

# Diversity and Occasional Anarchy

*On Deep Economic and Social Contradictions in Hong Kong*

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# 1

## The Panama Syndrome and the Origins of Deep Contradictions

When Premier Wen Jiabao met with Hong Kong SAR Chief Executive Tsang Yam-kuen in Beijing in 2005, he diagnosed Hong Kong as having deep contradictions that needed to be addressed. But what are these contradictions? Premier Wen did not offer any specifics, although in a 2010 press conference he elaborated on challenges and solutions that relate to the contradictions.

Premier Wen laid out five issues that Hong Kong needed to address: “First, how to build on existing advantages and continue to maintain and develop Hong Kong’s position as a financial center, shipping center, and trade center. Second, how to develop competitive industries that are appropriate for Hong Kong, especially in the services sector. Third, how to take advantage of Hong Kong’s proximity to the Mainland and further strengthen linkages with the Pearl River Delta. The Mainland’s vast market and rapid economic development present enormous potential for Hong Kong. Fourth, the people of Hong Kong should accommodate differences, build consensus, develop solidarity, and maintain Hong Kong’s prosperity and stability. Hong Kong will not only make huge advances in its economy, but will also develop democratic politics in accordance with the principle of gradual and orderly progress specified in the Basic Law. Fifth, focus on improving people’s livelihood and the development of education.”

The first three of these issues relate directly to Hong Kong’s position at the frontline of China’s opening up and at the interface of the country’s ongoing integration into the world economy. Hong Kong in effect has a challenge of dual integration—reintegrating with the Mainland and sustaining Hong Kong’s integration with the world economy. The other two issues cited by Wen relate to internal stresses that would inevitably arise in the process of dual integration: the need for Hong Kong to make public policy decisions in politics more inclusive and to regard issues related to people’s livelihood and education as solutions.

Many of the economic and social changes Hong Kong faces today are the consequences of China's opening up and its integration into the world economy. In a profound sense the origins of Hong Kong's deep contradictions stem from the broader phenomenon of the rise of the emerging economies on the global landscape. This brings both opportunities and challenges.

## Life in a Connecting World

### *A Panama Canal analogy*

The most significant global economic development of the past 30 years has been the momentous rise of China, India, the former Soviet Union and East European countries, and Latin America and Africa. Economies that were previously not connected to the global market economy have become its fastest growing members. By the middle of the twenty-first century, the new emerging economies will overtake the old developed economies in terms of total economic output. The sheer scale of this development means everyone will have to adjust and adapt to the new order. The China–Hong Kong nexus is simply an advance and concentrated version of this unfolding story. But it means the economic and social consequences for Hong Kong will be greatly magnified.

Hong Kong's situation can be usefully compared to the Panama Canal. The surface water levels on both sides of the Panama Isthmus—the Atlantic and Pacific sides—are different. The Panama Canal connects the two oceans and is designed with three sets of locks to let ships pass, but not the ocean waters. Without the system of locks, Panama would be submerged as the waters of the two oceans rushed toward each other and became connected.

Hong Kong, like the Panama Isthmus, has two sides—China and the world economy. Hong Kong connects the two economies, but it does so by having in place its own system of locks to prevent water flowing freely between the two oceans. If this free flow were to happen, we would have to ask whether the system of locks was fit for purpose and whether it should be reconfigured. Indeed, there are several dangers ahead for Hong Kong.

First is the problem of water level equalization. The Panama Canal was never intended to equalize the surface water levels of the two oceans, but as China continues to integrate into the world economy, the two “oceans” sitting on either side of Hong Kong will indeed begin to equalize. The completion of this integration will be a momentous event for the world, but it will also mean

Hong Kong's system of locks becomes superfluous and will have to be eventually dismantled.

Hong Kong must appreciate what its future holds and prepare for this. It has to make plans toward raising its ground surface level in order to avoid being submerged. For example, its residents must prepare themselves by gaining the necessary human and non-human capital wealth needed to survive in such an economic future. The city must also re-design its system of locks with a view to retaining flexibility for their eventual disappearance. The system of locks in the Panama Canal is fixed and not designed with such a purpose, but this will not do for Hong Kong in a rapidly changing world.

Second, canal locks let ships pass but do not allow water to flow freely. But what exists in Hong Kong is a system that sometimes allows the water to flow instead of the ships to pass. This paradoxical situation arises because the system does not completely fit the purpose of connecting China to the world economy. For example, Hong Kong's free market economy is ideal for this task, but its welfare state system is not. The challenge for Hong Kong is to reconfigure its system of locks so that it will wither away or be easily dismantled when it has outlived its usefulness.

Third, mainland China's economy has its own system of locks that makes it appear to be a "honeycomb economy," where many markets have barriers to entry that are not always transparent. Hong Kong's role is to help open these markets and thus help open or change the locks on the Mainland, but it also has to avoid being submerged when the mainland markets fully open up. The world today is learning to live with a rising tide of emerging nations, especially China. Hong Kong is in the unenviable position of being at the frontline and thus being the first to have to deal with the effects.

### *Cause or effect?*

Some of the salient features of Hong Kong's development over the past 30 years have been: alternating episodes of inflation and deflation due to external shocks, the division of society into "haves" and "have-nots" due to rising property prices, an ageing population, a workforce with rising numbers of less skilled workers, slowing productivity growth, rising poverty and income inequality, and welfare arbitrage. Are these features outcomes of the underlying forces that are changing Hong Kong's society? Are they themselves the contradictions? To the person in the street, they may appear to be so. But from another angle they can be viewed as the manifestations of deep contradictions.

Distinguishing between outcomes and underlying factors is important because treating the outcomes alone may not resolve the problems. At best this may provide temporary relief and at worst it could aggravate the contradictions. It is therefore better to analyze these underlying factors so as to identify solutions that address both the deep contradictions and their manifestations.

This essay is a broad analysis of Hong Kong's encounter with China's opening up using the analytic narrative method that combines historical narratives with the application of political economy analysis.

## **The Challenges of Dual Integration**

### *The need for integration*

Hong Kong's deep contradictions have arisen from the need to reintegrate with the Mainland after China's opening up. This has in fact given rise to a "dual integration" of having to adjust from being integrated with the global market economy to being integrated with both the Mainland and the global market economy.

Reintegrating with China is both a preference and an inevitability. It is a preferred choice because Hong Kong has always recognized that a city economy must engage the outside world and produce goods and services that can be exported if it is to sustain a high level of economic development. The city market is too small to allow for the division of labor and specialization required to support a high standard of living, so an outward looking entrepreneurial orientation is a necessity.

Reintegration is also inevitable because Hong Kong has an open economy and society that cannot be isolated from external influences. Its institutions are primarily designed to embrace the external world and this orientation has become part of Hong Kong's economic and social culture. If the city were insulated from the outside world, it would be forced to accept a lower level of prosperity and miss many economic and social opportunities.

These opportunities include having access to a growing middle class market. The recently released Global Trends 2030 estimates that 160 million people or 12% of the Chinese population are middle class consumers. By 2030, the proportion may be 74%.

Dual integration with the world and China has to be the best choice for Hong Kong. However, while this brings opportunities, it also gives rise to challenges.

Hong Kong will have to develop and adapt its institutions and infrastructure to meet the requirements of both kinds of external economic engagement.

### *Institutions and infrastructure for opening up to the world*

Integration means investing in various types of hard infrastructure such as airports, ports, high speed railways, telecommunications, information technology infrastructure, and the like to facilitate connectivity with the outside world. It also requires soft infrastructure skills, such as English language proficiency and knowledge of foreign cultures and arts to communicate effectively with the international world, and Chinese language proficiency and familiarity with contemporary Chinese culture and arts to engage effectively with people from the Mainland.

More importantly, integration means we need to preserve institutions such as the rule of law, free and competitive markets, and a low and simple tax regime, if we wish to be well connected with the mainland economy and provide an ideal benchmark for China to aim for as it pursues its own integration with the world economy.

An often neglected element of soft infrastructure that is particularly relevant in this case is the lowering or harmonization of regulatory barriers, for example, tax treaties, accounting practices, limits on the movement of people across borders, health and safety standards, foreign exchange and capital controls, and a myriad other regulations. Some of them are economy-wide but many are specific to particular industries or professions.

As a general rule, reducing or harmonizing regulatory barriers facilitates connectivity with the rest of the world. This is an on-going evolutionary process as regulation patterns around the world change continuously. In China's case, it often means creating workable engagement platforms that are half-way between lowering regulatory barriers to open markets and modifying some barriers to avoid too much market disruption. Hong Kong must engage the Mainland when these platforms are being formed.

One particular difficulty for Hong Kong in respect to the role of regulating integration is the different ways in which its fast-moving profit-oriented economic sector and its slow-moving subsidized social sector respond to change, which often leads to conflicting policy choices. This is an issue I will return to later in this essay.

Regulation tends to stem from the fact that while there are economic gains to be had from reintegration, not every group or sector in society will benefit equally. Some will make enormous gains and some may even be harmed. Although reintegration will still be preferred, insofar as the total benefits outweigh total losses, the resulting economic inequality requires the adoption of remedial measures to compensate those who are harmed, so as to avoid deep internal divisions and active opposition to change and to dual integration. An even better approach would be to put in place forward-looking policies that can reduce or avoid such pains ahead of time; however, that rarely happens.

The success of reintegration depends on many factors: the initial economic gap between Hong Kong and the Mainland, the size of China's economy, the speed of China's growth and opening up, and the capacity of Hong Kong's leadership to guide and steer change and dual integration.

In 1979, the economic gap between Hong Kong and the Mainland was substantial. Hong Kong's development path tied its economy to the world. Its product, labor, capital, and money markets were fully integrated with the global economy through its free port, unfettered capital flows, highly mobile population, and the linked exchange rate regime. And its prices, wages, and interest rates were all basically aligned with the world market.

The only significant exceptions were land prices, property prices and rentals, where the availability of a key resource—land—was (and continues to be) largely determined by government policies and legal-administrative rules. Government ownership of land and its regulation of supply have led to multiple distortions arising from planning rules, zoning plans, building codes, rent controls, and the public provision of housing. The detailed regulatory distortion of land resources is one of two key elements that have critically shaped the path of Hong Kong's reintegration with China. The other is Hong Kong's adherence to an open economy, including the linked exchange rate system.

This deep internal contradiction—of regulation and openness—has had an explosive result for Hong Kong that has intensified the challenge of managing dual integration. External macroeconomic and financial shocks have been transmitted through the linked exchange rate system to property prices, the effects of which have been amplified by stubborn planning rules, building regulations, land supply restrictions, environmental protection and conservation requirements, and public housing programs that freeze large amounts of land resources.

Fortunately this situation also paradoxically creates an unprecedented opportunity to improve matters. It is the opportunity to reconfigure our policies, create new institutional platforms to facilitate reintegration with the Mainland, and support China's integration into the world economy. In other words, Hong Kong has to learn to reconfigure its system of locks into a new design.

### *Institutional platforms and reintegration with the Mainland*

Economic reintegration with the Mainland is necessarily challenging because from 1949 to 1979 China's economy was essentially closed. Thirty years of isolation meant that China's prices, wages, interest rates, and rentals, if they existed at all, had to be very different from those in the world market and therefore in Hong Kong. Reintegration in practice meant that large gaps in demand and supply emerged as the market opened up, exposing imbalances in both business and non-business activities.

Given the enormous size of China's economy, Hong Kong has had to adjust by accommodating China's market demands and supporting its continued integration into the world economy. This requires an unending process of institutional innovation to manage and regulate market imbalances in all spheres of life. This is a new experience and challenge for Hong Kong.

In the very long run, full integration requires Hong Kong prices to eventually converge to Chinese prices; of course, when China has successfully aligned its economy with the world economy these will be world prices. This is the law of one price. The faster China opens up and grows, the greater the need for Hong Kong to respond swiftly and appropriately to meet the demands of reintegration. The pace of development in China in the past 30 years has been phenomenally rapid and unprecedented in human history. Hong Kong's challenge is therefore also an unprecedented one: to pull all possible levers to achieve dual integration.

Hong Kong is not inexperienced at working with managed or regulated markets. For many decades it had to work with the US Commerce Department on textile and garment quotas using the institutional platform created by the Multi-Fiber Agreement. There used to be a running joke that the Trade Department's only important job was to work on matters related to this single agreement. This is obviously an exaggeration, but it reveals the enormous

transactions cost of building and working with such platforms. By all accounts Hong Kong navigated the Multi-Fiber Agreement with distinction and performed better than any other textile and garment exporting economy in the world. Hong Kong should revisit this episode of its trade history and study the creative institutional response it adopted in the face of such adversity.

But generally, in the past, selling to the world simply meant marketing to clients overseas. This is what the Hong Kong Trade Development Council (HKTDC) has been doing for many years. Today, though, entering China's market means overcoming barriers to entry. It requires creating many new institutional platforms for managing each business and profession, and investing considerable public effort and administrative cost in these platforms. Given Hong Kong's diverse economy, the challenges are very real. The Mainland and Hong Kong Closer Economic Partnership Arrangement (CEPA) provides an overarching platform; nonetheless, it requires agreement on specific details in each market to make it effective and functional.

### *Positive non-interventionism is still relevant*

The need to manage market imbalances has mushroomed with China's opening up and places new demands on the work of government. The faster China opens up and grows, the greater the demands on government. Yet the bureaucracy appears to be a slow bungling laggard. Big business at times is able to forge ahead without the support of government platforms and this has become a complaint of other businesses that lack such capacity.

Designing institutional platforms requires innovation of the highest order and a lot of capacity building. The platforms have to be orderly, transparent, predictable, and open to all participants. They function like pseudo markets to create order when there is excess demand or excess supply. Their job is to allocate resources when prices cease to clear markets or when markets cannot function properly. As China continues to open up and grow, the institutional platforms will need to evolve and adapt to new supply and demand conditions. Institutional innovation has to be an on-going process until markets can function properly again, that is, when prices can once again equilibrate supply and demand. At that stage, the greatest challenge will be the capacity to retire institutional platforms that have outlived their usefulness.

This seemingly more active role by government begs the question: is positive non-interventionism now out of date as many have claimed? Quite the contrary, it is more relevant than ever. Hong Kong's dual integration means it continues to face the difficult challenge of reintegrating with China without creating disruptive shocks in the face of enormous imbalances in demand and supply. Such shocks could potentially mean the market ceases to work. So more than ever, Hong Kong needs to build and operate new institutional platforms whose task is to resolve the resource allocation problem outside the marketplace. This is a situation when government intervention is appropriate and therefore "positive."

The next question concerns how we should design and operate such platforms. Here, the market principles of rule-based orderliness, transparency, predictability, and open access become important and relevant. What should be avoided are *ad hoc* policy interventions that come across as exercises in crisis management. These new platforms should be designed accountably and in a manner that balances the interests of both service providers and service consumers; and between locals and outsiders.

The cardinal role of the government in building and operating such institutional platforms is to ensure open and equal access for all. The government performs the role of the referee rather than the advocate or the selector of winners. This is desirable for three reasons. First, a neutral referee means the government will be an honest broker and its role will command authority and respect by all participants.

Second, as an honest broker the government will be the only credible authority to retire an institutional platform once it has outlived its usefulness. This ensures that these platforms do not become a source of future inefficiency used to protect vested interests.

And third, while such platforms would be built specifically for Hong Kong to engage with the Mainland, it would be even more beneficial if they could be designed to be non-discriminatory from the outset so that the platforms would also help China to integrate with the world. The success of this function would depend on whether the government is perceived as an honest referee of all interests or an advocate of narrow local provider interests. Being seen as a referee would align with Hong Kong's mission of dual integration.

## Human Capital for Sustainability: Growth and Equity

### *Watering down human capital*

Another effect of China's opening up was the arrival of large numbers of unskilled immigrants. Over a two-year period in 1978–80, some 300,000 unskilled migrants came across the border to settle in Hong Kong. The pressures on social services and the labor market were overwhelming. Negotiations were initiated with the mainland authorities to regulate the inflow, which ended Hong Kong's reach-base policy for mainland arrivals.

In its place, a one-way permit scheme was introduced and administered by the mainland authorities to allow 75 individuals to enter Hong Kong every day, a figure that increased to 150 per day by 1995. To date, about 1.3 million new immigrants have entered Hong Kong under this system, mostly spouses and children of Hong Kong residents who married across the border, bringing the total number of new immigrants who have entered Hong Kong since China's opening up to 1.6 million.

On average, the new adult immigrant is less educated than the Hong Kong population. Therefore, while China's opening up created economic opportunities for the people of Hong Kong, it also led to a massive influx of unskilled new immigrants that has lowered the average stock of human capital in Hong Kong. The incomes of these immigrants are low and have not grown as fast as the rest of the population, resulting in a less equal distribution of income as the lower tail is stuck in low productivity. In terms of economic growth, Hong Kong lags behind Singapore, which has successfully attracted large numbers of highly skilled immigrants from China. Although Hong Kong's large body of new immigrants is familiar with the Mainland, most are too unskilled to take advantage of the opportunities there.

Hong Kong has yet to develop a population policy to attract skilled immigrants on a much larger scale and with greater effectiveness. Several admissions schemes have been introduced but none are adequate for the task. The best scheme is the university admissions of overseas students, but the lack of student hostels has compromised its effectiveness.

### *Investments in human capital*

To sustain a rising standard of living and continuous economic growth, the productivity of the city's population must increase. This requires investment in human capital. Investing in education by developing our educational institutions, inviting foreign educational institutions to partner with local ones, and supporting citizens to study abroad are examples of effective policy choices. These investments are not only good for economic growth but also for creating a more equitable society with greater equal access for all. The US experience best illustrates this case.

The US was a relatively poor country over much of the nineteenth century, but in the latter part of that century and throughout the twentieth century, it overtook the UK and other major European countries in per-capita GDP. Throughout that period, the US also developed a considerable lead over Europe in the schooling attainment of its labor force, especially at the higher education level. The lead remained significant through most of the twentieth century, although in the last couple of decades it has narrowed. The higher educational attainments in the US were perhaps the major reason why the country overtook Europe and became the economic superpower of the twentieth century. It also explains why the US was considered in the past century to be a place of opportunity for all and especially the less privileged in society.

### *Attracting skills and talents*

Another method for augmenting human capital is to import talent. New York City and London are magnets for talent from all over the US and UK, and also from foreign countries. Major economic cities are almost always located in large populous countries where they can easily attract national talent from the rest of the country. Small sparsely populated countries seldom have major economic cities.

Just as cities in a large country can benefit from the inflow of people from the rest of the country, they also need an influx of foreign talent to offset the detrimental effects of an ageing population. Many countries are experiencing this problem due to the post-World War II baby boom effect. The share of the working population is beginning to decline, which is bad for sustaining economic growth. Countries that are able to attract population inflows have the opportunity to offset the ageing effect.

However, international economic cities can only emerge when their governments recognize the value of implementing a liberal immigration policy that attracts foreign talent. Investment is also needed in social and cultural amenities such as quality international schooling.

Singapore, a city state, has aggressively pursued a population policy to attract skilled foreign nationals to counteract the ageing of its local population and achieve racial balance. Hong Kong has failed to develop an analogous population policy and it is apprehensive about the inflow of people from the Mainland. Those admitted are mainly allowed in for family reunion purposes and, as mentioned, they tend to be unskilled.

## Prices in a Connecting World

### *Haves and have-nots*

The opening up of China was a momentous event for Hong Kong. It precipitated a total transformation of our industrial structure. Manufacturing moved and expanded across the border, labor was redeployed into producer services to support that manufacturing base, and at the end of the process Hong Kong became a total service economy.

During the transformation period, wages rose rapidly as productivity increased across all sectors. The benefits of China's opening up therefore were broadly shared. Rising incomes and wealth fuelled the demand for all goods and services. Non-traded services that could not be imported experienced a rapid increase in prices and wages. Property prices also went up, especially for domestic premises, which were, of course, also a form of non-traded service. All those who became property owners during the 1980s and early 1990s became the new "haves" in society. But since the mid-1990s it has become more difficult to become a property owner for one reason or another. Many are still "have-nots."

At present only 36.2% of the households in Hong Kong are homeowners occupying private residential premises. The critical reason why the proportion of the "haves" is so low is that 45.8% of the households live in publicly provided housing units, where 15.5% live in Home Ownership Scheme (HOS) units and 30.3% live in Public Rental Housing (PRH) units. The remaining 18.0% lives in privately rented accommodation. It is enticing for households to live in HOS or PRH units because of the large subsidy involved, but the problem is that they

do not have ownership of these units. This is a particular issue for HOS owners who, despite the title of the scheme, are not bona fide property owners. They are not free to sell the units they ostensibly “own” unless they have repaid the unpaid land premium to the government.

For the vast majority of HOS occupants, this is simply not affordable. They are trapped there with little hope of being able to exit the system. Yet it would not be difficult to change their predicament if the government were willing to sell them the units they occupy at an affordable discount and, at the same time, either free them of the obligation to repay the unpaid land premium or set it at a meaningful level from the perspective of the occupant. This is what Singapore has done.

Another factor affecting property ownership is property prices, which have escalated over the past three decades for both internal and external reasons. The most important internal reason is the regulatory rigidities governing Hong Kong’s land supply and housing construction process. This is a vast subject that cannot be well covered here, but I plan to address it further in another volume of essays. The key issues about rigidities are the regulations themselves and the regulatory institutions. The entire process of regulatory approval is highly politicized with many interest groups working to achieve different and conflicting objectives. The result is delayed decisions that reduce the supply of housing and property. The rigidities on the supply side greatly amplify the asset price effects in the face of demand shocks from external sources. Our linked exchange rate system plays an important role in transmitting these demand shocks.

### *Moment of truth with the linked rate*

Every economy that connects with the global economy has to decide whether to float its currency or fix its value against that of some other currency. For almost its entire history Hong Kong has adopted a fixed exchange rate regime through its adherence to the currency board system. The advantage of such an arrangement has been to facilitate a close integration with the world’s economies by removing uncertainty about the exchange rate or currency value. It also adheres to Hong Kong’s overall strategy of sustaining economic growth through an outward oriented development path.

A fixed exchange rate regime, however, requires Hong Kong to maintain tight discipline in the conduct of its fiscal and bank credit policies. This means

Hong Kong no longer has autonomy to conduct its monetary policy. Monetary policy becomes purely passive and adapts to international capital flows in the balance of payments. The linked exchange rate also means that Hong Kong's nominal interest rate cannot diverge from that of its peg, the US nominal interest rate.

The consequence of this policy is that Hong Kong has endured two prolonged episodes of inflationary pressure and one of deflationary pressure in the last 30 years, all instigated by external events. China's opening up at a time when US nominal interest rates were low helped fuel a period of high inflation in Hong Kong from the late 1980s to the mid-1990s. The Asian financial crisis precipitated a period of deflation that lasted until 2003 and ended only after US interest rates had hit bottom and the US dollar began to soften. The global financial tsunami of 2008 led to another era of low US nominal interest rates and a weak US dollar, resulting in the reappearance of price inflation in Hong Kong.

### *Managing credit risks and asset price bubbles*

These external developments and shocks have contributed enormously to rising and falling property prices in Hong Kong. This has put enormous stress on banking system and explains why the Hong Kong Monetary Authority has periodically intervened to regulate bank credit policy, especially the loan-to-value ratios on mortgage loans, in order to manage the risks of systemic failure in the banking sector. One of the consequences of such regulation has been to make it more difficult for low-and middle-income families to purchase homes.

As with government housing policy, over the long term the management of credit risk in the banking system has contributed to a divided society of rich property owners and poor non-owners; between those who are "haves" and those who are "have-nots." It makes "unity" and "stability" challenging, if not impossible, to achieve in our community. Our commitment to the linked exchange rate therefore requires us to manage more pro-actively all the resulting economic, social, and political risks; and not just bank credit risk.

It is worth noting that the effects of external demand shocks on asset prices cascade down quick-moving financial markets, while supply adjustments work slowly through real housing and property markets that involve "brick-and-mortar operations" and have to grapple with "regulatory rigidities."

Macroeconomic stabilization policies have always been a huge challenge because different markets have uncertain and variable time lags. To believe that government can successfully achieve stabilization by varying the supply of property and housing is to hope for more than one miracle.

## Positive Non-Interventionism and Fiscal Rectitude

### *Fiscal prudence and external macroeconomic shocks*

A critical element of risk management for long-term macroeconomic stability under the linked exchange rate regime is fiscal prudence and conservative budget management by the government. Government spending entails permanent commitments that cannot be easily reversed in the short run. Whenever a severe external economic shock occurs, it can be a source of comfort if there are fiscal reserves to maintain government spending without having to resort to deficit financing.

Cash handouts for the poor that have been adversely affected by macroeconomic shocks have a useful purpose. They are fast to implement and easy to target. They are more likely to be temporary in nature so that it is possible to retire the handout measures when macroeconomic conditions reverse, as they inevitably do. Social programs that help the poor always become permanent and are seldom, if ever, retired even when they have outlived their use. A justification for their continued existence can always be found.

Fiscal prudence also means that whenever a positive economic shock buoys the economy and government revenues, the government maintains discipline and resists the temptation to provide permanent populist handouts to social groups, professional bodies, and business interests. Without such fiscal discipline, government would tend to fall into chronic deficits and public debt piles up. Fiscal discipline is a necessary condition for economic stability for an economy that has a linked exchange rate system.

Positive non-interventionism is both a policy and an economic ideology, and it gives respectability to the idea that it is usually better to let markets resolve problems over time rather than to rely heavily on the government, unless there is convincing evidence to do otherwise.

### *Wisdom of a limited government*

Over the years positive non-interventionism has been softened around the edges as the government has responded to greater representation in the Legislative Council and to more intransigent lobbying groups. The role of government has been re-conceptualized as “maximum support, minimum intervention, and fiscal prudence,” “a proactive market enabler,” “market leads, government facilitates,” and “small government, big market.” Nevertheless, the commitment to an essentially limited government role in the economy continues.

The re-conceptualization of the government’s role sees it keeping a level-headed approach with various interest groups and lobbyists, who clamor for benefits and come armed with many persuasive reasons for why they should receive them. Fiscal prudence remains a necessary governance and management tool for a small, open economy with a fixed exchange rate. Adherence to a policy of positive non-interventionism provides the rationale and legitimacy for government to say no to interest groups and lobbyists when it is appropriate.

The Hong Kong government’s bureaucracy is also well constituted and well trained to refuse to be overwhelmed by such requests. No doubt some are beginning to question why they have to be put in the hot seat and take the blame all the time, and some may be softening their resolve to resist some of the more persuasive lobbyists. Nevertheless, positive non-interventionism is, in general, a good economic ideology and a critical one for an open city economy with a fixed exchange rate.

Another benefit of positive non-interventionism is that it provides a legitimate cover for an administration wary of intervening too aggressively in the affairs of private businesses and individuals when its own political legitimacy to govern may be challenged. This was Hong Kong’s fate as a British colony, and a fate that the Special Administrative Region is still in the process of shedding. If today’s administration needs a new economic ideology, then it also needs to rethink how it can be made more legitimate through greater accountability. It needs to rethink what this new economic ideology might be, and how it will gain acceptance in a society that is divided and a political system that is still in transition. A populist ideology may help at the ballot box, but it may not bring sustainable benefits for all.

## Social Services and Welfare Arbitrage

### *Welfare arbitrage*

Welfare arbitrage occurs when a person is interested in leaving a group or community to join another one to take advantage of the more generous welfare benefits that is being offered. In Hong Kong, it is the result of China's opening up and Hong Kong's generous provision of subsidies to the social sector. There is a large element of subsidy in housing, education, health care, social services, and domestic transportation here and the government also provides a substantial component of such services directly. They are straining the city's resources. The rising demand for such services and the lack of productivity growth in some of these sectors means that most of them will, over time, absorb a growing share of Hong Kong's resources. To continue with the current funding mode would mean a significant increase in government expenditure. And when government expenditure increases as a share of the economy, our growth rate is likely to suffer and our ability to manage external shocks will be compromised. This inherent contradiction is not fully appreciated by the public, which see huge government fiscal surpluses but are not aware of the hidden liabilities.

On the other hand, the growing proportion of unskilled new immigrants in our population is increasing the demand for subsidized services and is exacerbating the inherent contradiction. Hong Kong's open society and generous welfare benefits encourage cross-border marriages. But while China's opening up has been a blessing for many local residents, the arrival of new immigrants has become a source of internal divisiveness because of the pressure they put on subsidized services in the social sector.

Hong Kong's welfare benefits appeal to mainland immigrants and encourage cross-border welfare arbitrage. One example of this is our prisons, where there are inmates with tuberculosis who entered Hong Kong to purposely commit a crime and be incarcerated so as to gain access to free medical treatment for their disease. Our welfare benefits are a magnet for low skilled and low productivity immigrants and visitors.

The problem is worsened by the one-way permit system that restricts Hong Kong to 150 new immigrants per day. As a consequence, most families have to be separated by the border for long periods of time. This measure may reduce the short-term pressure on welfare services, but it only compounds the problem further down the road. When the families are eventually united,

the new immigrants are often poorly prepared for life in Hong Kong and can become a bigger burden for society.

The heavily subsidized sectors have often been slow and reluctant to respond to the rising demands from new immigrants. They naturally resist growing their services without additional public subsidies, while the government struggles to respond with the usual limited resources. These are difficult issues where imaginative, coherent, and bold breakthrough solutions are sorely needed but are not easy to find. Hong Kong will continue to be subject to welfare arbitrage and attract unskilled immigrants as long as generous welfare benefits are provided.

A humane long-term policy solution requires a fundamental rethinking of Hong Kong's policies on subsidized social services. It is neither desirable nor appropriate to address welfare arbitrage by solely relying on a cap and control approach that limits the daily inflow of new immigrants. Instead we need a comprehensive population policy to attract skilled immigrants, invest in the education of residents, and redefine who has access to what kinds of welfare benefits in Hong Kong. It is worth noting that the massive migration of China's rural population into the cities over the past 30 years was made politically feasible because the cities denied most welfare benefits to newcomers. The sooner we address these issues in Hong Kong, the better off the city will be in the longer run.

## Charting the Way Forward

We can better understand Hong Kong's deep contradictions if we recognize from the outset that they originate from the need and opportunity to achieve dual integration—that is, to reintegrate with the Mainland after it began to open up in 1979 and to support its integration into the global economy. The challenge is to open up the system of locks on the Mainland and to redesign and reconfigure the system of locks in Hong Kong where necessary and appropriate. Hong Kong's rule of law and free enterprise market economy are vital core competencies to support our new role.

In the first 15 years of China's opening up, the reintegration process was relatively painless and mostly positive for Hong Kong. During this period, the primary mode of reintegration was the outflow of capital and management expertise to the Mainland. As an international economic city with considerable entrepreneurial talent, the role was easily taken up by Hong Kong's small and

medium businesses. There was little need for government involvement in the process. This was a period when reintegration did not require the creation of institutional platforms for engagement.

In the subsequent 15 years, the reintegration pains grew visibly over time. First, there was conscious political apprehension about economic and social reintegration after the restoration of sovereignty over Hong Kong from Britain to China. Second, Hong Kong became busy managing external shocks originating from the global economy. Third, economic reintegration increasingly entailed overcoming political-administrative barriers to entry on the Mainland. This favored big business as many small and medium enterprises in the service sector lacked the critical skills to overcome these barriers. The economic benefits of relocating manufacturing across the border had petered out, and there was a failure to build new institutional platforms to support cross-border engagement in the growing service economy, which led to an impasse and slow progress in almost all service areas except the high profile financial sector and the export of tourist services. And fourth, the arrival of new immigrants in Hong Kong and the southward movement of labor came to replace the northward movement of capital. Most of these new immigrants proved incapable of sparking new economic activities.

The need for new institutional platforms to engage with China is not the only challenge for Hong Kong's service economy. Many services in Hong Kong—including housing, education, health care, water services, transportation services, and so on—are either subsidized or publicly provided as a form of protection. If we use the Panama Canal analogy, they are the locks that Hong Kong created in the past to act as buffer against the shocks that emanate from the world economy. But it is no longer obvious that they are fit for purpose in the reintegration with China—in fact, the subsidized sector at times conflicts directly with that goal.

Social service providers are heavily dependent on public finance and so they understandably focus on their local clients. These clients regard the expanding engagement with the Mainland with caution because they see it as giving rise to competition for subsidized resources. In some cases this has prompted public hostility, as seen in the prominent example of mainland mothers who want to give birth in Hong Kong. In order to avoid disruptive shocks that can be economically, socially, and politically divisive, reintegration needs to be gradual. Managing demand and supply imbalances through new institutional platforms is equivalent to imposing a form of non-market order.

The differing responses of Hong Kong's economic and social sectors to the opening up of China could be seen as another manifestation of the deep contradictions in the city. The subsidized social sector sees reintegration as a source of competition for their limited resources and wants government to better insulate it from the effects of reintegration, while the private economic sector sees opportunities and welcomes the formation of new institutional platforms for engaging with the Mainland, yet increasingly looks to the government for help in overcoming barriers to entering the mainland market. Both sectors want new institutional platforms, but for different purposes.

Viewed through the lens of an economist, both sectors are responding to the shifts in demand for their services resulting from China's opening up. In the economic sector, successful entrepreneurs want to grow their business. Resources are being redeployed to areas of rapidly growing demand. A process of creative destruction is taking place, although not all businesses are impacted equally and beneficially. For example, the growth of tourist-related service exports bids up retail rents that has adverse effects for other businesses due to the more limited supply of retail space. For other businesses, their desire to sell to the China market is premised upon breaking through formidable regulatory barriers of entry. Economic reintegration with the Mainland requires the Hong Kong government to build its capacity in opening up markets on the Mainland.

Social services providers are very familiar with managing excess demand and instinctively know the name of the game is rationing. The emergence of new demand is troublesome only because it upsets their established methods for rationing their services. New rules have to be devised which means re-prioritizing access to subsidized social services. The sector would naturally want to set up barriers to prevent access by outsiders. The challenge is to devise operational rules that are not protectionist but allow subsidized services to be provided to locals who are taxpayers, while unsubsidized services are offered to outsiders.

The task of managing dual integration has certainly been made more difficult in the post-1997 era by Hong Kong having to navigate not only the political transition, but also two financial crises and the SARS epidemic. Economic growth has been constrained by slow progress in building up the appropriate stock of human capital. The influx of largely unskilled new immigrants has worrying long-term consequences, particularly in the areas of education, health care, and housing. The supply of some of these services has even fallen behind the growth in demand.

Rising and falling global interest rates and exchange rates have also brought great turmoil to our property markets, both residential and commercial. The migration of manufacturing operations across the border after China's opening up has rendered our industrial properties no longer fit for purpose. Our planning and land conversion rules have remained inflexible, and this rigidity has been a critical factor why property prices have skyrocketed in recent years. This is affecting not only livelihood issues, but also the economic competitiveness of our economy. The damaging impacts have convinced me that it is necessary for Hong Kong to commence the sale of all subsidized housing units to their occupants at an inexpensive price and set the land premium at a very modest level to jumpstart Hong Kong's future.

Those who are leading Hong Kong must devise a coherent and comprehensive strategy at the conceptual level to articulate the aims and goals of the Hong Kong SAR Government in managing and operating new and redesigned institutional platforms. Politicians, who are involved in the thick of battle, respond to client requests and struggle anxiously to keep their constituents happy, and they are poorly suited to finding the appropriate solutions. Mr. C. H. Tung recognized the importance of mapping the way forward for Hong Kong during his tenure as Chief Executive, but his groundwork does not appear to have taken off. Focusing our thoughts on the way forward is the most important task for Hong Kong.

The essays collected in this volume address some of the deep concerns raised here and the issues Hong Kong needs to consider as it looks to its future. They examine: (1) the development requirements of a city economy and its vulnerabilities to external shocks, (2) the structures and institutions of the domestic economy and their responsiveness to external shocks and capacity to sustain growth and maintain stability, (3) some anomalies of political accountability and its adequacy in legitimizing policies and policy changes; and (4) the advantages and disadvantages of simultaneously being a part of the world economy and seeking to become a more integrated part of China's economy. The essays, which were originally published in the *Hong Kong Economic Journal*, deal with how Hong Kong has so far managed the challenge of dual integration. Each essay has its own orientation and language, so it is inevitable that they do not appear as coherent as I would like them to be, but they reflect my thoughts on these pressing issues.

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