Fixing Inequality in Hong Kong

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Tackling Inequality in the 21st Century

Economic inequality is emerging as a serious problem in Hong Kong in the 21st century. Researchers, public policy makers, and commentators have taken to discussing the topic, but few have gone very deep. A comprehensive overview of the many facets of this multidimensional problem, and of its origins and consequences, is still not available.

One of the problems is that economic inequality is attributed to a great variety of factors, for example, elderly poverty, childhood poverty, the arrival of recent immigrants, single parenthood, the short supply of good-paying jobs, high housing rents, economic division into "haves" and "have-nots" due to escalating home prices, unequal access to education opportunities, and discrimination against minority groups. This is not an exhaustive list. Tackling all or most of these issues would be a very big task for any generation—so big that it would seem almost impossible without first adopting a strategic approach in which policy could be sensibly focused on the critical points for getting the biggest bang for the buck and making a sustainable impact.

To do this, though, we must first understand the deep causes and nature of economic inequality. Again, there is a long list of possibilities. I have seen economic inequality characterized as a consequence of any or all of the following: economic globalization, Hong Kong's marginalization after the opening of China, economic and social unfairness due to the failure of government policies, the dominance of a tycoon economy, bad governance, and the appearance of divisive politics after 1997. Clearly, this is a complex issue. If we want to address any one aspect of economic inequality, such as providing income support to all those without means, the implication is that we need to tackle these causes of economic inequality as well.

Some have argued that economic inequality today is a result of even more fundamental problems, such as something inherent in capitalism, a failure of government policy, or some combination of the two. Radicals who lay the blame on capitalism try to articulate a revolutionary agenda to reconfigure society. Reformers who see it as a failure of government propose solutions that are best described as the welfare state. Both are characteristically 20th-century approaches for tackling inequality in the previous century. But can they address the challenge of inequality in the 21st century? Economic globalization in the period 1980–2005 impacted every country. Many acquired economic wealth very rapidly, which resulted in great inequality in its distribution. The situation was particularly pronounced in major metropolitan centers, where rising home prices created an additional disparity of housing wealth.

This has made the problem of economic inequality in the West quite different today from that in the 20th century, when the liberal democratic state succeeded in reducing some inequality by sacrificing some economic growth through the invention of the social welfare state. One could even think of the liberal democratic state itself as an invention for tackling economic inequality. But in the 21st century, economic inequality has come back with a vengeance, and the social welfare state is insolvent in its present deadlocked political state.

The ability of the liberal democratic state to deal with economic inequality is now in question. Hong Kong is no different from the West in the characteristics, causes, and consequences of its economic inequality, except it is even more complex here because of the China factor.

China's opening and the birth of a more porous border between Hong Kong and the Mainland have led to economic and social interactions that have exacerbated economic inequality in the territory. Sometimes institutions, rules, and public policies that have intermediated such interactions further aggravated economic inequality. The problem has tested our governance arrangement at a time when our political system is still in transition.

For me, both the radical and the reformer perspectives conceptualize Hong Kong's economic inequality challenge largely in 20th century terms. They are still trying to fight yesterday's battle. Their solutions would not solve Hong Kong's economic inequality and might even wreck its free market economy. For me, economic inequality in Hong Kong must be conceptualized according to both global and China factors.

This collection of essays outlines the many elements of a fuller analysis of economic inequality and considers policy solutions to address the challenge while preserving the great vitality of our free market economy. It builds on my two earlier studies, *Anarchy and Occasional Diversity: On Deep Economic and Social Contradictions in Hong Kong* and *Hong Kong Land for Hong Kong People: Fixing the Failures of Our Housing Policy.*

Prosperity and Equality in Historical Context

Hong Kong's postwar development mirrors the transformations that took place elsewhere but at a much faster pace. The 19th century could be called the Age of Liberty, when nations in the West unleashed the forces of the free market. Industrialization took off, and the European economies and their offshoots in the New World enjoyed unprecedented prosperity. Politics also became more democratic over time. The process was sometimes gradual and peaceful and sometimes convulsive and violent.

Hong Kong similarly experienced its own Age of Liberty after 1945 and came to be called the world's freest economy by Milton Friedman. There were nonetheless strong undercurrents of inequality. The first serious economic inequality challenge appeared in 1966–1968, when there was widespread rioting in protest against working and living conditions in the colony. While it is commonplace nowadays to associate these protests and rioting as spillovers from the Cultural Revolution and left-wing agitation, the root cause was the harsh working conditions following industrialization and the extreme shortage of housing in the midst of a dire property market crash that left many without basic shelter and forced them onto the streets (see Essay 26).

In the aftermath of widespread social unrest, the government launched a massive public housing program, to placate the disaffected residents and rebuild livable communities at the local district level. Public investment in education and health was also increased, but the key breakthrough initiative was housing. A limited welfare state was created alongside a free market economy, and it brought social and political peace for nearly 30 years.

For Hong Kong, this was akin to the Age of Equality that appeared in the West during the 20th century, when rich countries tried to balance the prosperity unleashed by market forces with the political demand for a fairer distribution of that income and wealth. What was considered "fair" was vaguely defined as some degree of equality of opportunity and of outcome. Hong Kong under colonial rule succeeded in finding the proper balance between prosperity and equality, and the people felt contented and confident.

Taking the long perspective, one can with good reason view the Age of Equality in the West as a time when the benefits of economic and political liberty unleashed in the 19th century's Age of Liberty became consolidated and blossomed. Hong Kong in the 40 years after World War II shared essential similarities with this path taken by the nations in the West.

But in the latter part of the 20th century, prosperity took another giant step forward in a new wave of trade, investment, and financial market liberalization. This was a global phenomenon. Many large closed economies began to open their markets, affecting the lives of billions of people. Rising prosperity in the newly emerging economies in particular helped to lower poverty among those living in the developing world.

Within nations, however, domestic inequality widened and brought new economic, social, and political challenges. In rich countries, both income and wealth inequality increased, especially in the global metropolitan centers. New technologies and rising home prices created societies divided into the haves and have-nots, who lived together in the same city. Family breakdown among the less well-to-do households also emerged as a critical factor causing the lower- and middle-income classes to sink amid rising prosperity. Children were negatively impacted as a rising proportion of them were now raised in single-parent households. The disadvantages of early childhood magnified into a loss of lifetime economic opportunities. Social upward mobility suffered as a consequence, and inequality became transmitted across generations.

The challenge of inequality will continue to be at the top of the public policy agenda in the 21st century, but it is no longer obvious that the policies of the welfare state will provide an adequate answer. Most governments in rich countries are burdened with huge public debts and are still running fiscal deficits. There is not enough money to spend on supporting the consumption of the disadvantaged. The challenge of ending the causes of rising inequality appears ever more daunting.

I conjecture that inequality in the 21st century cannot be solved through 20th-century welfare state policies alone (see essays in Parts 2 and 9 and Essay 36). Ultimately, the answer will come from rising economic prosperity (see essays in Part 6). For this reason, we must preserve the vitality of our free market economy to sustain the economic prosperity that will be needed to address the challenge of inequality in the 21st century.

Hong Kong since the 1980s

In the 1980s, inequality, poverty, and near-poverty started to reappear in Hong Kong together with economic globalization and China's opening. The Gini-coefficient for measuring household income inequality increased from 0.429 in 1976 to 0.537 in 2011 (see Table 0.1). This rise is somewhat moderated if transfers to less well-to-do households are included as per government estimates, the Gini-coefficient increasing from 0.466 in 1996 to 0.475 in 2011.

One common explanation for the rising measured income inequality is the greater number of retired households due to the aging of the population. Hong Kong's aging problem is as severe as that of Japan (see Essay 30). Examining the Gini-coefficient among households with heads aged 20–65, which would exclude many nonworking elderly households, can reduce the measured effect of aging on household income inequality. But Table 0.1 shows that it has still increased from 0.432 in 1976 to 0.507 in 2011. Apparently, the main cause of rising income inequality is not population aging.

Hong Kong is similar to other rich economies in that multiple factors have fed on each other to make the problem of rising inequality very difficult to halt. It is likely to take one or two generations to stop and reverse its effects. The factors involved will be examined in detail in this volume of essays; below, I outline the six key drivers of inequality.



Figure 0.1

Gini-coefficients of Household Income Inequality, 1976-2011

Source: Hong Kong Population Census and By-Census, 1976-2011.

First, the inadequate provision of secondary and tertiary education has exacerbated individual income inequality between the more and the less educated. It has also worsened household income inequality because of positive marital sorting, whereby the better educated tend to marry the better educated, and vice versa. The inequality effect has arisen because underinvesting in education has led to rising average rates of return to schooling, increasing from 8.3% in 1981 to 14.8% in 2011 (see essays in Part 1 and Essays 12 and 20). The rate of return to a university first degree rose from 17.0% in 1981 to 22.7% in 2011. In contrast, the rate of return to primary schooling fell from 5.8% in 1981 to 5.3% in 2011.

Second, the growing number of cross-border marriages and remarriages has accelerated the breakdown of the family. The cumulative number of cross-border marriages in the years 1986–2014 was 680,017, or 40.3% of all marriages during this period. In 2014, there were 26,330 cross-border marriages. The number of divorces also increased steadily over the period, rising to a cumulative total of 365,229 divorces, including 20,019 in 2014. The cumulative number of cross-border remarriages, in which either the groom or the bride had a previous marriage, over the period 1986–2014 was 130,040 and constituted 44.3% of all remarriages, including 11,839 in 2014.

The large number of cross-border marriages has two consequences. First, the quota system regulating one-way permits has led to long delays before families separated across the border can become reunited in Hong Kong. Children's upbringing has been seriously affected, and they have become less well prepared for economic

life when they grow up. Second, it has increased divorce and remarriage rates and led to more broken families. The chance of children being brought up in single-parent households increased more than tenfold over the period.

Most cross-border marriages have occurred in low-income households. Recent immigrants and their children are seriously disadvantaged in receiving human capital investment. Their lifetime opportunities are fewer, and this threatens to transmit economic disadvantages from generation to generation. Economic inequality therefore has become an entrenched and growing problem for society.

The third factor affecting inequality is that the public rental housing sector increasingly has become a place where low-income households and elderly retired households are concentrated. The estimated percentage of households with heads aged 20–65 from the lowest income quartile of the population living in public rental housing increased from 24.5% in 1976 to 48.4% in 2011 (see Table 0.1), while the proportion of those below the median household income increased from 53.3% in 1976 to 80.0% in 2011.

Table 0.1

	Income Quartile	1976	1981	1986	1991	1996	2001	2006	2011
Number of public	<25%	76	82	103	135	178	180	222	255
rental households	25-50%	89	99	136	142	157	139	161	167
by income quartile	50-75%	88	101	122	114	116	93	91	89
(thousands)	>75%	57	69	74	57	56	32	28	17
(thousands)	Total	311	351	435	448	506	444	501	528
Percentage share	<25%	24.5	23.2	23.6	30.1	35.1	40.6	44.2	48.4
of public rental	25-50%	28.8	28.2	31.3	31.7	31.0	31.2	32.1	31.6
households by	50-75%	28.5	28.8	28.2	25.6	22.9	20.9	18.2	16.8
income quartile	>75%	18.3	19.9	16.9	12.6	11.0	7.3	5.5	3.3
meome quartite	Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Number and Percentage Share of Public Rental Households by Income Quartiles among Working Age (20–65) Heads of Household

Source: Hong Kong Population Census and By-Census sample databases, 1976–2011.

The percentage of elderly households with head's age above 65 living in public rental housing has increased from 30.6% in 1976 to 48.6% in 2011. By contrast, the percentage of households with head's aged 20–65 has declined from 36.3% in 1976 to 27.4% in 2011 (see Table 0.2). The number of public rental households above the age of 65 is 237,000 in 2011, which is very high compared to the 528,000 aged 20–65.

Many of the newer housing estates are located in remote areas of the New Territories, and children typically grow up fairly isolated and seldom visit the city center. A large proportion of the tenants are elderly retired individuals, some with limited means, who are not great role models for young children. Growing up in public housing estates today means living in an increasingly segregated, impoverished, and aging neighborhood, unlike the situation 30 years ago.

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	1976	1981	1986	1991	1996	2001	2006	2011
Number of public rental	311	351	435	448	506	444	501	528
households aged 20–65								
(thousands)								
Percentage share of	36.3	33.0	35.5	34.6	32.7	26.8	28.1	27.4
public rental households								
aged 20–65								
Number of public rental	26	51	81	112	178	203	220	237
households aged >65								
(thousands)								
Percentage share of	30.6	34.7	41.7	47.4	54.7	50.7	51.7	48.6
public rental households								
aged >65								

Table 0.2

Number and Percentage Share of Public Rental Households by Age of Head of Household

Source: Hong Kong Population Census and By-Census sample databases, 1976-2011.

The percentages of divorced individuals and children living in single-parent households have also been rising over time among households in the lowest income quartile living in public housing estates, which is not the typical case for those living in other types of housing (see Table 0.3).

Some 69.4% of divorced individuals living in public housing in 2011 were from the lowest income quartile, up from 41.8% in 1976. In all other households, the share decreased from 44.6% in 1976 to 34.7% in 2011. The share of divorced individuals in the highest income quartile living in public rental households decreased over time

Table 0.3

Percentage Shares of Divorced Individuals and Single-Parent Households with Children in Lowest and Highest Income Quartiles by Housing Type among Working Age (20–65) Heads of Households

		Income quartile	1976	1981	1986	1991	1996	2001	2006	2011
Percentage	Public rental	<25%	41.8	39.4	42.6	49.2	50.9	62.2	60.4	69.4
share of	households	>75%	12.7	15.5	9.8	6.6	5.8	2.9	2.7	1.3
individuals	All other	<25%	44.6	43.1	40.6	36.1	30.6	38.1	35.7	34.7
	households	>75%	18.5	19.0	20.8	22.9	19.4	16.1	17.1	17.3
Percentage	Public rental	<25%	28.2	32.9	32.6	45.3	59.2	70.2	69.3	79.8
share of	households	>75%	20.7	17.9	12.7	8.9	4.1	1.8	1.3	0.8
single-parent	All other	<25%	30.2	31.1	35.7	30.5	32.1	43.2	39.8	38.5
households	households	>75%	23.9	26.5	20.7	23.1	17.1	12.6	12.6	16.7

Note: Children are defined as those below age 19.

Source: Hong Kong Population Census and By-Census sample databases, 1976-2011.

even though the share was essentially unchanged among all other types of housing. Divorce is strongly associated with low-income households and is concentrated in public rental housing.

This phenomenon also means children of divorced parents are more concentrated in public rental housing. The share of single-parent households with children in the lowest income quartile living in public rental housing estates increased from 28.2% in 1976 to 79.8% in 2011. In all other households the share increased much more slowly, from 30.2% in 1976 to 38.5% in 2011. And in the highest income quartile, the share of children living in single-parent households in both public rental households and all other types of housing decreased over time. Single parenthood is also strongly associated with low-income households and is concentrated in public rental housing.

Recent immigrants are also concentrated in the public housing program, which has done a spectacular job in accommodating them. In 1996, immigrants who had arrived within the previous 20 years constituted 26.1% of all households in public rental housing. In 1998, public housing allocation rules for recent immigrant households were liberalized, with the result that they took a growing share of newly allocated public housing units. The percentage of recent immigrant households ("recent" meaning arrived within the previous five years) rose from 4.6% in 1996 to 10.0% in 2001. This declined to 6.4% by 2011 as the existing numbers gradually cleared and new inflows ebbed. Nonetheless, the share of immigrants who had arrived within the past 20 years and were living in public housing in 2011 was 39.1%, substantially up from 26.1% in 1996. At the same time, the number of immigrants living in all other types of housing fell from 30.2% in 1996 to 20.3% in 2011. One also generally finds that a larger share of recent immigrants is in the lowest income quartile, especially among those not living in public housing.

Table 0.4

	Income quartile	1976	1981	1986	1991	1996	2001	2006	2011
Public rental households	All	0.3	3.0	1.8	2.6	4.6	10.0	9.5	6.4
arrived within 0–5 years	<25%	0.7	3.4	2.4	3.2	6.6	14.0	11.5	7.2
All other households	All	5.4	18.0	10.8	11.1	11.7	9.2	6.9	7.0
arrived within 0–5 years	<25%	5.3	17.2	10.5	12.3	13.9	14.3	9.5	10.0
Public rental households	All	_	_	_	_	26.1	27.4	37.6	39.1
arrived within 0-20 years	<25%	-	-	-	-	35.5	35.8	43.0	41.1
All other households	All	_	_	_	_	30.2	23.3	21.7	20.3
arrived within 0-20 years	<25%	_	_	_	_	40.0	32.0	28.0	27.6

Percentage Shares of Recent Immigrant Households by Arrival Years and Housing Type among Working Age (20–65) Heads of Households

Note: Recent immigrants are defined as those who have arrived either in the past 5 or 20 years.

Source: Hong Kong Population Census and By-Census sample databases, 1976-2011.

These interrelated sets of outcomes are examined in the essays in Parts 3 and 4. They are largely the result of public rental housing allocation rules that favor married households without distinguishing between first marriage and remarriages, and relatively abundant cross-border marriage opportunities. This perversely rewards those who are divorced and who later remarry. It also suggests that the combined effects of our public housing program, cross-border marriages, and family breakdowns are powerful and perverse incentives driving economic inequality and reducing upward social mobility.

A fourth factor of inequality is economic globalization and China's opening, which have led to rising property prices that create great disparity in wealth between those with property and those without. This has made housing rents expensive for low-income households and home ownership impossible for those without rich parents. Since the 1980s, home prices have risen by about 250%. At the same time, the down payment for purchasing a home has risen from 5% to 40% for most units. Adding in the increase in home prices implies an almost twentyfold increase in initial payment.

The supply of land and housing has lagged severely behind rising demand, due to regulatory restrictions and divisive politics. It is estimated that regulatory and political delays in development alone have nearly doubled the cost of home prices (see essays in Part 5). On the demand side the rise of subdivided housing in urban centers is driven by rising divorce rates and the exit of young working adults from their oftencrowded parental homes.

Fifth, population aging is putting an increasingly heavier burden on the workingage population to sustain per capita economic growth in the future. Unfortunately, Hong Kong's working-age labor force is contracting. Raising workforce productivity, especially through innovation and entrepreneurship, is more difficult with a smaller workforce because the total amount of talent is less. It is already late in the day to invest in those who have graduated, so importing talent must be seriously considered as a policy action to sustain economic growth. This will be, of course, politically divisive, but the alternative is even slower growth (again, see essays in Part 6).

Finally, the sixth factor affecting inequality is population aging and slower economic growth, which are leading to serious long-term fiscal problems. As the major provider of funds and services, the government is under severe pressure to increase public expenditure on housing, medical and health care, education, and social welfare. Hong Kong's fiscal reserves will not be adequate to support such expenditure growth. Raising tax revenues will further compromise economic growth. Popular demand for universal social pensions is fundamentally a nonstarter given Hong Kong's adverse demographics (see Essay 33).

A far more productive approach is to devise a long-term fiscal strategy of investing in economic growth and privatizing our public housing so as to unlock frozen land values that could help finance public expenditure growth (see Essays 24 and 39). This will come at little cost to society and will avoid the kind of fiscal deficits most rich countries in the West are inflicted with today.

The Way Forward

Inequality in the 21st century is not only about alleviating poverty among the lowincome classes but also about preventing the middle-income classes from sinking into near-poverty. It is about investing in people to make them more productive and in possession of both hard and soft skills, and attracting overseas talent. It is about lowering regulatory restrictions to increase the supply of land, housing, and buildings to prevent the worsening of division in society. It is about investing in medical and health care so that elderly people can live with dignity in old age. It is about providing income support for those without means, especially in old age.

Rising economic inequality has begun to polarize politics. Most of it has manifested as a demand for democracy and frustration with "one country, two systems." More people, especially the young, are losing hope; some are disaffected, and some are angry. At the center of this unhappiness is a complex interrelated set of issues that are simply different sources of rising economic inequality. There is a strong sense of injustice because the political system has failed to address the problem for a very long time.

The problem is a difficult one, but it can be studied and understood, and therefore solved. Getting the analysis right and devising a sound strategy will make a huge difference. But this is only half the solution. Politics could get in the way. Unless the government can build a consensus in support of a policy change in our society, then the people will not rally around the government's solutions. Hopefully, these essays will be able to contribute to the first half of this effort.

Hong Kong will pay heavily if the government fails to set its policy priorities and sequencing correctly. Our existing and future fiscal reserves will not be able to fund the growing demands of our aging population for old-age support and medical and health-care support, and the human capital investment demands of our young population to address their growing disadvantages and improve their prospects. We will only be able to fund rising public expenditure demands if we first fix our public housing finances by unlocking the frozen land values. It is only in this way that our future prosperity can be secured and our hopes realized to alleviate economic inequality in the 21st century.

5 Differential Growth Rates in Singapore and Hong Kong

Policy versus Human Capital

Singapore and Hong Kong are city economies well known for their economic growth miracles. There have been many discussions about the differences between the two, and sometimes these have flared into political and academic debates over the proper role of government in economic policy. One long-standing issue has been whether Singapore's government-driven interventionist policy delivers better economic performance than Hong Kong's noninterventionist, market-driven policy. This essay is not concerned with this old debate although for historical interest I will recount some of the main points at the end of this essay. Rather, my interest here is to examine the economic performance of these two cities according to the role played by human capital investment.

Growth Rate Gap Widens

First, let's look at the growth rate of these two cities. To measure their economic performance, I rely primarily on data from the Penn World Tables (Version 8) covering 1960–2011, which are the best and most reliable source of quantitative data for making cross-country comparisons.

Changes in the standard of living in Singapore and Hong Kong over time can be compared using their per capita real GDP growth rates, based on the expenditure approach. Table 5.1 gives two sets of estimates—the government figures and the Penn figures—and they are more or less consistent with each other. Both sets show the Singapore growth rates are almost always higher than the Hong Kong growth rates.

According to the Penn estimates, the average annual growth rate in Hong Kong was 4.86% from 1960 to 2011, and for Singapore it was 6.19%. That means Hong Kong was growing at a slower rate than Singapore by 1.33% each year. The government-sourced GDP estimate of the gap is smaller, at only 0.56%. In any case, the standard of living in Singapore has risen faster than in Hong Kong over the past 50 years. The interesting question, of course, is why Singapore's growth has outpaced Hong Kong's.

I believe a big part of the difference can be easily accounted for by the fact that the market value of government-subsidized housing units in Hong Kong is not adequately

	Hong Kong's annual grow	average 7th rate	Singapore's a annual grow	average th rate	Difference b Hong Kong Singapore gro	etween g and wth rates
	Government	Penn	Government	Penn	Government	Penn
	RGDP ^e	RGDP ^e	RGDP ^e	RGDP ^e	RGDP ^e	RGDP ^e
	figures	figures	figures	figures	figures	figures
1960-1970	6.17	7.39	6.62	8.11	-0.45	-0.72
1970-1980	6.37	6.86	7.30	7.80	-0.93	-0.94
1980-1990	5.27	5.08	5.37	5.10	-0.09	-0.02
1990-2000	2.33	3.15	4.38	6.39	-2.05	-3.24
2000-2011	3.68	2.49	2.95	3.86	0.74	-1.37
1960-2011	4.70	4.86	5.26	6.19	-0.56	-1.33

 Table 5.1

 Percentage Growth Rates of Real GDP per Capita

Note: RGDP^e is the expenditure-based estimate of real GDP per capita, which is the appropriate measure for comparing standards of living across countries and over time.

Source: Penn World Tables, Version 8.0.

reflected in GDP figures, because the units cannot be traded on the open market. This contrasts with the units subsidized by Singapore's Housing and Development Board, which are tradeable. Moreover, I have always believed that commoditizing subsidized housing in Hong Kong would bring substantial benefits in addition to the effects on GDP alone. I have elaborated on these points in Wong (2015) and will not dwell on them here.

The figures highlight an interesting difference, though, that relates to human capital. According to the Penn estimates, Hong Kong fell even further behind Singapore in the period 1990–2011. The difference in average annual real GDP per capita growth was 3.24% for 1990–2000 and 1.37% for 2000–2011. The corresponding government estimate for 1990–2000 was 2.05%; but for 2000–2011, the government estimate shows that Hong Kong took the lead by 0.74%. The government figures may have been skewed by a period of high inflation in the early 1990s as China opened up, and subsequent deflation during the Asian financial crisis, which distorted the prices of nontraded goods and services in Hong Kong. The Penn figures probably present a more accurate picture.

Human Capital Key to Growth

Another reason why Hong Kong fell further behind Singapore starting from the 1990s may be related to investment in human capital. Table 5.2 shows population growth in Hong Kong has declined over time, from 2.56% per year in 1960–1970 to 0.44% in 2000–2011. Over those 50 years, the population grew an average of 1.63% per year. In contrast, Singapore's population growth rate averaged 2.28% per year from 1960 to

Table 5.2

Average Annual Growth Rates of Population, Employment, and Human Capital Index

	fuoH	g Kong growth rate	es	Sing	apore growth rate	s	Difference Sing	between Hong Ko apore growth rate	ng and s
			Human			Human			Human
	Population	Employment	capital	Population	Employment	capital	Population	Employment	capital
			index			index			index
1960-70	2.56	9.16	1.42	2.34	2.93	1.66	0.22	6.23	-0.24
1970-80	2.47	4.00	1.70	1.53	4.83	0.06	0.94	-0.84	1.64
1980-90	1.38	2.14	0.96	2.25	3.51	1.41	-0.87	-1.38	-0.45
1990-2000	1.59	1.69	-0.07	2.65	2.88	1.44	-1.06	-1.18	-1.51
2000-2011	0.44	0.83	0.71	2.58	4.01	0.66	-2.14	-3.18	0.05
1960-2011	1.63	3.53	0.92	2.28	3.64	1.04	-0.64	-0.11	-0.12
H	-		-	т. т	: -				

Note: The HCI is the product of the rate of return to schooling and the average years of schooling for individuals over 15 years old.

Source: Penn World Tables, Version 8.0.

2011 and rose slightly over the period 1990–2011. What accounts for the difference in population growth rates, and what is the significance for human capital?

Overall employment growth rates in 1960–2011 were not very different between the two cities, averaging 3.53% per year in Hong Kong and 3.64% in Singapore. But their patterns came to differ over time. Hong Kong received an enormous injection of population and human capital during 1945–1951, when immigrants flooded into the city from the Mainland. During 1960–1970, employment grew an amazing 9.16% per year on average as the first generation of baby boomers entered the labor market and joined the export-oriented, labor-intensive manufacturing workforce.

In the absence of a proactive immigration policy, however, the overall population has aged, with the result that employment growth has been progressively falling off. By 2000–2011, the employment growth rate had declined to an average of 0.83% per year. The aging of the population was cushioned somewhat by the inflow of immigrants from the Mainland from 1978; however, population quality did not improve. For example, the Penn estimate of the HCI (defined as the product of the rate of return to schooling and the average years of schooling for individuals over 15 years old) actually declined slightly in 1990–2000.

By contrast, Singapore adopted an immigration policy focused on recruiting highly skilled workers from abroad so as to help sustain employment growth. This resulted in employment growing significantly faster than the population in the period 2000–2011. Not only that, but there is clear evidence that the HCI rose much faster in Singapore than in Hong Kong in the 1980s and 1990s even though the average annual growth in the HCI during 1960–2011 looks quite similar for the two cities (0.92% in Hong Kong and 1.04% in Singapore). This was the result of Singapore's policies to attract highly skilled immigrants and expand postsecondary education—policies that were far more aggressive than Hong Kong's.

In the decade leading up to 1997, Hong Kong lost some talent when uncertainties about the British colony's future after its handover to China prompted many to immigrate. The expansion of opportunities for higher education at that time was in part a response to the outflow, but replenishing a lost talent pool takes many years. The expansion of postsecondary education began to gain some traction only after 2000, but by then the diluting effects from an inflow of less skilled immigrants from the Mainland had already lowered the average human capital level of the population.

Productivity Gap Narrows

Table 5.3 gives the Penn estimates of total factor productivity (TFP), which is a measure of the productivity of all the inputs, including capital and labor, used in production. Hong Kong's TFP estimates are higher than Singapore's, but the difference has narrowed considerably over time. From 1960 to 2011, Hong Kong's TFP

	1 0	0 01 1	
	Hong Kong TFP	Singapore TFP	Ratio of Hong Kong TFP to Singapore TFP
1960-1970	1.053	0.686	1.535
1970-1980	1.095	0.972	1.127
1980-1990	1.100	0.976	1.128
1990-2000	1.159	0.934	1.241
2000-2011	0.980	0.939	1.044
1960-2011	1.075	0.898	1.197

Note: The TFP figures are derived from production-based estimates of real GDP per capita, which is the appropriate measure for comparing production capacity across countries over time.

Source: Penn World Tables, Version 8.0.

was, on average, 19.7% higher than Singapore's. But in the period 2000–2011, the difference was only 4.4%. This is a huge drop compared with 1960–1970, when the difference was 53.5%, and still a considerable drop compared with 1990–2000, when it was 24.1%.

Hong Kong's TFP appears to have peaked in the years 1990–2000 and fallen since then. Why would this happen, especially in contrast to Singapore, where the TFP has been relatively stable since 1970?

The obvious explanation is the slower growth in employment and human capital in Hong Kong. This is evident from the figures in Table 5.2, showing the progressive decline in the growth rates of population, employment, and average years of schooling in Hong Kong over time. The combined effect has been to lower the critical mass of human capital necessary for sustaining productivity growth.

Singapore's population has experienced robust growth in both numbers and quality, explained, again, by its immigration policy to bring in a highly educated workforce, much of it from China, and by sustained investment in education. The figures for 1980 to 2000 in Table 5.2 show Singapore's average employment growth rate was higher than Hong Kong's by at least 1.2% per year. Also, the HCI of the population in Singapore over the same period was increasing faster than in Hong Kong by an average of nearly 1.0% per year.

Combining these two figures implies that, over the two decades, the total human capital stock accumulated from schooling in Hong Kong would have declined by over 50% relative to that in Singapore. This point can be illustrated by assuming, hypothetically, that in 1980 the human capital stock in both Singapore and Hong Kong equaled ten units. Twenty years later, Singapore's stock would have grown to 15 units, while Hong Kong's stock would have remained unchanged at ten units. The drop in Hong Kong's TFP numbers after 2000 is largely attributable to the much more rapid growth of Singapore's human capital stock relative to that of Hong Kong's.

Table 5.3

Economic Miracle Unfazed by Ideological Disdain

This is a good time to revisit the debates that occurred two decades ago on East Asian economic growth miracles and TFP growth rates. Professor Alwyn Young published two articles in 1992 and 1995 showing that the miracle economies of East Asia had experienced no or little growth in TFP in the period spanning 1960–1991. All of their spectacular growth was the result of capital accumulation through high savings rates and hard work rather than productivity increases, Young said. Comparing Hong Kong and Singapore, he found some evidence for TFP growth in Hong Kong but none for Singapore. Interestingly, Young's findings are confirmed by the Penn estimates in Table 5.3.

Young further hypothesized that this was due to Singapore's misguided industrial policy of picking winners, resulting in low rates of return on capital and adverse effects on productivity. His work gave indirect support for the noninterventionist policy adopted by Hong Kong in favor of free markets. Professor Paul Krugman, Nobel laureate in economics in 2008, did not challenge Young's findings and interpretation but asserted, shockingly, that the growth model in East Asia was similar to that of the Soviet Union—based on perspiration rather than inspiration—and he predicted that growth rates in the region would decline as a result of the effects of diminishing marginal returns to capital. Young's findings and Krugman's oratorical onslaught lit a fire under the Singapore government. Krugman's prediction has not been borne out, as the miracle economies have not stopped growing.

In a surprising argument, Professor Joseph Stiglitz, Nobel laureate in economics in 2001, wrote that, if Hong Kong's TFP was, in fact, higher than Singapore's, "Is it because of better economic policies? Or is it because Hong Kong was the entrepot for the mainland of China, and as the mainland's economy grew, so did the demand for Hong Kong's services? In this interpretation, Young's explanation of Hong Kong's higher TFP relative to Singapore is turned on its head: Hong Kong's success actually was a result of the growth of perhaps the least free-market regime of the region."

Stiglitz's ideological disdain for Hong Kong's free-market policies led him to clutch at any interpretation that could discredit the city's record, but he was wrong. Young's figures covered the period 1960–1991. China was essentially a closed economy until the early 1980s. Young's estimates of TFP growth rates for Hong Kong did not reveal any substantial change in TFP immediately after China's economic opening, a finding that is confirmed by the recent Penn TFP estimates. Stiglitz could not be more mistaken. It is a pity that he allowed ideological belief to cloud scientific judgment.

The debates over East Asian TFP were largely much ado about nothing. One cannot really prove whether Hong Kong's free-market policies were the sources of its higher TFP any more than Singapore's industrial policies were the reasons for its

lower TFP. At the end of the day, TFP is an imprecise measure of productivity that cannot tell us where the sources of productivity lie.

No Time to Lose!

The crucial driver of the difference in growth rates between Hong Kong and Singapore—two of the freest market economies in the world—is their different rates of growth in human capital. Free markets in labor, capital, and land allow these resources to be allocated more efficiently, but you cannot achieve growth and productivity increases if you do not invest in capital. In a modern economy, the most important form of capital is human capital. Human capital markets are imperfect, so there is an important role for government and nongovernment charities and voluntary organizations to play in fostering and financing investment in human capital.

In the Gobi Desert, there is no life. If you practiced free-market policies there for a century, there would still be nothing there. To build a modern economy, you must first invest in human capital. When human capital is present, people will sooner or later discover that freer markets work better, at least in the long run. China discovered the wisdom of education 2,500 years ago and the value of free markets in agricultural land 100 years later; in the past 30 years, it has rediscovered the importance of both education and free markets. Hong Kong must not lose any more time getting its act together on human capital.

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32 Health Care and Rising Public Budgets

My previous essay showed that half of government expenditure today is spent on four areas—housing, education, health, and social welfare—compared to one-third 30 years ago. The growth in spending has been the result of economic growth, demographic change, and organized political pressure. Barring unforeseen circumstances, these underlying factors are expected to continue to drive public spending higher in all four areas.

I have singled out these four areas because how we manage public spending on them will determine to a large degree what kind of society Hong Kong will become in the future. A number of commentators and voices in society are wary of the financial secretary's attempt to warn the public of runaway structural fiscal budget deficits. Some have lashed out at infrastructure spending they deem to be less essential then spending on social welfare, health care, or other areas. Their voices are sometimes joined by the environmental lobbies, some of which are totally opposed to development. Then there are those with vested interests on both sides of the divide: some want more infrastructure spending and others oppose it.

How do we decide what should or should not be done? The issues at stake are more than just a matter of balancing the fiscal budget as an accounting exercise. The choices we make will impact whether Hong Kong will remain, in the long term, a free and just society with a vibrant economy. Hong Kong's ability to sustain economic prosperity and political stability depends on how we respond to the continuous growth in the demand for housing, education, health, and social welfare spending.

Unlike episodic, one-time increases in infrastructure spending, these four areas require sustained increases in recurrent public spending in order to meet society's rising demands. But relying on public spending alone will inevitably lead to a larger and more interventionist government, higher taxes, and the curtailment of some of the freedoms and liberties we are accustomed to. Life will not be the same anymore.

Some in Hong Kong may welcome this, but if society is to transform itself and reinvent a brave new world, we owe it to ourselves to have a serious political debate first. I am sure the central authorities in Beijing will be as interested in this debate as the people of Hong Kong are. The basis for this debate must be the projected rising demand and expected costs in these four areas.

Before considering the possible choices and what is to be done, we need to first look at (1) the relationship between economic growth, demographic change, and public spending growth; and (2) why the growth in demand for public spending in each of these four areas will not be the same in the future. I will start with health expenditure—the greatest challenge posed by an aging population for containing fiscal budget deficits.

Salient Features of Health Spending

We know that spending on health care increases with (1) the number of persons in an economy, (2) the proportion of elderly persons in the population, (3) the average income per person, and (4) the cost of health-care services. So, a growing economy with an aging population will spend more on health care. Health is a form of human capital. A healthier population can become economically more productive; for example, by having fewer hours lost due to sickness. For this reason, spending on health is not entirely consumption spending but partly investment spending that enhances economic productivity.

Increasing public spending on health care also potentially enhances the capacity of the medical and health industry to export medical services. This contributes to economic growth and adds to public revenues in the long run. One notable form of public spending that is classified under education expenditures is the training of medical and health-care personnel. These investments not only enhance the capacity to provide health-care services but also research and development activities that create demand for skilled jobs in the biomedical sector and enhance long-term economic growth.

Increasing health-related public spending, therefore, affects the public budget on both sides of the equation. It raises both expenditures and revenues. The extent to which public revenues will rise is not clear. In principle it can be empirically estimated, although I am not aware that anyone has seriously done this kind of calculation for Hong Kong. It is highly likely that, in the short run, the effect of increasing public spending on health will be to enlarge the fiscal deficit, and the offsetting effects will appear in the long run.

Health spending also varies enormously from person to person. Some people stay healthy most of their lives and die suddenly without incurring a great deal of medical and health expenses over their lives. Others have chronic diseases that require expensive treatments over long periods. The incidence of disease is not highly correlated with ability to pay. This implies health-care spending has to be provided in part through some form of social insurance scheme, perhaps through public subsidies. Our current public health service provision is a form of heavily subsidized social insurance modeled largely after the British National Health System but with a lot less competition among hospitals and clinics for containing costs and enhancing efficiency.

Public spending on health will increase rapidly in the future not because of rising population numbers but aging. According to the Hospital Authority's (HA) published health-care services costs, treating elderly populations is a lot more expensive than treating other age groups (see Table 32.1). For example, it cost the HA on average \$3.1 million per annum to treat a population of 1,000 persons aged 15–64 in 2009–2011, but \$11.4 million to treat those aged 65–74, and \$25.3 million to treat those aged 75 or over. This meant it was 8.15 times more expensive to treat those aged 75 or over than to treat those aged 15–64, and 3.68 times more expensive to treat those aged 65–74. Children aged 0–14 were also slightly more expensive to treat by 1.05 times. These figures averaged out at \$5.1 million per annum for treating 1,000 persons.

Health-Care Costs per	Thousand Pop	ulation by A	Age Group,	2009-2011 (HK\$	6 Millions)
Age	Under 15	15-64	65-74	75 and over	Population average
2009-10	3.2	3.1	11.4	25.0	5.0
2010-11	3.3	3.1	11.4	25.5	5.1
Average	3.3	3.1	11.4	25.3	5.1
Cost indexed to the population group aged 15–64	1.05	1.00	3.68	8.15	1.63

Table 32.1		
Health-Care Costs per Thousand Population by Age Group, 2009-	–2011 (HK\$ Mil	lio

Source: HKSAR Hospital Authority.

Demographic Drivers of Future Health Spending

These cost figures can be used to construct the underlying demographic demand for health-care services. We can then construct a "health-care cost standardized population" that would multiply the number of persons aged 65–74 by 3.68 times and the number of persons aged 75 or over by 8.15 times. This "standardized population" would embody the increase in demographic demand for health care due to changes in both population numbers and the age structure. In Figure 32.1 we use the projection figures of both the Census and Statistics Department and the United Nations to make population and standardized population projections up to the years 2041 and 2100, respectively.

Table 32.2 shows the population and standardized population numbers for various years in 1989–2100. The population in the years 2013, 2041, and 2100 is estimated or projected to be 7.18, 8.47, and 10.35 million. But the standardized population is

Figure 32.1

Actual and Projected Population Numbers and Health-Care Cost Standardized Population Numbers, 1950–2100



Note: Projections based on figures provided by CSD and the UN. Source: HKSAR Census and Statistics Department, Hospital Authority, and UN Population Projection.

Table 32.2

Population Numbers, Health-Care Cost Standardized Population Numbers, and Growth Rates, 1989–2100

		1989	2013	2041	2100
(1)	Population (in millions)	5.69	7.18	8.47	10.35
(2)	Line (1) indexed to 2013=1.0	0.79	1.00	1.18	1.44
(3)	Standardized population (in millions)	7.70	12.29	22.08	27.61
(4)	Line (3) indexed to 2013=1.0	0.63	1.00	1.80	2.25
(5)	Line $(3) \div$ Line (1)	1.35	1.71	2.61	2.67
			1989-	2013-	2041-
			2013	2041	2100
(6)	Population annual percentage growth rate		0.98%	0.59%	0.62%
(7)	Standardized annual population percentage growth rate		1.97%	2.11%	1.38%

Note: Projections based on figures provided by Census and Statistics Department and the UN.

Source: HKSAR Census and Statistics Department, Hospital Authority, and UN Population Projection.

found to be 12.29, 22.08, and 27.61 million. These latter numbers provide a much clearer idea of the demographic pressure on health expenditures.

In 2013, health-care demand from the standardized population was 1.71 times higher than the population. In 2041 and 2100 it will be 2.61 and 2.67 times higher, respectively. The implied annual percentage growth rates of the population in 2013–2041 and 2041–2100 are 0.59% and 0.62%; those for the standardized population are 2.11% and 1.38%, respectively.

Clearly, the standardized population growth rates during 2013–2041 are on average significantly higher than the population growth rates, even when compared with rates in the past, in the period 1989–2013. This clearly implies that the demographic demand for health expenditure will be quite overwhelming in the coming three decades. Fortunately, projections for the second half of the century will be moderate with little difference in the projected population and standardized population growth rates.

Forecasting Future Income Growth

Health spending will increase in the future as per capita GDP rises, but by how much? Two factors are relevant. First, what is the income elasticity of demand for health? Second, by how much will GDP grow?

The income elasticity is a concept used by economists to describe the quantitative demand response of a good or a service to changes in income. Estimates of the income elasticity of demand for health among the Organization of Economic Cooperation and Development (OECD) countries are around 0.8 when the US is excluded. We will use this number to forecast our future "baseline scenario" of the demand for health because Hong Kong's income level is about the same as that of the member countries in the OECD. The US is excluded because it has a uniquely higher income elasticity of demand due to its market insurance system, which drives demand for health services and produces higher levels of health spending.

We also produce a second "high growth scenario" forecast for health care by assuming an income elasticity of demand of 1 if the government is unable to resist the rising political pressure to increase health-care spending and is unable to reform the present, essentially free public health-care services delivery system.

Table 32.3 presents some figures on the relationship between real GDP and employment growth in the past and for the future. Real GDP per employed persons was 4% per year on average in 1961–2013. This is the labor productivity of the employed population for the past half century. During 1961–1997 it was 4.7%, and in 2003–2013 it fell to 3.1 %. Despite this drop, I have assumed that a 4% rate of productivity can be sustained into the future.

iteui OD1						
	1961-	1961-	1997-	2003-	2013-	2013-
	2013	1997	2003	2013	2041	2100
% Growth rate of real GDP per employed	4.0	4.7	1.4	3.1	4.0	4.0
person						
% Growth rate of population	1.59	2.01	0.61	0.65	0.59	0.42
% Growth rate of employed population	2.22	2.75	0.14	1.59	-0.22	-0.02
% Growth rate of real GDP	6.2	7.6	1.5	4.5	3.8	4.0
% Growth rate of real GDP per capita	4.6	5.4	0.9	3.8	3.2	3.5

Annual Percentage Growth of Real GDP per Employed Person, Real GDP per Capita, and Real GDP

Note: Future employed population is defined as 73% of the population aged 20–64, the average rate in 2002–2012.

Source: HKSAR Census and Statistics Department.

I believe there is a very reasonable chance that our productivity will not slow down as in other countries because our rapidly aging population will trigger more investments in health-driven increases in the productivity of our working population. Similar investments in health around the world will extend life expectancies and by implication lead to longer working lives in Hong Kong. Therefore, the assumption of an employed population bounded between the ages of 20 and 64 is likely to underestimate productivity growth that should be offset to produce more reliable forecasts.

Effects of Rising Health Costs

The final element determining rising health expenditures is the cost of providing medical and health services. A variety of price indices are available, but for the purpose of estimating the fiscal impact of rising health expenditures the most logical one to use is the medical services component in GDP. Figure 32.2 shows the price relative to the real GDP deflator. It rose from 57.0 in 1989/90 to 100.0 in 2010/11. This is equivalent to an average annual rate of increase of 2.45%, which is roughly comparable to the 2.13% increase in the government consumption expenditure deflator relative to the GDP deflator. This is expected since the major component of the medical services deflator and the government consumption expenditure deflator is workforce costs.

How does the rising relative cost of medical and health services affect demand? One would expect it to decrease the quantity of health-care services demanded by the population, so changes in the total expenditure would depend on the price elasticity of demand. If the price elasticity is equal to 1, then the total spending will be unchanged because a 1% decline in health care will be offset by a 1% increase in the price.

We assume, again relying on OECD calculations and excluding US estimates, that the price elasticity of demand is -0.4. In other words, the price elasticity is relatively

Figure 32.2

Relative Price Index of Medical and Health Services and Share of Public Sector Health Expenditure



Note: Relative Price of Health and Medical Services = Private Consumption Expenditure Deflator for Medical Services/GDP deflator (Index 2010=100).

Source: HKSAR Census and Statistics Department, Food and Health Bureau.

inelastic; therefore, price increases in medical and health services will trigger increases in expenditure.

I will also assume for the purpose of forecasting future health expenditures that the relative price of medical and health services will increase at 2.5% per year, which is the average rate in the period 1989–2011. How fast it will actually rise will depend critically on government policy to influence the salaries and incomes of medical and health-care personnel. If we train more doctors and other health-service providers and admit more foreign-trained ones, then the increase in costs will be more moderate. This is the single most important lever the government can pull to control future medical and health-care costs, but its ability and willingness to do so have been quite limited to date.

Long-Term Forecasts of Health Expenditure

Finally, for total health expenditure I use the domestic health accounts prepared by the government. Since these figures cover total health expenditure in both the private and public sectors, one has to determine the share of public expenditures in total future health spending to ascertain the impact on the fiscal budget. In Figure 32.2 we

can see that the share of public health expenditures rose from 39.4% in 1989/90 to a peak of 57.7% in 2003/04 before falling to 48.3% in 2011/12. I will assume that, in the future, government will be able to keep the public share of health expenditure roughly at 50% of total health spending.

The assumptions I have made up to this point for the baseline scenario are very simple: (1) population growth up to 2041 according to the Census and Statistics Department projections and to 2100 according to the United Nations projections, (2) growth in real GDP per working person at 4% per annum, (3) the income and price elasticities assumed to be 0.8 and -0.4, and (4) medical and health-care prices to rise at 2.5% per year in real terms. For the high growth scenario, I assume the income elasticity will be 1.0 instead.

Although there is always room for some debate, I believe my assumptions are quite reasonable. They can be used to forecast future total health-care expenditure in a straightforward manner using a spreadsheet model. Table 32.4 presents the estimated public expenditure forecasts as a percentage of GDP.

Table 32.4

Forecasts of Public Health Expenditures as a Percentage of GDP to 2041 and 2100

	2011	2021	2031	2041	2060	2080	2100
Baseline scenario:	2.56	3.40	4.65	5.65	7.70	7.80	8.80
income elasticity = 0.8							
price elasticity = -0.4							
Percentage increase relative to 2011 figure		33	82	121	201	205	244
High growth scenario:	2.56	3.65	5.20	6.85	10.80	12.50	16.15
income elasticity = 1.0							
price elasticity = -0.4							
Percentage increase relative to 2011 figure		43	103	168	322	388	531

Note: Forecasts to 2041 based on Census and Statistics Department population projections and those to 2100 based on UN ones; real GDP/working person is 4% each year; medical relative prices rise at 2.5% each year; and public health expenditure is 50% of total.

In 2011, 2.56% of GDP was spent on health in the public sector. This will increase to 5.65% in 2041, an increase of 121% under the baseline scenario. The corresponding figures for 2100 are 8.8% of GDP and an increase of 244% above the 2011 baseline public sector health-expenditure figure. These are very large increases. Of course, the high growth figures are even more alarming, especially over the long term. Such increases in public spending on health expenditures alone cannot be accommodated under the present fiscal arrangements without severely sacrificing the quality of health care. Politically, no government can even contemplate such an outcome, given the power of the elderly vote.

Health is not the only issue that will be seriously impacting our future fiscal budget. The most important issue is how to manage public spending for an aging population, a problem I look at next.

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40 The Challenge of Poverty, Near-Poverty, and Inequality in 21st-Century Hong Kong

The essays in this volume show that poverty, near-poverty, and inequality are multifaceted conditions. They have coalesced into a growing economic and social condition in Hong Kong, which is also developing into a difficult political problem. The origins can be traced to the effects of economic globalization and China's opening in the 1980s. It then grew during the late 1990s and worsened in the early 21st century.

Many rich cities in the world have experienced similar phenomena. First, a small fraction of the population is in poverty; some may even be destitute. Second, the middle class begins sinking as growing numbers of its members become less able to afford a comfortable life in the manner they are used to. Third, income inequality and inequality in the ownership of wealth rise, especially as a result of escalating property prices. Unlike in other places, in Hong Kong these conditions are developing at a faster pace and with greater severity.

This is not surprising. Hong Kong happens to be the most open economy and free society in the world. The effects of external shocks sweep into Hong Kong like a gale. The economy has adapted rapidly to such changes as the transformation from a manufacturing to a service economy, the escalation of property prices, and the rise of cross-border marriages and remarriage. But in other areas, the adjustment has been much slower, in particular investment in human capital, the attraction of skilled immigrants, changes in land uses, and housing supply. Action is often politically deadlocked by interest group politics. Vested interests and advocacy groups have lobbied and created much talk, but this has resulted in little effective policy action.

With an aging population in the background, these developments are cause for serious concern. They are creating economic problems and becoming growing political problems. If we fail to address them in time, Hong Kong could stagnate much like Japan has in the past two decades.

The challenge of poverty, near-poverty, and inequality in the 21st century is not the same as the challenge Hong Kong experienced in the lead-up to the 1967 disturbances and afterwards. At that time, Hong Kong's limited government decided to intervene in social matters and create a limited welfare state focused on housing, education, health care, and social welfare. Financial Secretary Philip Haddon-Cave deemed these interventions appropriate under the policy of "positive non-interventionism." The solution to a considerable degree was to allocate a publicly affordable sum of money to crack the problem without compromising economic growth.

Today's challenge is much more difficult. In the 20th century, many rich governments tried to tackle poverty by throwing money at the problem. It did not work for them and is unlikely to work for Hong Kong for several reasons.

First, poverty, near-poverty, and inequality today are a product of the optimizing micro decisions of households and firms. Choices made by people are directly responsible for producing these conditions; for example, some poverty is the result of choosing divorce and single parenthood.

Second, tackling the challenge requires reforming old ways of approaching new things. This is often resisted, sometimes vehemently and stubbornly so, by bureaucrats and vested interests.

Third, the amount of money required is too substantial to be affordable by any government; even Hong Kong's comfortable budget surpluses and fiscal reserves would be inadequate.

Poverty, near-poverty, and inequality in the 21st century are embedded in the fabric of the economy and society. They require smart programs, time and effort, and incentives to change the behavior of those who are in poverty or falling into poverty.

The scale and severity of these problems in Hong Kong will require a very substantial number of resources if they are to be tackled effectively. Given our aging population, rising divorce rates, underinvestment in human capital (both education and health care), and expensive cost structures, it is obviously beyond the reach of what standard government fiscal measures can afford.

However, a strategy based on higher taxes would compromise economic prosperity by making our workforce even less productive. Our workforce will stop growing in the coming decades. Our entrepreneurship has already fallen off because there is not enough critical mass and we have not been able to attract sufficient young talent. Growth in Hong Kong will suffer further if higher taxes and more regulation are introduced to sap the vitality of our population.

What we need to do is to sufficiently incentivize the disadvantaged to change their behavior. Smart measures and policies could be introduced to induce people to respond positively to interventions. A vibrant third sector, for example, would be helpful.

We have the opportunity to learn from the failures of the last century. And there is real hope that Hong Kong's economic and social problems can be solved. With a smart strategy, we can find the resources to fix our problem. But we have to understand our problems better first.

The Poverty Line Is Not a Useful Statistic

Poverty is about standards of living. Inequality is about the distribution of standards of living among people in a society, and it is a different phenomenon from poverty. Inequality exists in both rich and poor societies. Since 1980, income inequality appears to have worsened within most countries, but worldwide it has improved. The rapid growth of China and many other emerging economies has enormously reduced the number of poor people in the world and made the household distribution of income in the world more equal.

In rich societies, only a very small percentage of the population is actually destitute. These families make up no more than 5%, or at most 10%, of the population in normal times. In Hong Kong, where the official poverty threshold is 50% of the median household income, about 15% of people are found to live in poverty, but most of them are not destitute.

The poverty line threshold currently is HK\$17,400 per month (including regular social welfare cash benefits) for a family of four. This comes out to US\$18.60 per day per person, or 15 times the poverty level defined by the World Bank for the world's population. In the US, about 16% of American households live below the country's poverty line, which is currently US\$23,000 per year (or HK\$14,950 per month) for a family of four. Interestingly, the US poverty line is lower than Hong Kong's.

Of course, not every family living below the poverty line in rich societies is genuinely in poverty. The poverty line is a snapshot at a given point in time. These families are at different stages of their life cycles, and direct comparison of dissimilar families is very difficult. Even the number of family members normally varies over the life cycle.

The notion that a "line" can separate poverty from non-poverty is ridiculous. If HK\$17,400 per month is the threshold for a family of four, does that mean a family with an income of HK\$18,000 is not poor? Can one meaningfully compare a single mother with one child to a couple with no children even if we ignore age and other differences? Fluctuations in income, changing life cycle events, and simple evolution over the life cycle mean households can fall in and out of the poverty threshold year to year.

Unless benefits are tied to the poverty line in a smart way, they could perversely interfere with life-cycle events and income fluctuations by providing incentives for households to game the benefits. Poverty then becomes institutionalized. The programs we have adopted will never be abandoned, because they have created stakeholders. Politically, these programs have become the vested interests of their advocates and stakeholders. No wonder US Federal Court judge Richard Posner has said the poverty line is a useless statistic.

How to Approach Poverty and Near Poverty

Still, poverty does exist, and alleviating poverty is about devising smart policies to help the poor become more economically productive and maintain their standard of living (for example, by means of income supplements and the provision of subsidized services).

Although poverty has been around for a very long time, near-poverty is potentially a more menacing new threat. This is also known as the problem of the "sinking middle class." It affects far more people, which has implications for political stability. Political democracy in the 20th century was founded on the support of a large prosperous middle class with good prospects for upward economic and social mobility. If the middle class sinks, the future of democracy becomes worrying.

The sinking middle class refers to the large percentage of people who do not appear to be able to earn a sufficient income to live comfortably. Some of the most important things most people want for a comfortable life have become very expensive: health, education, housing, getting married, raising children, and enjoying 30 years of retirement. It has also become increasingly difficult to earn an income that will allow one to live comfortably. I would guess that half the population in rich societies could become part of the sinking middle class today.

Although people's standards of living have not fallen according to the number of cell phones and other mobile gadgets they can afford, or the amount of clothing, food, or ordinary consumer durables they can buy, it is the bigger, more important items that are moving out of reach. The median household income for a family of four in Hong Kong today is HK\$34,800. What proportion of people earning that income can feel confident they can own a home, afford quality education for their children, afford quality medical care when they become sick, retire in comfort, and believe that their children can do the same?

Both wider economic developments, like the Third Industrial Age, and the breakup of low-income families are threatening middle-class prosperity and security. In Hong Kong, both forces have hit with unusual speed. Unfortunately, this has happened at a time when our political system is in flux.

Poverty, near-poverty, and inequality have appeared in Hong Kong due to a combination of supply-side and demand-side factors. The supply-side refers to individual characteristics, family background, community and neighborhood factors, and the like to explain why individuals are poor. The demand-side focuses on economic conditions such as business cycles, population trends, and technological trends in affecting the fortunes of industries and occupations. Below, I outline some of the relevant supply-side and demand-side factors.

Four Major Supply-Side Factors behind Poverty

I. Education

Individuals with more human capital have higher earnings. Tackling poverty and near-poverty means supporting those who lack the opportunities to augment their human capital from an early age. Human capital is acquired through three institutions: (a) the family, (b) the school, and (c) the community. Each provides learning and nurturing activities. Strengthening them represents an investment in children.

For (a), poor families and broken families (meaning single-parent families) make fewer investments in their children. Rising divorce rates are a major reason why children are failing in life. Hong Kong's divorce rate is among the top ten in the world.

For (b), education is costly because it requires intensive teacher time. A university graduate has to spend 16 years in full-time learning (not counting nursery and kindergarten). Assume schools have a teacher to student ratio of 1 to 40 and universities a ratio of 1 to 20. This implies that in a teaching career of 32 years, a teacher can produce only four students who graduate from university. To achieve quality learning, students need to have quality teachers and attend quality schools and universities. This is expensive. Modern information technology can help up to a point, but it cannot replace the face-to-face encounters between teacher and pupil that are critical for quality education.

In Hong Kong, and elsewhere, the training of teachers and the incentives to motivate them in their work leave much room for improvement. The organization of teaching and learning is critical to the training of future generations and to our future, and I fear society itself will fail if it fails in this task.

For (c), community learning opportunities are important, too. Hong Kong has a fully developed civil society, with numerous charitable voluntary services that help the less fortunate. Unfortunately, Hong Kong's low-income families are now increasingly concentrated in public rental housing estates that provide a limited and homogeneous living environment located far from the urban center. These estates provide neither a nurturing nor a stimulating environment outside the home and school.

II. Medical and Health

Individuals in good health live longer. Those who expect to live longer invest more in human capital, because the return to every dollar invested can be utilized for a longer period and yield a higher rate of return. The rich live longer, too, and invest more in human capital. Rich societies therefore spend more on medical and health care. Quality medical and health care can be very expensive for those in poverty and near-poverty. Hong Kong heavily subsidizes medical and health care by making hospital care essentially free to all. This implies a rationing of services, as demand greatly exceeds supply. Such an approach is superficially egalitarian but essentially forces the vast majority of those in poverty and near-poverty to accept mediocre care as a result of rationing. Grievances are particularly strong among those in near-poverty, as they demand more. A far better way to subsidize such services is to expand the supply of medical and health-care personnel and to target expensive training subsidies at those who cannot afford them.

III. Housing

The shortage of housing is a phenomenon in rich countries worldwide. Congestion in urban areas, where the population most wants to live, has made land very scarce. Rigid government regulations have made redevelopment difficult, while building codes and planning rules have made housing supply increasingly limited. The problem is compounded by the political lobbying efforts of special interest groups that prefer less development to more. The groups that seek to preserve country living—conservation-ists, heritage lovers, and other environmentalists—have demanded limits on building heights in city centers and have contributed to making housing very expensive.

This is an area where governments have totally failed to coordinate conflicting interests. Small minorities have been able to prevail over society's wider interests by hiding behind rules and regulations and manipulating the law. That politics has developed to this stage, often in democratic societies, reflects the erosion of the rule of law and the triumph of the rule of lawyers, as Professor Niall Ferguson has pointed out. Our town planning and building regulations have to become friendlier if housing supply is to be increased effectively.

IV. Retirement in Old Age

If you have a long life but a low income, you should be worried. How should society arrange to support the elderly poor? When universal social pensions were introduced in Britain at the end of World War II, men and women could start receiving their pensions at age 60. Life expectancy at that time was also 60. Today it is 80, but the pensionable age has not caught up, and that is why the pension scheme is bankrupt. Reforming it is politically difficult; politicians have been kicking the can down the road for decades.

If Hong Kong opts for universal social pensions today, then the scheme will be bankrupt even before it gets off the ground. Life expectancy will continue to increase, and any system with a fixed retirement age will face bankruptcy. Introducing such a flawed scheme breaks the intergenerational social contract that throughout human history has ensured parents invest in their children when they are young and children take care of their parents in old age.

The state today is very vulnerable to being hijacked by vested interest groups and shortsighted politicians. It is no longer a reliable institution for delivering old age support compared with partnerships between parents and children. Privatizing public housing and reducing the unpaid land premium will do far more to help people retire comfortably, especially the poor who are concentrated in these estates. It will be at no cost to government and generate huge benefits for the economy and society by making land and housing markets efficient and restoring choice to many families to plan their lives.

The Demand-Side Factor behind Poverty

On the demand side, the most important change is technology. The two central enabling technologies humankind has discovered so far are electricity and information technology. They have been transforming our world and will continue to do so. But everything we know today suggests there is no guarantee that the new technology will mean that everyone who wants to work will be able to find a job that is sufficiently rewarding for a comfortable life.

The wage differential between skilled and unskilled workers has been widening for over 30 years, and there is no sign it will stop. Robotics, new materials, and digital technology will allow companies to shed many jobs at the low end of the skill spectrum. The middle class must become far more skilled to move up or risk being hollowed out. Parents, even poorly educated ones, know this already. And that is why so many of them are feverishly putting their children through a barrage of training programs to develop the necessary enabling skills in the hope that they will rise above the crowd left behind by the advance of technology.

For those unable to develop the hard skills necessary for success in the new economy, there is still the prospect of developing soft skills. A technology-driven economy is also predominantly a service economy, and the rewards will go to those who are able to learn people skills and who acquire an appreciation for quality service and attention to detail.

Many hard and soft skills are developed in the family and in early childhood. Good neighborhoods also help children to grow up with more skills; they also foster higher aspirations. Putting young people's development at the center of our policy focus will be most helpful.

On an aggregate level, the average quality of the workforce is an important determinant of the productivity and competitiveness of the economy. Size of the workforce also matters. The declining entrepreneurialism observed in our society in the past two decades is a result of the falling numbers of our young population. Hong Kong is in danger of slipping into the Japanese syndrome of economic stagnancy.

If Hong Kong is unable to improve not only the quality but also the size of its young labor force through attracting overseas talents to sustain its economic prosperity, then the battle against poverty, near-poverty, and inequality cannot be won. Hong Kong has probably upwards of 291,776 emigrants abroad with higher education that we can target to attract home. Only by sustaining prosperity can we take on the 21st-century challenge of alleviating inequality in our midst.

Implications for Hong Kong

The essays in this collection attempt to show why the problems of inequality in Hong Kong are deeply embedded in our society. They are, however, not the product of mysterious global forces or capitalist exploitation but the logical unfolding of individuals and households responding to a changing international economic environment, rapid demographic change, technological advances, and opportunities across the border for business and marriage.

The challenge of inequality in Hong Kong is very similar to what we find in other rich societies, especially in the great metropolitan centers of the world. Our local variations are unique simply because they have become greatly magnified in the speed and scale at which they have developed.

To a large extent, they are the consequences of our openness and deep integration with the global economy and our proximity to Mainland China. Our porous border with the Mainland has not only allowed capital to flow between the two places but allowed much deeper social integration through marriages and remarriages.

These events have happened at a time when our political system has had to take giant steps in transition as sovereignty was restored from Britain to China in 1997, which has further complicated our inequality challenge. Our knowledge of the scale and nature of the inequality problem has been inadequate and seriously lagging. The combination of both politics and inadequate knowledge has served to delay and stall the adoption of the necessary corrective policies. Moreover, because action has been delayed, we have fewer options. and we are experiencing more intense political bickering, which is making it increasingly impossible to rekindle Hong Kong's magic.

The resources Hong Kong will need to address the inequality challenge are colossal, in part because we have the world's worst aging problem. On paper it is second only to Japan's, but it is probably worse because of our poorer human capital endowment.

We cannot solve the inequality challenge with the classic 20th-century solution of redistribution policies alone, which would require a compromise between economic growth and equality. The challenge can only be met if the solution simultaneously creates additional resources to sustain growth, as well as prosperity that replenishes the public coffers and helps restore vitality to our most important resource—human capital.

Investing in human capital, through education, health care, and immigration, will be essential if growth is to be sustained. There is, however, public resistance to immigration. This is not surprising, because individual workers perceive immigrants as a threat to their livelihood but fail to see that collectively they gain from the opportunities that arise from a better-endowed workforce.

To align the interests of all, it is necessary to revise our public housing strategy to allow all households that cannot afford homeownership to become homeowners at the earliest possible instance. A city of homeowners will welcome immigrants because the benefits of economic prosperity that immigrants bring will then be shared by all through rising housing values. It might even induce some young highly skilled immigrants with low incomes to return to Hong Kong. In a crucial sense, reforming public housing policy holds the key to unlocking the virtuous circle of fostering prosperity with equity.

Privatizing public rental housing and replacing it with subsidized ownership units would be the first step in narrowing the enormous wealth gap in Hong Kong and unlocking resources for public investment in human capital and for sustaining our many welfare programs.

The free enterprise system is the greatest asset Hong Kong possesses. Although society and markets occasionally struggle to adjust fast enough to rapid changes, we can draw guidance from the doctrine of positive non-interventionism, which instructively tells us that now may be the time to make the relevant policy changes. Sir Philip Haddon-Cave once explained:

I have frequently described the government's policy stance as being that of 'positive non-interventionism'... some have claimed that this is really just a fancy term for laissez-faire ... This is simply not so: positive non-interventionism involves taking the view that it is *normally* [emphasis in original] futile and damaging to the growth rate of an economy, particularly an open-economy, for the Government to attempt to plan the allocation of resources available to the private sector and to frustrate the operation of market forces, no matter how uncomfortable may be their short term consequences.

But, he went on to explain, when a positive and cogent case is made for intervention, the government would intervene robustly but only to the minimum necessary to address the mischief. Positive non-interventionism raises a strong burden of proof against government interference, but it is not an immutable rule prohibiting any government intervention when necessary. The case was justified in the aftermath of the 1967 disturbances. I hope a convincing case for intervention has been made in this volume; and to do so in ways that preserves the vitality and virtues of a free market economy. Needless to say, Haddon-Cave would have cautioned only to do the minimum necessary.

Reference

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