The Popular 2007–08 Budget

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Introduction

The 2007–08 Budget (henceforth "the Budget") is the last budget of the current term of the HKSAR Government (henceforth "the Government"). While the current term of the Government will end on 30 June 2007, the Budget's fiscal year will continue to 31 March next year; that is, three quarters of the span of the Budget will fall in the next term. This feature is not specific to the current-term Government. It is a general structure. The Government of any term is allowed to formulate a budget that covers the first nine months in office of the next-term Government. The current-term Government has the noble intention of leaving room for the next-term Government and refrains from making commitments for the next term. The unfortunate consequence is that the Budget is bound to be short-term.

The highlight of the Budget is a generous HK$20.3 billon package of tax relief and one-off tax rebate measures. The package has three one-off measures and over 70 per cent of the $20.3 billion is allocated to them as follows:

- $8.1 billion for rebating 50 per cent salaries tax (up to $15,000 a taxpayer)
- $5.2 billion for waiving two quarters of rates (up to $5,000 a quarter)
- $1.5 billion for giving one additional month of CSSA and SSA payments

On the other hand, the offer is modest relative to the higher-than-expected fiscal surplus. The Budget revises the surplus to $55.1 billion, which is almost 10 times the surplus estimated a year ago in the last budget. The fiscal reserves are revised to $365.8 billion, which corresponds to 18 months of government expenditure, up from 15 months of government expenditure estimated initially.[2]

Not surprisingly, the Budget has been well received by the society. For instance, 62.4 per cent of respondents were satisfied with the Budget, according to an instant survey conducted on 28 February 2007 by the HKU POP SITE.[3] In a follow-up survey conducted between 19 and 21 March, the satisfaction rate for the Budget remained high, at 62.1 per cent. Additionally, the popularity of Financial Secretary Henry Tang jumped on the announcement date of the Budget and remained high. His support ratings were 60.8, 64.1, and 65.6, respectively, between 1 and 6 February, on 28 February, and between 1 and 6 March.

Popularity, however, is not used here to evaluate the Budget, because a popular budget often sacrifices the long-term interests of the society. The Budget is examined in light of this proposition. This assessment shows that the Budget is not only myopic but also unfair. Alternative uses of the $20.3 billion are suggested to address these two problems. Our proposal also touches on two structural problems in Hong Kong: population aging and the narrow tax base. The evaluation is extended to other budgetary issues.

Tax Relief and One-Off Tax Rebate

In addition to the three one-off measures mentioned in the introduction, the $20.3 billion package has other (recurring) tax-relief measures. For example, three concessions for salaries tax are proposed. First, the marginal rates and marginal bands for salaries tax will be reverted to the 2002–03 levels. Second, child allowance will be increased from $40,000 to $50,000 for each child, and an additional one-off child allowance of $50,000 will be introduced for each child in the year of birth. Third, the maximum amount of deduction for self-education expenses will be increased from $40,000 to $60,000. These three concessions are estimated to cost the Government $4.9 billion a year.

There are two other recurring measures in the package, which are to (1) lower the stamp duty on property transactions with values between $1 million and $2 million from 0.75 per cent to a fixed amount of $100, and (2) halve the duty rate on beer, wine, and other types of liquor containing not more than 30 per cent of alcohol. These two measures will lower government revenue by $250 million and $350 million, respectively, a year.

Note that the total cost of these recurring measures is $5.5 billion, which is only one-tenth of the fiscal surplus and about one-third of the total cost of the three one-off measures. We support emphasising the use of one-off measures for tax relief.[4] The tax base in Hong Kong is narrow and relies heavily on profits tax and salaries tax. As a result, tax revenues in Hong Kong fluctuate widely with business cycles. Using one-off measures has the advantage of avoiding the unnecessary difficulties of raising taxes back during economic downturns. However, there are alternative one-off measures better than the ones proposed in the Budget.

The problem with the current one-off measures is that they are purely short-term. One might wonder whether this is a valid criticism. Isn't it true that all one-off measures are short-term? We argue that this is not necessarily the case. Specifically, we suggest that the Government make a one-off contribution of, say, $13.3 billion (the sum of the one-off tax and rates rebates) to individual MPF/ORSO accounts. The amount each individual receives can be a percentage of the employer contribution in 2006-07,[5] subject to a minimum as well as a maximum amount. This proposal corrects the short-sightedness of the Government. It allows the Government to provide leadership to address the anticipated population aging problem in Hong Kong and highlight the need of relying on private savings accounts to deal with the problem. The same idea can be used to address a related problem: medical financing. The Government can use a one-off contribution as a sweetener for the introduction of private medical savings accounts.

Another advantage of our proposal is that it benefits the entire working population. A criticism of the package in the Budget is that it is unfair to the lower working class who (1) don't pay salaries tax, (2) don't own their homes, and (3) don't rely on CSSA. They are completely neglected by the Budget. We agree that it is absurd for the Government to allow the CSSA recipients to enjoy, but not the lower working class to share, the fruits of economic prosperity, to which the latter group have contributed.

One feature of our proposal is that an individual will receive a positive net transfer from the Government if the individual does not pay salaries tax or pays a salaries tax less than the government contribution to the individual's MPF/ORSO account. This feature can be used as a package to lower the basic allowance. It can ease the resistance from new taxpayers if it is structured in such a way that the salaries taxes paid by new taxpayers are less than the government contribution to their MPF/ORSO accounts. The advantage is that the Government can widen the tax base in the long run.

One Additional Month of CSSA

The Budget has an atypical one-off measure of giving one additional month of CSSA and SSA payments. The total cost of the additional CSSA and SSA payments is about $1.5 billion, but a breakdown is not provided by the Budget. We use the figures in the latest annual report of the Social Welfare Department to estimate the breakdown.[6] The ratio of the annual total expenditure of the CSSA Scheme to the SSA Scheme increased continuously from 2.64 in 2000–01 to 3.36 in 2004–05. The average ratio over this five-year period was 3.02 and is used to estimate the cost of the additional month of CSSA payments. The cost is estimated to be more than $1.1 billion. This is a conservative estimate, because the total expenditure of the CSSA Scheme is rising relative to the SSA Scheme. Since $1.1 billion is not a small number, it is important to figure out what the Government can achieve with it.

Do the additional payments mean that the current level of CSSA payments is not sufficient to meet the basic and special needs of CSSA recipients? If yes, how can the problem be solved by giving only one more month of payments to them? If no, why does the Government reward CSSA recipients for economic prosperity that they do not seem to have contributed to? Of course, the Government has the authority to insist on sharing the fruits of economic prosperity with CSSA recipients. Our point is that CSSA recipients deserve more than one additional month of payments. They deserve an opportunity to regain their dignity by moving from welfare to self-reliance. We just do not see how giving them one more month of payments can help them achieve this.

To be fair, the Budget does have two more positive measures for helping CSSA recipients become more self-reliant: (1) introducing a one-year pilot Transport Support Scheme, and (2) relaxing disregarded earnings. The costs of (1) and (2) are $300 million and $30 million, respectively. In other words, the total cost of these two measures is only 30 per cent of the additional month of CSSA payments. One cannot help but ask why the Government allocates substantially more to a purely myopic measure than to these two more positive measures. It only shows that the Government really does not know how to help CSSA recipients. The provision of the additional month of CSSA payments is the most disappointing part of the Budget. The Government gives away money that could have been used to create opportunities for CSSA recipients to become self-reliant.

Film Development Fund

Another unusual measure of the Budget is the earmarking of $300 million for setting up a film development fund. Recall that the cost of the pilot Transport Support Scheme is also $300 million. It seems that $300 million is a magic number in the Budget. Indeed, exactly the same amount is earmarked for setting up a child development fund. Why does the film industry deserve the same financial support as CSSA recipients who struggle to be self-reliant or children from a disadvantaged background who need more development opportunities? No rationale has been provided by the Government for allocating the same amount to these three different initiatives. It is important for the Government to understand that resources allocation cannot be arbitrary.

More importantly, why does the Government subsidize the film industry but not other (creative) industries? The policy of "positive nonintervention" was renounced by the Chief Executive Donald Tsang in a statement at the Economic Submit on "China 11th Five-Year Plan" on 11 September 2006. Does this mean that the Government can pick a winner now? Is it a manifestation of the new regime of "market leads, government facilitates"? Now the Government can "facilitate" the development of a special interest group in the market if the group has "led" a successful lobby. We hope that this is not what the new regime stands for. The point is that the Government needs to articulate its policy clearly and implement it accordingly.

Fiscal Reserves

The discussion in the Budget reveals that the fiscal policy is arbitrary in setting the target level of fiscal reserves. In 2003, the target level was lowered to 12 months of government expenditure, in view of the then serious fiscal deficit problem. Now the fiscal reserves have already reached a level equivalent to 18 months of government expenditure and are projected to further increase to 24 months of government expenditure by 2011–12. One would expect the Government to adjust the fiscal reserves to the target level, if the target level is taken seriously.

However, the discussion initiated by the Government indicates that the opposite is true. The Government suggests using the IMF recommendation as a frame of reference for setting the target level of fiscal reserves, which is between 30 and 50 per cent of GDP. Note that the IMF recommendation sets the target level in terms of a percentage of GDP, which is different from the old basis (as a certain number of months of government expenditure). No explanation is offered by the Budget to justify the change. If one wants to compare the new basis with the old basis, it is handy to use the 2011–12 fiscal reserves, which are projected by the Budget to be 30.1 per cent of GDP and, at the same time, 24 months of government expenditure. Hence, the Government essentially proposes to at least double the target level to 24 months of government expenditure. Can the target level be meaningful if it can be adjusted arbitrarily downward (upward) when the Government experiences fiscal deficits (surpluses)? If the Government wants to initiate a meaningful discussion on the optimal target level of fiscal reserves, it has to take the target level seriously first.

The persistently low investment returns of the fiscal reserves are also an issue. In response to calls for higher returns from the fiscal reserves, the Government proposes a new income-sharing arrangement between the fiscal reserves and the Exchange Fund as follows: The return of the fiscal reserves is now computed as the average return of the Exchange Fund's investment portfolio over the past six years, subject to a minimum return of not less than the average yield of three-year Exchange Fund Notes for the previous year. Note that the change proposed by the Government is purely in accounting. It is naive for the Government to use the new income-sharing arrangement to increase the return of fiscal reserves. The effect of the new arrangement is to shift most of the fluctuations in investment returns to the balance of fiscal reserves at the Exchange Fund. The Government should understand that the return of fiscal reserves cannot be increased by any accounting changes to the income-sharing arrangement, as long as the Government keeps depositing the fiscal reserves in the Exchange Fund and the Exchange Fund fails to improve its investment performance.

Conclusion

This assessment of the Budget is consistent with the proposition that a popular budget often sacrifices the long-term interests of the society. This assessment also reveals that the Government fails to manage public finance prudently when the fiscal surplus is abundant. Money is not spent in a way that addresses the two structural problems (population aging and the narrow tax base) in Hong Kong. More seriously, the Government gives away some money that does not seem to be able to achieve anything. Last but not least, there is evidence indicating that the fiscal policy is becoming arbitrary.

Endnotes

1. I am grateful to an anonymous referee for helpful comments.

2. The 2006–07 fiscal surplus is further revised up to $58.6 billion by the Financial Services and the Treasury Bureau on April 30, 2007.

3. All the rating scores referred here are based on the surveys conducted by the HKU POP SITE (http://hkupop.hku.hk).

4. See also Stephen Ching, "Has the Budget Addressed the Deficit Problem?" *Asia-Pacific Journal of Taxation* **5(1)**, Spring 2001, 71–75.

5. Employees are not required to make contributions if their monthly income is less than $5,000.

6. Social Welfare Department Annual Report 2003 & 2004 (http://www.swd.gov.hk/doc/annreport/0304annrepe.pdf). T