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Editorial

The Right Approach to Dealing with the Deficit

The Budget announced on March 5 focused on narrowing the deficit. Facing up to the challenge of narrowing the deficit is correct. Unfortunately, the approach taken by the SAR Government will never succeed. We predict that the deficit will continue to grow, and that the economy will continue its slump.

The reason is obvious: the domestic economy has been the weak spot for years and there are no initiatives to deal with the source of all the difficulties. The analysis conducted by Lingnan's Centre for Public Policy Studies shows clearly that the housing market slump "caused" the slump in domestic consumption and domestic investment and not the other way round. Moreover, the housing market slump eroded the government's revenue base tremendously. It eroded not only the value of the government's most valuable asset, land, but also reduced revenues from profits tax, stamp duties, and even salaries taxes. The slump in domestic consumption and domestic investment directly caused the jump in unemployment and welfare payments. Indeed, the housing market slump caused such weakness in domestic demand that we have deflation that is more serious than about anywhere. Interestingly, we also found that the housing market slump caused the high real interest rates, and not the other way round.

Increasing taxes and reducing government expenditures will only hurt the domestic economy more. It must be noted that our external sector had been doing

great until quite recently. Given the US invasion of Iraq and the outbreak of SARS, even our external sector is now suffering. How can we be optimistic about the government closing the deficit by 2006/2007?

We have long argued, ever since the introduction of the Tenants Purchase Scheme, that the TPS would erode the incentives for public housing tenants to buy HOS housing and would undercut their "bid price" for HOS and other types of housing. We had advanced the theory that this broke the chain of "trading up" activity and had predicted a continual fall in housing prices and particularly second hand transactions. All these predictions have now been vindicated.

The government has now announced that TPS will be ended after the last phase of 50,000 units have been sold this year. This is much too late. On top of that the excessive housing supply, which was clearly a result of the government's policy to boost supply, is causing the housing market to continue to decline for years. There is no hope for the domestic economy to recover, given this scenario, and no hope for the government to balance its budget. There is no hope for the government to continue its funding to universities, health care, social welfare.

But this scenario must not be. The Lingnan Centre for Public Policy Studies held a press conference and advised that the government deal with the excess supply problem in a forthcoming fashion. The downward price adjustment will not eliminate the excess supply fast enough to protect us from the scenario of escalating bankruptcies, surging unemployment, and bankrupting of the government's fiscal position.

On the other hand, the government can act positively and effectively. Our worry is that the SAR government may not have the necessary understanding and political will to do what is necessary. Given government's virtual monopoly on land supply, the government will be well advised to set up a \$100 billion fund to snap up 60,000 to 70,000 units of flats worth \$2 million or below, and use the rental proceeds to pay for the interest. These units, together with the stock of unsold HOS housing units, can be rented out in the open market, with priority and rent concessions to public rental housing tenants. This way, the downward pressure for housing for the below 2 million dollar category will be eliminated. Indeed there will be a good possibility for housing prices of this category to rise. When prices rise, flat owners may

sell and with the proceeds from the sale trade up to better homes. This way the benefits of the government's purchases will diffuse throughout the entire housing market. Jobs will be generated, and government revenue will rise. Stamp duties from home sales and the stock market, profit tax from banks, lawyers, brokerage houses, and developers, even salaries taxes will rise. In a few years, given the controlled supply of developable land onto the market, we can expect these government-owned flats can be privatized with a handsome profit, again benefiting the fiscal balance.

There are talks in the community about the possible benefits of abandoning the linked exchange rate, as if this would help balance government's budget. This presumption cannot be correct, because a depreciation of the Hong Kong dollar will not eliminate the huge excess of supply of housing. A depreciation of the Hong Kong dollar may promote our exports and stimulate tourism, but currently our exports sector and tourism are doing just fine—discounting the short term effects from SARS. A depreciation of the Hong Kong dollar will not benefit the domestic economy if housing prices continue to slump and people have to pay much more for imports.

In public policy and economics, proper understanding is what it takes to make the right decisions. Without such correct understanding, good policy can only come with good luck. We have learnt painfully that we cannot depend on luck.