

7 March 2002

2002/2003 BUDGET COMMENTARIES

Mr. Antony Leung delivered his first budget speech yesterday, showing us how he sees the issues we are facing and how he plans to deal with them. Most notably, his plan is to have the books balanced in 2006-07 without introducing any structural changes to our tax system.

Budget Strategy – Medium Term

The proposed strategy is simple: reduce civil service and subvention salaries by 4.75% in 2002-03; then, curb the growth of public spending at 1.5%, and hope that revenue will grow in line with the trend growth of our economy estimated at 3% per annum. This strategy will allow us to keep public spending below 20% of our GDP in five years time; however, it will entail the reduction of our fiscal reserve by almost 100 billion. Many may question if this move is practical. Our question is: can we do it faster?

The annual trend growth of 3% seems reasonable but cannot be taken for granted. Should there be any unfavourable developments that affect this projection, the reserve may further diminish to below the guideline level of 12-month government spending and revive the voice for a new tax. Accordingly, instead of controlling the growth rate of spending at 1.5%, the spending growth should be curbed at below one-half of the GDP growth to ensure the deficit gap will be eliminated.

The 100-billion reduction in reserve do not seem strictly necessary if we can speed up the cut in spending or introduce fine-tuning revenue raising measures earlier. We appreciate maintaining the current level of tax relieves to allow individuals to recover from the pains of economic adjustments; the public will likely approve reducing such relieves once the upturn of the economy is confirmed.

Further, the one-off reduction in civil service salaries by 4.75% is an important component of the strategy. We do not know if the pay survey mechanism will produce a similar outcome. As the labor market has obviously experienced a much greater adjustment, we will be surprised if the survey outcome is less than the proposed cut. Together with other cost cutting measures that we believe possible, there is room for a quicker pace of cost reduction and it is possible to preserve the reserve at a higher level.

Budget Strategy – 2002-03

The fiscal year of 2001-02 is expected to close with a deficit of over 65 billion and 2002-03, 45 billion.

At a time when the economy is in a state of transition to recovery, we agree an expansionary approach is appropriate. However, a deficit of 65 billion for the current year is in our view too high when the government should have had the opportunity of issuing debts in a low interest environment. Let bygones be bygones; we should now capitalize on other revenue opportunities that may help speed up the reduction of our deficit.

A deficit of 45 billion for the next year also seems a bit conservative; the firming economy should provide the upside for closing the books with a better result. We suggest the government should look for revenue opportunities that the reviving economy may offer.

The Economic Roles of Government

Mr. Leung highlighted a number of economic functions that the government should perform even though he clearly emphasized his belief in market economy. In essence, he believes that the government should only create institutions and foster an environment to facilitate the efficient operation of our market economy. However, he also recognizes the government's role in providing leadership for the development of certain strategic industries where the private sector cannot initiate effectively.

We applaud the vision that the government should take a more proactive role in promoting a better industry structure. The government will have to practice this role with great care, as there will be objections from various quarters for different reasons. Notably, governments are not usually regarded as good at business acumen and are therefore prone to bad investment decisions. Mr. Leung did not elaborate in his speech how the government was going to implement this role. One possible approach is for the government to devise relevant industry policies to encourage both local and overseas investors to explore the opportunities and avoid driving projects directly as a principal investor.

If this role of the government is well implemented, it can be the most creative and value creating part of the administration. We look forward to seeing firm commitments and actions on the part of the government in this respect.

Relieves totaling 6 billions

The budget proposed a number of temporary relieves including reduction in rates, waiving business registration fees, freezing government fees and charges, and some other concessions. The concessions will cost the government 6 billions in total, about the same as saving from the reduction of civil service salaries. Note however that the saving in salaries is structural whereas the costs of granting the concessions are

largely temporary in nature. The trade-off is a smart one: providing immediate relieves to “help the community to ride out of the storm” without adverse long-term effect on the revenue structure.

Boundary Facilities Improvement Tax

The government is contemplating the introduction of a Boundary Facilities Improvement Tax on passengers departing from the SAR through land crossing. The proposal may generate annual revenue of about 1 billion, which can help reduce our fiscal deficit in the coming years.

We believe the benefits that may arise from further economic integration with the Mainland should be more significant than the additional tax dollars the proposal may raise. However, we have no objection to the proposal provided that there is a corresponding adjustment to the train fare.

Many now consider that the existing fare has already contained a hidden tax on travellers to the border. The adjustment will avoid the perceived “double tax effect” and alleviate the burden of those who have to travel frequently to the Mainland.

In case the proposed fare adjustment cannot be effected, we hope this new tax will be eliminated when our fiscal pressure eases.

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