensively. The report is very informative.\(^5\) However, good policy formulation requires much more than fact finding. Vigorous analysis of the problem is most crucial, but the current practice is sorely lacking.

**References**

Advisory Committee on New Broad-based Taxes (2002), *Final Report to the Financial Secretary*.


Financial Secretary (2002), *The 2002-03 Budget*.

KPMG Australia (2001), *Tax Base Study for the Hong Kong Government Advisory Committee on New Broad-based Taxes*.


**Endnotes**

1. These subventions include all universities in Hong Kong.

2. There are altogether two phases.

3. The unemployment rate in Hong Kong increased from 3.3 per cent in the first quarter of 1998 to 7 per cent in the first quarter of 2002.


5. The consultancy report on the review of the civil service pay policy and system falls into the same genre.  

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