The Incredible 2003/04 Budget

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Introduction

The Hong Kong fiscal deficit was, at the time of the Hong Kong Budget, estimated to reach the unprecedented level of HK$70 billion for 2002/03, equivalent to 5.5 per cent of GDP, a level significantly higher than that of the United States and the European Union. Though the US fiscal deficit is anticipated to be enormous, it is not expected to exceed 3 per cent of GDP, while the EU requires its member states to keep their fiscal deficits below 3 per cent of GDP. Indeed, 2002/03 is already the second fiscal year in a row in which the Hong Kong deficit has reached such a high level, having been HK$63 billion in 2001/02. These two huge consecutive deficits indicate the severity of the problem.

Antony Leung, the Financial Secretary, alas, failed to anticipate the problem a year ago and did not adopt appropriate measures to prevent it from worsening. In the 2002/03 Budget, his maiden budget, he did not propose any concrete measures to raise revenue. Nor did he propose any thoughtful measures to control expenditure. For instance, he proposed a 4.75 per cent pay cut in the civil service and the subventions, but the actual cut turned out to be substantially lower. Nonetheless, it should be pointed out that he did set the following three 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

We agree with these targets. But setting the right targets is only a first, and a very small, step towards solving the budgetary problem. Mr Leung did not start to address the problem until it had become acute. He began, in the 2003/04 Budget, to outline his plan of achieving the three targets by 2006/07. In this article, we review his plan and argue that it is not a credible proposal.

A Metaphor

A certain company experienced a change in management five years ago. The company had an excellent track record under the old management, but the performance of the company has declined over the past five years under the new management.
The loss for the last financial year was HK$63 million and has risen to HK$70 million for the current financial year. It is the worst of times for this company.

The company has a dispersed ownership structure; that is, no single shareholder has a say in management. When reporting the HK$70 million loss at the annual shareholder meeting, the CFO of the new management team blamed the old management for the decline in performance because of the high operating costs left behind by them. This accusation pays no heed to the fact that the old management left five years ago. The CFO reported that the new management has now successfully helped the shareholders bring the operating costs down to a reasonable level. He claims that it is the best of times for the company. But it is ludicrous that a CFO does not use the bottom line to measure the performance of the company. What was the problem with the old management if they could deliver an excellent performance, measured by the bottom line, at high operating costs? Why would the shareholders care about low operating costs if the company continues to suffer huge losses?

According to the CFO, the HK$63 million and HK$70 million losses are a serious problem because persistent losses will increase the company’s costs of raising capital. This CFO commits the same mistake twice by focusing again on costs rather than the bottom line. He tells the shareholders that he has a plan to balance the books in four years. First, he projects that revenue per annum will be increased by HK$30 million in the fourth year as a result of natural economic recovery. He further proposes measures to cut costs gradually and expects that costs per annum will be reduced by HK$20 million in the fourth year. Lastly, the remaining HK$20 million gap will be filled by some revenue-raising measures, but the measures he proposes are only expected to raise revenue per annum by HK$14 million in the fourth year.

This plan has two faults. First, there is a HK$6 million gap in his revenue proposal. The gap is acknowledged, but not addressed, by the CFO. Second, and more important, his whole plan relies critically on the HK$30 million revenue from natural economic recovery, which is completely out of his control. Due to this substantial uncertainty, it is unthinkable that the shareholders will be convinced that the CFO’s plan will work. Had the ownership structure been less dispersed, the shareholders would have replaced the CFO and possibly the new management.

**The Three-Pronged Approach**

The CFO’s strategy to balance the books is the same as that adopted by Mr Leung and is termed a three-pronged approach. In the context of the 2003/04 Budget, the three-pronged approach to solving the HK$70 billion deficit problem consists of natural recovery, cutting expenditure, and raising revenue.

**Economic Recovery**

Mr Leung forecast that economic recovery in Hong Kong will increase government revenue by HK$30 billion in 2006/07. This forecast is based on the following assumptions:

Over the period 2003/07, there will be

- a 3 per cent growth in real GDP per annum
- a 0 per cent inflation rate per annum
- a 3 per cent growth in nominal GDP per annum
We believe that these assumptions are too optimistic. First, according to his own forecast, in 2003, real GDP will grow at 3 per cent, deflation at 2 per cent (measured by the GDP deflator), and nominal GDP at 1 per cent. There is a significant gap between the 2 per cent deflation in 2003 and 0 per cent inflation over the period 2003 to 2007. Indeed, deflation has become a threat to the global economy. We do not see how Hong Kong, as a small and open economy, can be immune to the global deflationary threat. Consequently, the underestimation of deflation overestimates growth in nominal GDP, which is more important than growth in real GDP for bringing up revenue. Hence, the underestimation of the deflation over 2003 to 2007 overestimates the additional HK$30 billion revenue in 2006/07.

Second, his forecasts were made before the outbreak of Severe Acute Respiratory Syndrome (SARS) in Hong Kong and other parts of the world, and the war in Iraq. The outbreak of SARS has had a “severe acute” impact on domestic consumption and tourism in Hong Kong. In 2002, real GDP grew at 2.3 per cent, deflation grew at 2.7 per cent (in terms of the GDP deflator), and nominal GDP fell by 0.6 per cent. It is unlikely that 2003 will be a better year than 2002. Mr Leung should revise his 2003 forecasts downward to reflect reality. In addition, the Government is offering relief measures amounting to HK$11.7 billion to the society at large and the hardest-hit industries. It is almost certain that the outbreak of SARS will push the deficit for 2003/04, originally forecast at HK$67.9 billion, to another record high.

The war in Iraq will have a negative medium-term impact on the global economic recovery. The US “unilateral” action of by-passing the UN has disturbed the global political relationship, which is not conducive to a global economic recovery. The war in Iraq has ended sooner than expected. Conventional wisdom sees this as good for the US economy. We are more conservative, however, since the end of the war exposes the uncertainties the US has to face in trying to reorient the Middle East. As the US has the largest economy in the world, a US economic recovery will certainly affect the global economic recovery, and more significantly the economic recovery in Hong Kong (the US being the largest export market of Hong Kong). Mr Leung’s 2003 to 2007 medium-term forecasts are clearly too optimistic from this perspective.

We believe that the medium-term economic recovery in Hong Kong will be slower than what Mr Leung has assumed and, hence, will increase revenue by substantially less than HK$30 billion in 2006/07.

**Expenditure Cuts**

While we are not convinced that the first prong will work, we believe that the second and third prongs are in the right direction. The second prong involves reducing the establishment, cutting the salary of civil servants, improving the pay adjustment mechanism, and adjusting social security payments downward.

In his 2003 Policy Address, the Chief Executive, Tung Chee Hwa, set a new target of reducing the establishment of the civil service to 160,000 posts by 2006/07. (We proposed cutting the establishment a year ago (Ching 2002).) According to Mr Leung, this target is to be achieved via a voluntary retirement scheme. We do not think, though, that a voluntary retirement scheme can effectively achieve the target. *Ipso facto*, this is the second-round voluntary
retirement scheme, which is less generous than the first-round scheme, and the job market now is much worse than before. In our opinion, Mr Leung should convince Mr Tung to retract his promise of not laying-off civil servants. Otherwise, Mr Leung will not have the leverage to meet Mr Tung’s target. Our analysis will show that Mr Leung will need to cut the establishment further in order to achieve his three targets for public finance by 2006/07.

Civil servants’ salary will be cut to the level in cash terms as at 30 June 1997 in two phases. The pay adjustment mechanism will also be reviewed. We doubt the usefulness of reviewing the pay adjustment mechanism alone since there is no room to cut the salary of civil servants further as it is protected by Article 100 of the Basic Law. We propose taking the pay adjustment review further by overhauling the existing civil service pay policy and system. Our specific recommendation is to convert all non-cash benefits to cash at a discount. The advantage is that it will cut personnel-related expenses and save resources from administering the associated tedious procedures, without compromising the well-being of civil servants (Ching 2002).

Social welfare payments will be adjusted downward to restore their original intended purchasing power. The adjustment is based on the movements of the Social Security Assistance Index of Prices. This adjustment is commendable since social welfare payments should not be used to distort incentives to seek jobs.

Mr Leung also mentioned the “3R1M” approach as a general measure of controlling expenditure. The 3R1M approach refers to Reprioritising the provision of services, Reorganising the structure of government departments, Reengineering procedures, and Making full use of the market. The 3R1M approach certainly sounds more sophisticated than the “1P” approach (i.e. Privatisation) we proposed two years ago (Ching 2001). However, we believe that the 3R1M approach will not be as effective as the 1P approach at addressing the fundamental inefficiency of bureaucracy.

Revenue Proposal

Salaries tax, profits tax, property tax, motor vehicles first registration tax, air passenger departure tax, and betting duty will all be increased under the revenue proposal. The proposal also introduces two new taxes: soccer betting duty and boundary facilities improvement tax. Mr Leung acknowledges that this proposal is estimated to generate an additional revenue of HK$14 billion, but he has yet to come up with other measures to bring in the remaining HK$6 billion.

In essence, the salaries tax will be reverted to the 1997/98 level. This is very close to the recommendation we made two years ago (Ching 2001): to revert the salaries tax to the 1996/97 level. Furthermore, Mr Leung proposes increasing the standard rate from 15 per cent to 16 per cent, while we recommended no change to the standard rate. We think that Mr Leung’s proposal of increasing the standard rate is unjustified. According to his forecast, the salaries tax proposal will generate an additional HK$6.8 billion in revenue, while the profits tax proposal will generate an additional HK$3.5 billion in revenue.

We do not see how Mr Leung can justify an increased tax burden on salaries taxpayers, which is double that of profits taxpayers. According to him, the main problem of the fiscal deficit is
that it may lead to an outflow of capital, thus pushing up interest rates. A higher interest rate has, at worst, a neutral impact on salaries taxpayers since they have interest-bearing assets as well as interest-paying liabilities. Their overall net asset position is generally positive. However, a higher interest rate will have an adverse impact on profits taxpayers since it increases their costs of doing business. Why should salaries taxpayers take on a bigger responsibility than profits taxpayers for solving a problem that affects profits taxpayers? In our opinion, the unjustified 16 per cent standard rate should be brought back to 15 per cent. Similarly, the profits tax rate for unincorporated businesses and the property tax rate should be kept at 15 per cent.

It should be made clear that we are not arguing for a profits tax rate higher than the one proposed by Mr Leung. He proposes to increase the profits tax rate from 16 per cent to 17.5 per cent. Two years ago, we recommended that the profits tax rate be reverted from 16 per cent to the 1996/97 level of 16.5 per cent. Our position is that Hong Kong should preserve its simple tax regime with low tax rates. We certainly do not want to see the profits tax rate exceed 17.5 per cent. The implication is that Mr Leung has limited room to raise revenue via higher tax rates.

Mr Leung also proposes increasing the motor vehicle first registration tax. In principle, we object to having a motor vehicle first registration tax. A motor vehicle first registration tax is a tax on ownership. An ownership tax, per se, is not justified. Otherwise, what prevents the Government from taxing owners of luxurious watches, jewellery, and other pricey assets? The fundamental reason that motor vehicles are taxed, but not watches and jewellery, is that motor vehicles can cause traffic congestion, which imposes a negative externality on other road users. Taxing ownership is an indirect, and hence ineffective, measure to address this negative externality problem. The direct solution to the problem is electronic road pricing. It should be pointed out that privacy is no longer an issue with current technology. We believe that an innovative and creative government should embrace the latest technology of electronic road pricing to solve the traffic congestion problem, not to mention that it helps the Government raise revenue.

Mr Leung also introduced a soccer betting duty. This is the same as the recommendation we proposed a year ago (Ching 2002). Mr Leung estimates that the soccer betting duty will increase government revenue by HK$1.5 billion. Another new tax proposed by Mr Leung is a boundary facilities improvement tax. The problem with this tax is that it contradicts the general government policy of promoting integration of Hong Kong with the Pearl River Delta Area.

We commend that the Government is committed to not introducing a Goods and Services Tax in the near future, but we are not convinced that it is necessary to introduce such a tax in the long term either. The reason for this is that the benefits of a Goods and Services Tax could easily be outweighed by the costs. For instance, one oft-mentioned benefit of a Goods and Services Tax is that it is broad based, providing a stable source of revenue to the Government. However, it is not only a stable, but also a convenient source of government revenue. The availability of easy money undermines the Government’s discipline in controlling expenditure. Higher expenditure is financed by higher taxes. A vicious circle can easily develop. This explains why a Goods and
Services Tax is addictive. The consequence is that we probably will end up with a big government and a small market, contrary to the “big market, small government” principle laid down by Mr Leung.

Gary Becker made a comment about keeping the currency board, a fixed exchange rate system, in Hong Kong at the end of last year. His general comment was that a flexible exchange rate is better if you trust the government; but if you don’t, a fixed rate is superior. He then went on to say that Hong Kong should keep the currency board unchanged. We extend Becker’s comment to a Goods and Services Tax. A Goods and Services Tax should be introduced if you trust the government; but shouldn’t if you don’t. We think that a Goods and Services Tax should not be introduced in Hong Kong unless the Government can credibly commit to not abusing such a tax. It is necessary for the Government to demonstrate that it can make such a credible commitment first.

**Conclusion**

Our analysis shows that Mr Leung’s 2003/04 Budget is an incredible proposal. We are not convinced that he can achieve the three targets for public finance in 2006/07. First, he is too optimistic about the medium-term economic recovery — he especially underestimates inflation and, consequently, the additional HK$30 billion revenue in 2006/07 from the economic recovery is overestimated.

Second, his current revenue proposal is estimated to generate an additional HK$14 billion revenue in 2006/07, but he admits that the additional revenue he needs in 2006/07 is HK$20 billion. More important, we find it unjustified to ask salaries taxpayers to shoulder a higher burden than profits taxpayers for a problem primarily affecting the profits taxpayers. As a result, the standard rate should be kept at 15 per cent. However, we are not arguing for a profits tax rate higher than 17.5 per cent as proposed by Mr Leung. Our point is that he will have a difficult time raising the additional HK$20 billion revenue in 2006/07.

The preceding analysis shows that the only way Mr Leung can balance the books is to cut expenditure by substantially more than HK$20 billion. However, he has too many constraints to cutting expenditure. He has already planned to push the civil service pay to the cash level as at 30 June 1997, which is the limit allowed by the Basic Law. He has no choice but to cut the establishment of the civil service to below 160,000 posts. However, he does not yet have the leverage due to Mr Tung’s “no lay-off” promise. In our opinion, he should convince Mr Tung to retract this promise. Otherwise, we do not see how he can achieve the three fiscal targets by 2006/07.

**References**


Financial Secretary (2002), The 2002/03 Budget.

——— (2003), The 2003/04 Budget.
Endnotes

1. The 2002/03 deficit was revised to HK$61.7 billion at the end of April, but it has no material impact on our original argument.

2. This article will not discuss Mr Leung’s (lack of) integrity in not declaring the purchase of a Lexus LS430 prior to announcing the higher motor vehicle first registration tax.

3. The comment was made during a public lecture held at The University of Hong Kong on 20 December 2002.