

Reserves, Fiscal Balance, Fiscal Policy, and Housing Policy

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The Basic Law of Hong Kong stipulates clearly that the HK SAR Government should balance its budget. I am totally in agreement with this stipulation, although I take issue with the recommendation, also made in the Basic Law, to “spend within one’s means” for governments (*liangru weichu*). Balancing the budget is important because that is what is expected of governments, and because it is consistent with stable financial markets and with economic stability.

It is obvious, however, that balanced budgets should not be maintained year in year out. It is well known that economies swing from good times to bad and from bad times to good. During bad times government revenues fall. So it is to be expected that deficits will arise. To try to maintain a balanced budget during hard times is to make already hard times even harder. Deficits during bad years are not unhealthy and will not cause problems. Indeed they make life easier for everybody. Since they will disappear when the economy recovers and will be made up for when the economy is booming, *there is really no need to find stable sources of revenue*. Stable sources of revenue cannot ease the pain during bad times.

So the famed economist Abba Lerner had argued for balancing the budget over the cycle. This is well said. But there is not sufficient understanding among the public as to what this really means. To me, this does not mean that the government should thoughtlessly increase spending during bad times. I cannot agree to Keynes’ suggestion that it makes sense when there is high unemployment to hire people to dig up holes and fill them back. Increasing government spending during bad times would increase the government budget deficit beyond what the economic cycle would result in. This will lead to problems down the road. Having said this, I would nonetheless agree to increasing government spending if this is for a worthwhile purpose (such as a social investment with a good rate of return). The problem is that it is unlikely that opportunities for worthwhile investment will appear just at the time when the economy is in decline. It is more likely that any increase in spending during “bad times” is made simply to pacify different the demands of various interest groups according to their political clouts.

I wrote that I do not support the “spending within one’s means” principle for the government, because the government’s revenues should not be taken as given. If there is a good case for public spending to increase, such as an investment project that will bring good social returns, then it makes sense to spend more and to increase taxes. Provided that it is a really profitable investment, the combination of higher taxes and the investment will not hurt Hong Kong’s competitiveness. On the other hand, raising taxes per se will hurt Hong Kong’s competitiveness, and will dampen Hong Kong’s land prices.

I want to address one more subject. This is the optimal size of government. This question, I hate to say, is largely “academic” in the sense that it is not meaningful. What use is having the government at the “optimal size” if the government itself is lousy or if the mix of the spending areas are all wrong? The relevant question is whether each spending area is optimally sized. If each spending area is expanded to the optimal level, then the size of government is not only optimal, but its structure is also optimal. So again we need to ask the benefit versus cost question. Should we marginally increase the health budget, the housing budget, the security budget, the public works budget, etc. If the marginal benefit exceeds the marginal cost, let us expand it. If the marginal benefit falls short of the marginal cost, let us shrink it. If we find it worthwhile to expand spending, we need to increase taxes.

So I am all for a stable fiscal policy that aims at balanced budget at full employment. This means that the revenue-expenditure structure would be such that, *provided full employment occurs*, the government will have budget balance. In a paper I published in the eighties I argued that once this has been done, it should be entirely up to the monetary authorities to revive confidence and boost private sector activity by easing monetary policy when there is impending recession. If the recession is avoided, any deficit will disappear.

What all this means is that it is all right to draw down our reserves to finance truly worthwhile projects, but it is not all right to draw down reserves simply to put money in peoples’ pockets. There is little doubt that cutting back the spending later on will prove difficult.

In my view, maintaining an operational budget balance at full employment is basic to fiscal prudence. This means we should tolerate cyclical budget deficits but not structural deficits. Cyclical budget deficits disappear when the economy gets back to normal trend growth. Structural deficits will not go away even when the

economy runs in full steam.

Are the prevailing budget deficits structural? I strongly suspect so. Indeed I am worried that things will get worse over time. This is because the structure of our housing market has been utterly changed after 1997. Land-based revenues, which have been so important to Hong Kong traditionally, have suddenly plummeted because of the government's policies. Short of a credible fix in such policies, the revenue problems will not go away.

The government must not increase taxes. That would hurt HK's competitiveness and will hurt HK's property market more, further depressing the economy.

The government could cut spending. But this is politically very difficult to do. Already people have suffered so much from cutbacks. People already feel exploited for having to work much harder for less pay.

The government should really change its housing policy. In particular, the government must stop its policy to sell public rental housing to tenants or to anyone in the queue. As I have been explaining since early 1998, that policy had destroyed the incentives of public housing tenants to buy HOS housing. HOS owners, failing to sell their units to rich public housing tenants, cannot trade up. The entire housing market hurt badly. I truly believe that the deep recession in 1998 and the lackluster recovery in 1999 are due to this major change in public housing policy.

It may be a little late now. But, better late than never. Eventually, public housing tenants will feel the pressure of the Housing Subsidy Policy (this is the policy that makes rich tenants pay more) and will seek to buy HOS or in the private sector. That will revitalize the property market and will revitalize HK's land-based revenues. HK will then begin to see better times. I attach below the historical economic growth rates of Hong Kong to show that the economic performance after 1997 is really not typical of Hong Kong. Italicized figures show how strongly Hong Kong's economy rebounds after an economic slowdown. We should seriously ask ourselves what is wrong with Hong Kong after 1997 and address the fundamental questions. Before we do so, I am afraid Hong Kong's fiscal woes will be with us for a long time.

Hong Kong's Economic Growth 1962-2000(GDP % change)

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|-------------|-------------|-------------|-------------|-------------|-------------|-------------|------|
| 1961 | n.a. | 1971 | <i>7.1</i> | 1981 | 9.2 | 1991 | 5.1 |
| 1962 | 14.2 | 1972 | <i>10.3</i> | 1982 | 2.7 | 1992 | 6.3 |
| 1963 | 15.7 | 1973 | <i>12.4</i> | 1983 | 5.7 | 1993 | 6.1 |
| 1964 | 8.6 | 1974 | 2.3 | 1984 | 10.0 | 1994 | 5.4 |
| 1965 | 14.5 | 1975 | 0.3 | 1985 | 0.4 | 1995 | 3.9 |
| 1966 | 1.7 | 1976 | <i>16.2</i> | 1986 | <i>10.8</i> | 1996 | 4.5 |
| 1967 | 1.7 | 1977 | <i>11.7</i> | 1987 | <i>13.0</i> | 1997 | 5.0 |
| 1968 | 3.3 | 1978 | 8.5 | 1988 | 8.0 | 1998 | -5.3 |
| 1969 | <i>11.3</i> | 1979 | 11.5 | 1989 | 2.6 | 1999 | 3.0 |
| 1970 | <i>9.2</i> | 1980 | 10.1 | 1990 | 3.4 | 2000 | 10.5 |

Source: Gross Domestic Product 1961-1999, and the Census and Statistics Department website. Year 2000 growth is a preliminary estimate.