Some Views on the Hong Kong Economy

By Francis T. Lui

From 1997 till now, the Hong Kong economy has gone through a period of unprecedented volatility—something certainly not expected by its government. After the first attack on the Hong Kong dollar during the Asian financial crisis, the official forecast of real GDP growth rate for 1998 was still as high as 4%. The actual figure turned out to be a negative 5.5%! In 2000, the growth rate was a spectacular 10% but this did not last long. The following two and a half years of almost zero growth culminated in one of the most serious crises that Hong Kong had ever seen, manifested as a mass demonstration of half a million people on July 1, 2003. Yet Hong Kong never stops surprising people. The economy began to show clear signs of sustained recovery in the second half of that year, and economic growth rates for 2004 and 2005 were 8.6% and 7.3% respectively.

These ups and downs could be shown not only by GDP growth figures, but also by unemployment rates. From the 1980s to the mid 1990s, unemployment in Hong Kong typically fluctuated within a very narrow range around 2% to 3%. Yet it slowly climbed to a peak of 8.6% in the summer of 2003. Since then it has fallen to the current 5% level.

One could argue that the lackluster economic performance after the handover was simply due to bad luck. There was nothing wrong with what Hong Kong had been doing. The Asian financial crisis – an external factor – just screwed things up. This argument is problematic because the main effects of the crisis should already have been dissipated in the high growth year of 2000. The unusual volatility can be better understood by examining some deep and powerful economic forces underlying the Hong Kong society.

What is Hong Kong endowed with?

Despite the volatility discussed above, Hong Kong is arguably the richest economy in Asia. According to World Bank estimates, Hong Kong's Gross National Income (GNI) in 2004, measured in purchasing power parity, is US$31,510, surpassing Japan's US$30,040. Yet, except for its labor force, Hong Kong has almost no natural resources. So how has it been able to produce that much?

I have used simple economic theory and data from the 2001 official census to answer this question. According to my estimates, the labor force in Hong Kong contributes to 54% of the GDP, while providers of capital contribute 46%. I have also disaggregated the returns to labor into two components, namely, that for raw labor and human capital. Raw labor, as it turns out, contributes to roughly 14% and human capital 40% of the GDP. These figures are unusual for a well developed economy. As a comparison, in the United States the capital share is around 30%, with the remaining 70% due to human capital and raw labor.

These figures have several implications. First, capital plays a very important role. Hong Kong people save and invest a lot, and capital accumulation is relatively fast. I have estimated that the total value of productive capital assets in Hong Kong could amount to over US$ 1.3 trillion, around eight times its GDP, which is unusually high for a well developed economy.

The endowment in human capital stands in stark contrast to the abundance of capital. The median number of years of schooling for the adult population in Hong Kong, according to the World Bank, is only 11 years. In highly developed Western countries, the corresponding figures are around 15 to 16 years. Moreover, the 2001 census indicates that of the 5.6 million adult population, the education attainment (highest level completed) for approximately one million people is kindergarten or below, another one million completed primary school and 950,000 finished lower secondary school. Around 7% of the adult population can be classified as illiterate.

This low level is mainly due to two factors. First, there is a quota of 150 people per day for immigrants coming from the Chinese mainland, and their selection is controlled by the Chinese government. In the past, the vast majority came from rural areas and were not well educated. Only in recent years have the quotas been under-utilized, with the average education level slightly improved. Second, public expenditure on education in Hong Kong as a share of GDP has always been below the world average of around 5%. Before the handover, it was 2.8%. Now it has just surpassed 4%.

One can therefore see that Hong Kong's prosperity is to a large extent due to its high savings rate (around 32% of GDP) or fast capital accumulation. Contributions from human capital are more limited than in other advanced economies. Not that having a large endowment of capital is by itself bad. However, one has to note that capital is very mobile. It flows to places where larger profits can be made. An abundance of talent in an economy can raise the returns on investment and therefore attract more money. The other side of the coin is that once investors find that a shortage of human capital has made the place less productive, money goes away. I have estimated that in order to make the capital to human capital proportion more appropriate and hence the economy less fragile, it would be a good idea to increase the number of professionals from the current level of one million to around 1.7 million. This is not an easy task. It requires aggressive importation of talent from overseas and China, and much heavier investment in education and on-the-job training.

Since capital is mobile, the Hong Kong economy could remain volatile. Investor confidence during the Asian financial crisis, and also after 2000, appears to have suffered. In the latter period, local people often perceived that the government was not competent. There was also the lingering question of whether the investment environment of cities such as Shanghai would surpass that of Hong Kong. However, in the summer of 2003 the Chinese government extended the scope of Close Economic Partnership Agreement (CEPA) for Hong Kong and allowed more tourists to come. These new policies can be interpreted as signals indicating that the Chinese leadership has reached a significant conclusion – that the role of Hong Kong in the development of China's economy is not replaceable and must not be allowed to diminish. The direct and immediate effects of these policies are limited. For example, contrary to popular belief, total contributions of inbound tourists constituted only 2.2% of the GDP in 2004. The additional Chinese tourists have at most raised the economic growth rate by half a percentage point. However, the signals conveyed by these policies are important. They tell investors that the central government is serious about the Hong Kong economy and they should feel confident about investing there. Apparently, investor confidence improved and the economy bounced back.

Political economy and public spending

Another factor that has had far-reaching consequences for the Hong Kong economy is the changing size of its government, when defined as public spending as a percentage of GDP. In the 1980s, the size of government reached a low of around 14%. In the 1990s, it began to rise quickly. In fiscal 1994-95, it was 16%. Then it went to 17.5% in 1997-98, 21% in 1998-99, and peaked at 22% in 2003-04. Within less than two decades, the growth in public spending outpaced the growth in GDP by more than 50%. Although government size in Hong Kong is not big by international standards, we should note there is no military spending and no pay-as-you-go social security system as found in most Western countries. The rising trend is inconsistent with not only the received doctrine of small government in Hong Kong, but possibly with the Basic Law itself.

The immediate effects of the rapid rise in public spending were more frequent government budget deficits, which rarely occurred in the past. In the early 2000s, the deficit reached the dangerous level of 6% of GDP. The government named this phenomenon the "structural budget deficit" problem, meaning that the rise in revenues could hardly keep pace with spending increases. The main official explanation for these deficits is that land sales, which have always been an important source of government revenue, have become much less reliable because of falling real estate prices.

Upon closer scrutiny, however, we cannot blame the revenue side too much for the budget deficits. Revenue as a share of GDP in recent years has been much higher than in the 1980s. Moreover, even though revenues from land sales may have decreased, another source has become more important. Total foreign reserves of Hong Kong exceed the US$125 billion level. Average investment returns from these reserves have correspondingly increased, allowing the drop in land sales revenue to be offset. Although a small share of reserves and their returns are earmarked to back up the currency board system in Hong Kong, the Financial Secretary has the full legal right to utilize the remainder.

The real reason for the deficits must be rapid increases in public spending. However, the implications go far beyond balancing the government budget. Many economists believe that big government spending would necessarily lead to an inefficient allocation of resources because a person would typically be much more careless when spending money on behalf of others.

The problem is confounded by an unusual feature of the taxation system in Hong Kong. Sixty per cent of Hong Kong wage earners do not pay any salary tax, and fully 90% of all salary tax revenues are paid by only 100,000 taxpayers, i.e., 3% of the workforce. This skewed system may raise issues about equity, but is not the subject of interest here. The more important implication of this imbalance involves moral hazard behavior.

When (salary) tax payers constitute a minority of the population, a problem occurs. Constraint on government spending becomes very weak. When the government spends, the majority of people do not have to pay for it, and don't feel directly responsible for the payments. From their perspective, the more the government spends for them, the better off they are. After all, other people are paying on their behalf. Politicians can quickly grasp the opportunity. It would be a relatively risk-free endeavor to gain votes by pressuring the government to spend as much as possible. In good times, they can argue that the government has surplus money, which should be spent. In rainy days, people would need more help and there is urgency for the government to spend as well. Taxpayers, who are predominantly middle class, typically do not get any significant benefits. They also have no political representation in the Legislative Council of Hong Kong. I have estimated that the middle class constitutes slightly more than half of the population in Hong Kong and they contribute well over 50% of the GDP. Nevertheless, for a long time the main players in the political sphere, both in Hong Kong and in the Chinese mainland, did not even recognize their existence. Businessmen and the "grass-root class" were the only two groups whose interests supposedly had to be balanced. The 2003 mass demonstration was, however, predominantly a middle class event. After that, politicians began to "discover" the middle class.

The increasing size of the government also aggravates the problem of "rent-seeking." Politicians understand that the government has the resources to distribute "goodies" to various people. But these are not exactly free lunches. To get a larger share of the benefits, one must invest resources so that the efforts of lobbying the government can be more effective. Investment in such lobbying activities can be beneficial to oneself, but is not necessarily productive from society's point of view. People are just fighting to get a larger portion of the same pie. When these activities, called rent-seeking activities, have become prevalent, there would be efficiency losses. As long as the size of the government remains sufficiently small, politicians would find spending resources to lobby or pressure the government cost-ineffective. The latter does not have many goodies to give away, so why bother? However, as the size of government grows, such activities become more attractive. Since the 1990s, rent-seeking has intensified so much that it has become a hallmark of everyday life in Hong Kong.

The political system also plays a role here. Half the politicians in the Legislative Council are elected by popular voting. However, the government's Chief Executive is selected by a small group of people. Although the Basic Law provides the legal basis that makes the mandate of the Chief Executive legitimate, the lack of a democratic process for choosing the CE has weakened the rule of government. Different groups of rent-seekers tend to specialize in what they do best. Business elites, who constitute the most important component of the selection committee, have numerous direct channels for communicating their wishes to the government. "Grass-roots" people, on the other hand, have found it more effective to resort to frequent demonstrations and protests. Since it is not clear whether the government has a popular mandate, it could more easily yield to pressure. When resource allocations are overly affected by rent-seeking rather than by rational decisions, the economy could become more volatile.

The competitive edge

Despite the problems discussed above, it would be a mistake to be pessimistic about the future of the Hong Kong economy. One can easily come up with a long list of advantages for it. For example, the proximity to China makes Hong Kong the envy of Singapore. Total bank deposits exceed US$500 billion, making Hong Kong one of the world's five leading banking centers. By comparison, total deposits in China are only six times larger even though the population is 200 times greater. Hong Kong is also the world's number one air cargo center. The volume of cargo handled by its container terminals is the second largest in the world. The legal system is commonly perceived as the most credible in China, if not in Asia. Some organizations, such as the Heritage Foundation, routinely rank Hong Kong, which adopts the policy of free trade and free flow of capital, as the freest economy in the world.

Some of these advantages may not be long lasting. The decreasing costs of transportation and communication have made geographic location much less important. Other cities in China have invested heavily in building up their own competing container terminals. To move ahead successfully, Hong Kong has to identify its true core competency.

The government has identified four types of activities as its economic "pillars"; these are financial services, trade and logistics, professional services and tourism. These are not bad choices. It is well known that Hong Kong is one of the world's major financial centers. Total exports of goods and services amount to more than two times the GDP. Lawyers, accountants, educators, managers and other types of professionals have been exporting their services to China and other parts of the world for years. The tourist sector, though small, is increasing in importance. If we take a closer look at these "pillars," we can see that they share a common element, namely, being international. Hong Kong has such a long history of being the most open economy in the world that no Chinese city can rival it – not even Shanghai. The latter is constrained by the incomplete convertibility of the RMB and the incompatibility of the Chinese legal system with those in many parts of the world. The ability to serve as the economic and cultural link between the East and the West is, I believe, the true core competency of Hong Kong.

To achieve robust prosperity, Hong Kong needs to do several things. First, more talent should be attracted to Hong Kong and more money should be spent on education and training. If not done, many of Hong Kong's low-skill workers will have to compete directly with cheap labor in China. This would result in high unemployment rate and/or low wages. However, when a larger high-value-added sector, supported by a big talent pool, comes into place, the income it generates can increase the demand for locally consumed goods and services. This would in turn help reduce the high unemployment among the less educated. Second, it is important to enhance Hong Kong's role as a world city. Better training in foreign languages, upholding the common law tradition, welcoming talent from all over the world and developing international business connections are examples of things that should be done. Third, the taxation system should be rectified so that the burden is borne by a larger proportion of the population. Public spending as a share of GDP has dropped to 18.2% in fiscal 2005-06. The government should remain steadfast in its plan of lowering it to 16% by the year 2010-11. Reducing a fertile ground of rent-seeking could make political activity more constructive and reduce economic volatility. ■

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