

# GOVERNMENT'S ROLE IN ENHANCING COMPETITIVENESS

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## *Introduction*

1. Starting from basic economic principles, this paper examines what can be done to increase Hong Kong's competitiveness. The Government can adopt administrative measures as well as pecuniary ones such as tax cuts, infrastructure construction and direct incentives and assistance to businesses. The Budgetary considerations are covered more fully in the paper *Restructuring housing assistance: benefits for Budget and economy* by the same authors.

## *Role of government*

2. In general, government should do whatever would make society better off, wherever the private sector cannot do as well, i.e. as cost-effectively, if left to itself.

3. Subject to the above basic criterion, the government would take measures and deploy public funds to: (A) provide cost-effective public goods and services for consumption, (B) effecting transfers of wealth, ensure that the less well-off enjoy basic standards of living, such as in housing, (C) see to it that markets work as efficiently and equitably as possible, (D) conduct, where appropriate, macro-economic monetary and fiscal policies, basically for adjustments within an economic cycle, and (E) endeavour, on a longer-term basis, to increase value-added by the economy, i.e. to

increase employment (until full employment is reached) and output per capita (i.e. productivity) and hence the standard of living. For a small externally oriented economy in a global market, competitiveness is the ability to generate value-added sustainably and cost-effectively in a global context.

### ***External balance test***

4. Where government acts in pursuance of (E), three criteria or tests have to be met. The first is that, given Hong Kong's import-dependent economy, such action should, over the longer if not short term, at least not worsen the external balance. This does not mean that such endeavours should only be aimed at helping export manufacturers. Investment in most types of infrastructure or in education can be said to earn some foreign exchange in the long term. At least part of the restaurant and retail industries earn tourism dollars. Some industries like building and construction are domestically oriented at present, but can, if sufficiently competitive, become export earners.

5. As well, government should act to prevent domestically oriented businesses or sectors from becoming non-cost-competitive in the global context, as that would increase the costs of the export earners, or even foster a speculative bubble. Hong Kong's property sector around 1997 provided a painful example. On the other hand, in an export-led economy, domestically oriented businesses would benefit indirectly, via the multiplier effect, from any government assistance to the export sector. A note: as Hong Kong should maintain its freedom of foreign exchange, no stipulation can be made on how much of a foreign investor's earnings here could be remitted abroad.

### ***Rate of return test***

6. The second and main test is that the project should add a stream of value in the future to yield market-competitive rates of return on the factors of production, viz. labour, land and capital. This means that market wages would be paid, any input involving land should be costed at market, and thereafter the rate of return on investment should also be market-competitive. Market competition ensures that resources are allocated to the most efficient producers, and put to globally competitive uses that are the most productive available, thereby maximizing value-added for the economy.

7. Where governments need to be involved are mostly those projects where there are externalities, i.e. benefits/costs that are not reflected in the profit-and-loss statement of, or rate of return to, the investor concerned, but which would, if properly taken into account in a cost-benefit analysis, go toward making a market-competitive rate of return on the total investment. (Here the benefits or value-added taken into account should not include those arising as part of the multiplier effect.)

8. The fact that cost-benefit analysis is not an exact science, and the difficulties of making good cost-benefit analyses, are no reason not to undertake them or not to act. Making high-quality cost-benefit analyses in an open and transparent manner is the best way to build consensus and public acceptance for a policy. Meanwhile it seems

not very clear to many people whether, say, a Silicon Harbour, or a wastewater treatment plant, the likes of which are being built elsewhere, represent lost opportunities or are really inappropriate for Hong Kong.

***“Government does it better” test***

9. Governments also need to be involved where, even if there were no externalities, only the government, because of its relative permanence and size, is able to take on certain risks – by making investments, loans, guarantees etc. These are risks where there is a satisfactory risk-adjusted rate of return, usually over the longer term, but which private entities are reluctant to take on, at least not until the government has shown the lead.

10. A good example is the mortgage insurance function of the Mortgage Corporation. Mortgages are insured by the Corporation, then reinsured out. While insuring individual mortgages is quite risky, the Corporation, by insuring a very large number of them over a lengthy period, thereby exploiting an economy of scale, is able to conduct a profitable business in the longer term, and, it seems, over the short term as well. Government is the ultimate long-term investor for the economy.

11. Only the government is able to provide certain administrative support for, and set certain standards to be met by, businesses and trades, to facilitate their operations and help upgrade their capabilities – especially for domestically oriented businesses and trades, which are relatively little exposed to the discipline of global competition.

12. Conversely, the government should, as far as possible in all its endeavours, seek participation by private investors and management while relegating itself to a passive role, in order to maximize returns and efficiency. Examples include letting banks make the lending decisions in SME loan schemes, and the public listing of the MTRC. The private investors concerned should bear at least the same risks as government. (Unfortunately, under some past SME loan arrangements, in case of default the Government’s portion of the loan would be lost first. That provision was often self-fulfilling.) In a similar vein, the Mortgage Assistance scheme proposed by these authors calls for banks to make, crucially, the lending decisions.

13. Two examples of public spending that do not meet the tests mentioned above for (E) are: (1) some Japanese public works – gleaming highways and bridges in remote areas, that mostly sustained a number of construction companies, and (2) cash or other gratuitous distributions to consumers – transfers that in many cases exceed need. Both do not yield competitive rates of return, and hence are ultimately detrimental to the fiscal Budget. They also tend to weaken general confidence, and so hurt consumption through a reduced multiplier effect. Moreover, they worsen the external balance. In Canada, one consequence of over-spending and giving away welfare money 30 years ago is that 45% of the Canadian budget now goes to servicing accumulated national debt.

### *Non-pecuniary measures*

14. Towards (E), the government should, first and foremost, take all available non-pecuniary measures. A knowledge-based can-do attitude should prevail. That is, the only issue at stake before deciding on a project or policy is whether it is beneficial – i.e. passes the rate-of-return test after taking into account all benefits and costs – and passes the other two tests as well. And, for every “practical difficulty”, there is a practical resolution, which necessarily involves compromises and subordination of interests.

15. A recent measure that enhances competitiveness has been the unlimited admission of immigrants with skills that can increase Hong Kong’s overall output “pie” in the global context. Administrative measures might also be adopted to, say, help raise language standards, or further open up the education and other industries. The Government might take the lead by a greater opening up of the civil service to candidates from outside Hong Kong. To foster the pursuit of excellence throughout the community, a standards institute might, working with each professional or trades association, set a hierarchy of standards that practitioners can work towards. The issue of border industrial areas that open to workers from across the border, notwithstanding the difficulties concerned, may well merit further consideration.

### *Tax cuts*

16. There are basically three ways in which government can deploy public funds to boost the economy’s ability to add value in a global market: a general tax cut, infrastructure construction, and direct pecuniary incentives for private sector endeavours.

17. A general cut in business and personal income tax rates would be easy to administer and benefit almost everyone. Like a cut in interest rates, it leaves consumers with more disposable income to spend, and businesses with lower costs, higher sales and greater profitability, and hence induces more investments in businesses old and new, existing and from abroad, for years to come. Derived spending is generated via the multiplier effect. Tax revenue will rise, offsetting the original tax cut. (Tax hikes have the opposite effects.) It also seems that the external balance will largely hold its own as both domestic demand and export production, as well as inward investment, will be stimulated.

18. A general tax cut would be relatively cost-effective. To give some idea, a 1% rise in profits tax and salaries tax would yield \$2.6bn and \$2.2bn respectively (Advisory Committee on New Broad-based Taxes, 8/2001). A tax cut of 2% would thus likely cost under \$10bn, but should have notable impact on competitiveness, incentive, economic activity, and ultimately revenue.

19. Another type of general tax cut might be tax incentives across all industries for research and development, automation, training etc. Productivity and value added would increase as a result.

### ***Infrastructure construction***

20. Infrastructure provides a service in the future, typically consumed by a large number of users. It is often provided by government wholly or partly free of charge. That free-of-charge portion, in cases where the service is consumed in the production of either domestic or export-oriented goods or services, constitutes in effect a subsidy for such production, which may fall under policy objectives (A) or (E) above. Public spending on infrastructure would be justified where the imputed value of the externalities generated (i.e. the said free-of-charge portion of the services provided) yields a competitive rate of return on investment. Launching all projects that meet this criteria would further enhance Hong Kong's competitive edge and ability to serve the region in terms of infrastructure.

21. In an infrastructure project, the government's role might range from being only the administrative facilitator for private investors, to being the sole investor providing a good/service free-of-charge because, say, it is difficult or not worthwhile to collect the charges from diffuse users. In between those two roles, the government might invest as a passive partner alongside the private investor(s), due to, for instance, the need to maintain some say in vital functions. It might also inject some form of subsidy into privately run projects where there are externalities, i.e. benefits not reflected in the returns to the private operator.

### ***Incentives to businesses: subsidies***

22. One area of economic development that has traditionally been under-exploited in Hong Kong is where government needs to be involved. In these cases there are externalities, economies of scale, and long-term perspective that only the government can exploit.

23. In line with the "rate-of-return" principle, direct subsidies to non-infrastructure business ventures may be justified where there are externalities generated, such as: (a) increases in business and hence value-added and employment to other existing businesses; (b) introduction to the territory of technology or know-how which would otherwise not be available locally and which would be conducive to the establishment of new industries generating more value-added and employment; and (c) where employment in other existing or new businesses increase as a result, the social and economic costs of unemployment (e.g. CSSA payments, low confidence and morale) thereby avoided.

24. Often, due to imperfect information and the perceived risks of being the first one to go into a new operating environment, an industry that might otherwise be appropriate for the economy is hesitant to move in until a major player has shown the lead. Related businesses then follow the leader, bringing more of the new know-how and expertise. That major player will require some form of subsidy as incentive, since governments elsewhere are likely to be offering incentives in competition for its commitment.

25. Upto \$10bn, say, per year of subsidies should be offered as incentives to

establish new engines of economic growth, viz. industries that would otherwise not operate locally and which enhance the territory's overall output and external balance. Subsidies offered should preferably be of known (though not necessarily fixed) quantity made available at the outset only. The notion is that the government would not keep on subsidizing a concern that fails to be competitive. Subsidies may take such forms as cash grant, reduction in land use premium, low-interest loan, tax holiday, etc.

26. In making a subsidy the government is reliant on the business decision-making by the private-sector recipient(s) concerned to keep the project market-competitive. Hence, to qualify for subsidy, a recipient has to sink in a substantial investment itself, or otherwise be made to pay for the service.

27. One way is for the private investment to be matched at a certain ratio by government grants or tax allowances etc. Where subsidy is in the form of shared research or other facilities provided for a particular industry, levies should, wherever possible, be collected either from the users or from all members of the industry.

#### ***Incentives: loans and investments***

28. Pecuniary assistance may be offered to engines of economic growth by way of investments and loans. In these cases the government may be the only investor/lender with the capacity to exploit the available economy of scale and/or take a sufficiently long-term view, and thereby set in train a viable business/industry.

29. Again the market will provide the autopilot. The Government should set up a venture capital fund or company that stands ready to make investments matching those by private venture capital companies, in a partnership arrangement. The Government will also either, together with commercial banks, hold shares in a long-term credit bank, or, through a solely owned long-term credit bank, make long-term loans matching those by private banks. In time the venture capital company and long-term credit bank may also issue shares and bonds.

#### ***Budgetary considerations***

30. The economic activities made possible by tax cuts, infrastructure construction and direct incentives to businesses should generate healthy business profits and employment income down the road, including those from derived spending each time income received is spent (multiplier effect). Coupled with a stimulated economy, the Government should, over time, reap more revenue than the initial expenditure concerned. One option is to finance the competitiveness programmes by issuing bonds.

31. There should be no real upper limit to the aggregate amounts of incentives, investments and loans offered to qualifying engines of economic growth – except during inflation when demand is outstripping resources. (subsidies) for business endeavours. The more qualified projects that turn up, and hence the more government funds drawn down, the better it means for Hong Kong.

32. However, the decline of Hong Kong's fiscal reserves over the past few years may pose too much of an ostensible threat for the authorities to decisively adopt those measures, particularly if deficits continue and reserves decline further. To remove that threat, the Government should adopt as early as possible, in complement to the competitiveness-enhancing programme, a system of housing allowances as outlined in the paper *Restructuring housing assistance: benefits for Budget and economy*. That paper contains an outline of how the Budget deficit can be resolved, mainly by adopting the two programmes.

***Are new economic engines possible?***

33. Who would qualify for the pecuniary assistance offered? Because costs are relatively high in Hong Kong, viable new businesses and industries will likely have to be in the high value-added category, which usually means that they are classified as hi-tech or knowledge-intensive. Yet, with the demise of the dot-com boom and failure of some publicly aired ideas to blossom, many seem to think that "hi-tech" has clearly failed for Hong Kong and that anything more knowledge-intensive than the four "core" service industries are probably unrealistic. The Government has provided assistance to the hi-tech and knowledge-intensive sector in a low-key manner and on a relatively small scale.

34. In fact, the viability of hi-tech in Hong Kong has never been conclusively tested. Dot-com does not equate high tech. One factor that might have led to the rejection of the Silicon Harbour proposal was that there were possibly insufficient established criteria and mechanisms for those concerned in Hong Kong to properly evaluate and make such a major decision.

35. The following are grounds to believe that Hong Kong can do well in knowledge-intensive industries including hi-tech: (1) Technology/knowledge and the relevant manpower, capital and production are now more mobile than before, with geographical distance posing less barriers. (2) Hong Kong is near to the burgeoning China market and yet more advanced in the rule of law and protection of intellectual property. As such it is attractive to foreign companies as a venue for regional R&D and other higher value-added functions. (3) The SAR is still an attractive place in terms of living environment, scenic amenities, freedom of lifestyle, etc., for highly trained people with skills Hong Kong is short of, be they from China or North America, of Chinese ethnicity or otherwise. A policy to facilitate their immigration has been announced. However, these people need to see career opportunities opening up before they will come. Hong Kong people, too, seem ready to adapt and learn the required skills once there are clear directions. (4) Costs of labour and land, particularly the latter, have adjusted downward. High land costs will likely be a thing of the past, and land supply is now realized to be more flexible than once thought. Moreover, as exemplified in various advanced economies, higher costs are no objection as long as higher value is added. (5) A strong government initiative incorporating the approaches outlined in this paper would fuel and set in train a whole new movement.

### *Need to take the high road*

36. Sentiment has improved recently. Exports by Hong Kong manufacturing concerns in China have done well, and the recent weakness of the US dollar will provide further help. That export business along with the four “core” service industries represent what Hong Kong has always done best, and should benefit further from the China factor, viz. productivity gains of the Pearl River Delta and the robust future of the China market. Five years of painful adjustment of the domestic cost-price structure has also played a part. Further modest economic growth, possibly trending up, is expected near-term. Things seem to be going as well as they realistically can.

37. However, with no clear resolution of concerns over competitiveness, there may still be a circular chain of government spending cuts and tax increases, continuing softness in property prices, and more budget deficits. Some downward cost-price adjustment may also persist, along with pressure from time to time on the currency peg.

38. Still, there is risk that such relative respite bought with five years of pain might not last. Both pundits and many ordinary citizens fear that the down side is over the longer term. While the Special Administration Region will continue to possess superior geographical location, software and hardware over neighbouring China, its relative advantage in terms of openness and knowledge, and now perhaps tax rates, will likely narrow overall. By adhering narrowly to what it has always done best, the SAR’s share of the growing China pie will decline, and the net result is worryingly uncertain.

39. Hong Kong should build new global competitive advantage. It should use all financial means at its disposal to help it acquire a knowledge-generating capability with knowledge-intensive activities at the cutting edge, constantly upgrade its infrastructure wherever economically advantageous, and charge the lowest possible tax rates. It also needs to be amongst the world’s most open and knowledge-guided communities in mindset and practice.

40. Only if Hong Kong maintains or expands its lead in these areas will it help upgrade, and thus preserve or even increase its value to, the Pearl Delta, which is both its support base and market. Integration with the Delta is inevitable and should proceed as fully and quickly as possible, but should not mean a merging with the gradual diminution of the openness and knowledge gap.

41. The following might be some descriptions of what can be found in Hong Kong over time: a nerve centre for research and development in the region; knowledge parks where the world’s best universities are represented; headquarters of world-class companies; original theme parks; health science parks; centres where Chinese and Western culture are brought together and ferment the contents and software for media, fashion etc.; and tradesmen, professionals and managers who set or match world standards for quality, reliability transparency and efficiency.



### *Getting from here to there*

42. What would give the present initiative to increase Hong Kong's competitiveness a reasonable chance of success? In what might be considered a major re-construction of its economy, (1) Hong Kong will open up to the fullest to what is best, in know-how and manpower, from China and the rest of the world; (2) the Government will assume an activist role, making use of hitherto unexploited externalities, economies of scale, and long-term perspective; and (3) billions of dollars will be invested, by way of incentives and assistance to secure the new knowledge base, as well as in new infrastructure and tax cuts.

43. In respect of (1), import of pertinent know-how and manpower was what made Hong Kong successful in the first place. Now, its know-how and manpower again need an upgrade that has to come from beyond itself. For instance, setting high standards would be meaningless unless it is with reference to the most advanced standards abroad.

44. In addition to openness-related measures mentioned above, the Government might, say, working with trades bodies, offer stipends to bring in top tradesmen from abroad, or scholarships for locals to attain advanced standards in those countries where they are set. In education, largely imported primary and secondary schools independently managed by educators from abroad have provided stimulus and reference for change within other schools. A parallel at the university level should be helpful. In every field, newcomers could play a part towards beneficial changes.

45. In respect of (2), the Government's agenda would include: (a) the above programme of administrative and pecuniary measures including tax cuts, infrastructure construction and direct incentives to businesses; (b) implementing a system of housing allowances which would, among other things, alleviate the Budgetary constraint on competitiveness policies; (c) an immigration policy to admit those who help enhance Hong Kong's competitiveness; and (d) other measures to instigate a full opening up, and greater integration of Hong Kong vis-à-vis both China and the rest of the world

46. An activist government is not big government. Quite the opposite: the basic principle stated above is that government should leave to the private sector whatever the latter can do better. As much as possible, fiscal policy should consist of spending cuts in the public sector and tax cuts for the private sector. Spending cuts – as in the housing allowances proposals – can be by rationalization along market principles, as well as privatizations, with, where appropriate, payment of cash or cash vouchers to consumers. In theory, privatization should save more than efficiency efforts within the civil service, though quality should be compared carefully.

47. It is the market that will decide the outcome. In the worst scenario, there may be either no takers of Hong Kong's offers or only disappointing ones, with a lot of careful planning and some public money going to waste. But that would be a modest price to pay for the chance – perhaps never to be had again – of securing a long-term

future in which Hong Kong can live up to its potential.

48. A knowledge-generating capability through: asking questions and making in-depth analyses; going the length it takes to set the highest standards and quality in every field; a broad orientation that values diversity: opening up to those from outside; readiness to undergo discomfiting change on faith in its longer-term benefits... these are a different kind of strengths from those that Hong Kong people have been known for over recent decades. Its people's relative weakness in these areas is a major obstacle to Hong Kong realizing its potential. Yet it is not inherently obvious why Hong Kong cannot forge new strengths incorporating its old ones. With the help of government leadership, the people will see that that they and their young can and will change for the better. Confidence will then return.

### ***Summary/Conclusions***

49. With China opening up and modernizing more than it has in centuries, Hong Kong's unique position is diminishing, relatively, in a number of respects. A small but activist government can build new competitiveness for the SAR. Letting itself be guided foremost by market economic principles, the Government can cut taxes and make use of hitherto unexploited externalities, economies of scale, and long-term perspective, as well as making the SAR even more open and fostering the attainment of the world's most advanced standards in all fields.

50. Specific steps might include: a 2% general tax cut, stepped up infrastructure construction: \$10bn per year of direct incentives or subsidies, along with long-term investments and loans, to businesses that constitute new engines of economic growth; and other administrative measures.

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### **Note on authors**

James Lee, writing as an independent observer in Hong Kong, and Lawrence Lau, a Chartered Accountant in Vancouver, have published various articles on the economy. This paper builds on an earlier article, *開發新產業，前景更美好* by 天行 and 劉鈺威, in Hong Kong Economic Journal, 23/8/2001. Comments and queries are welcome at [jlee\\_hk@hotmail.com](mailto:jlee_hk@hotmail.com). This paper may freely be made available to interested persons.

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