

Taxation Policy and Hong Kong's Economic Growth

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Outline

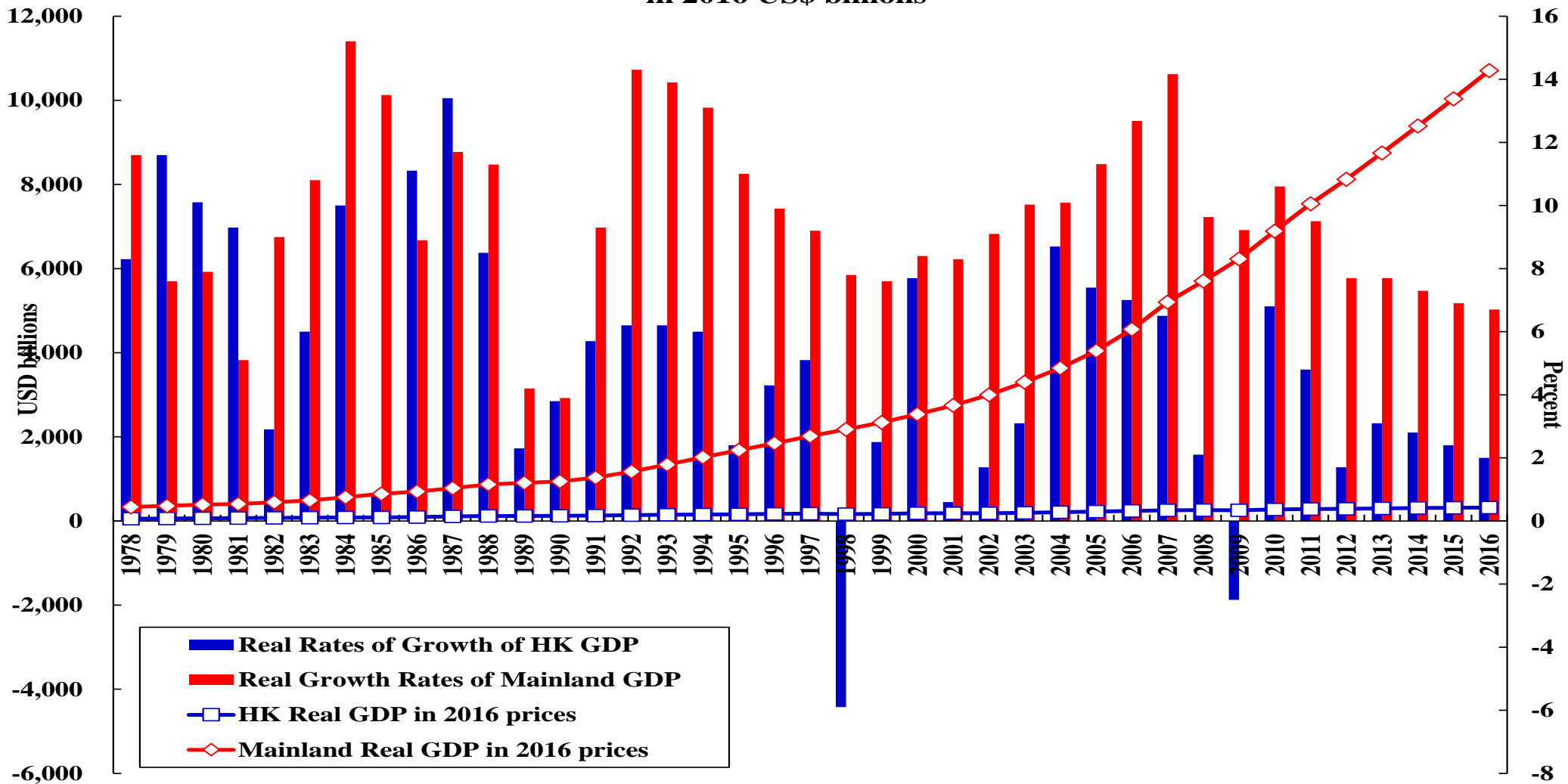
- ◆ Introduction
- ◆ Global and Mainland Economic Development Trends
- ◆ The Hong Kong Economy at a Turning Point
- ◆ Possible Directions for Future Growth
- ◆ The Role of Fiscal and Taxation Policies
- ◆ Concluding Remarks

Introduction

- ◆ In 1978, the real GDP (2016 prices) of Hong Kong was almost one-sixth that of the Mainland. In 2016, the real GDP of Hong Kong was only 3 percent of that of the Mainland.
- ◆ The real GDP per capita of Hong Kong was almost 33 times that of the Mainland in 1978 and still 5.6 times in 2016.
- ◆ Since 1991, the rates of growth of Mainland real GDP and real GDP per capita have exceeded those of Hong Kong in every single year, often by large margins. The respective Mainland rates averaged 9.8% and 9.0% annually over this period, compared to Hong Kong's 3.7% and 2.6%.
- ◆ Even then, it will probably take another half-a-century before the level of Mainland per capita GDP catches up to that of Hong Kong's.

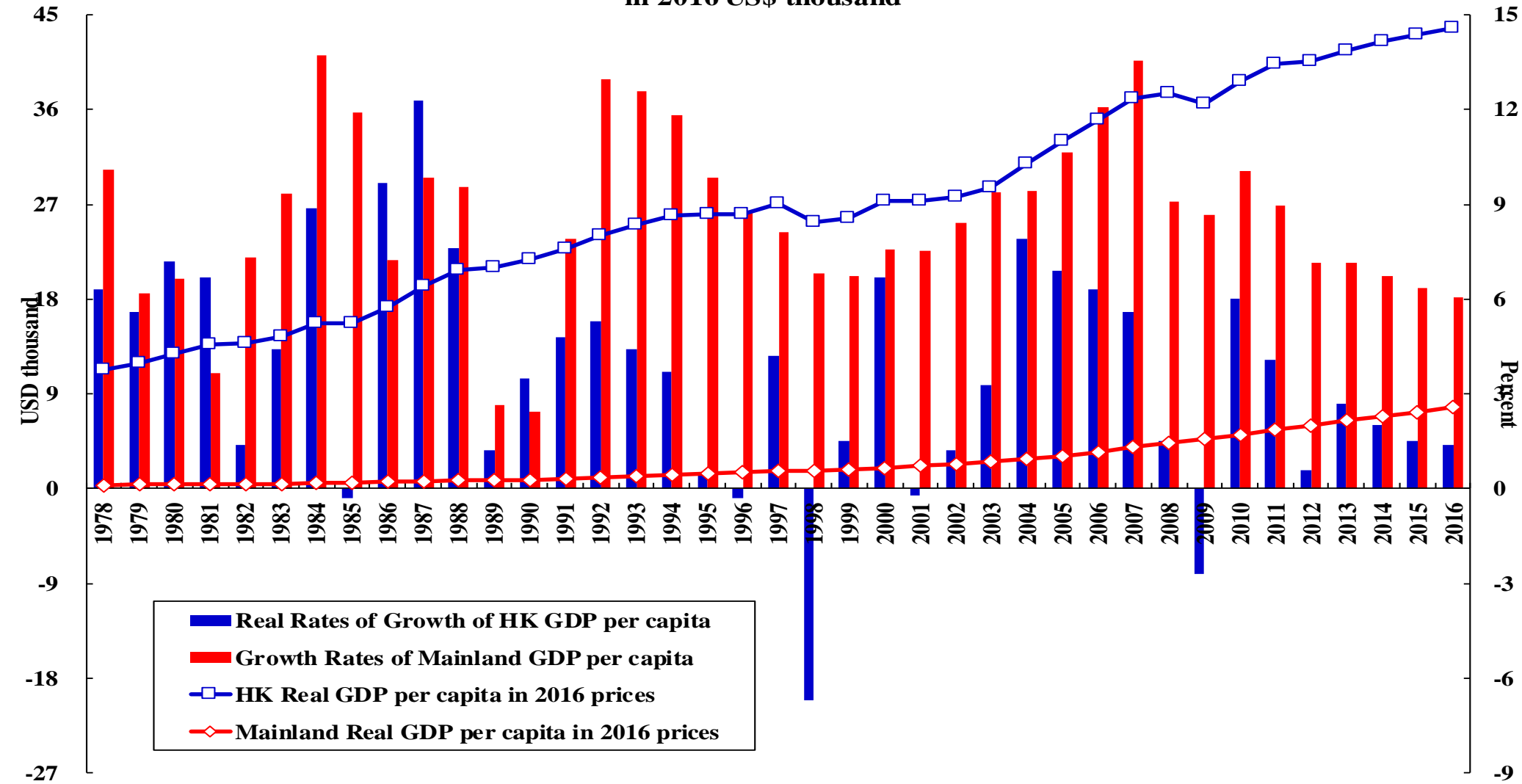
Mainland and Hong Kong Real GDPs and Their Rate of Growth (billion 2016 US\$)

Real GDP of the Mainland and Hong Kong and Their Growth Rates, in 2016 US\$ billions



Mainland and Hong Kong Real GDPs per Cap. and Their Rates of Growth (thou. 2016 US\$)

Real GDP Per Capita of the Mainland and Hong Kong and Their Growth Rates, in 2016 US\$ thousand

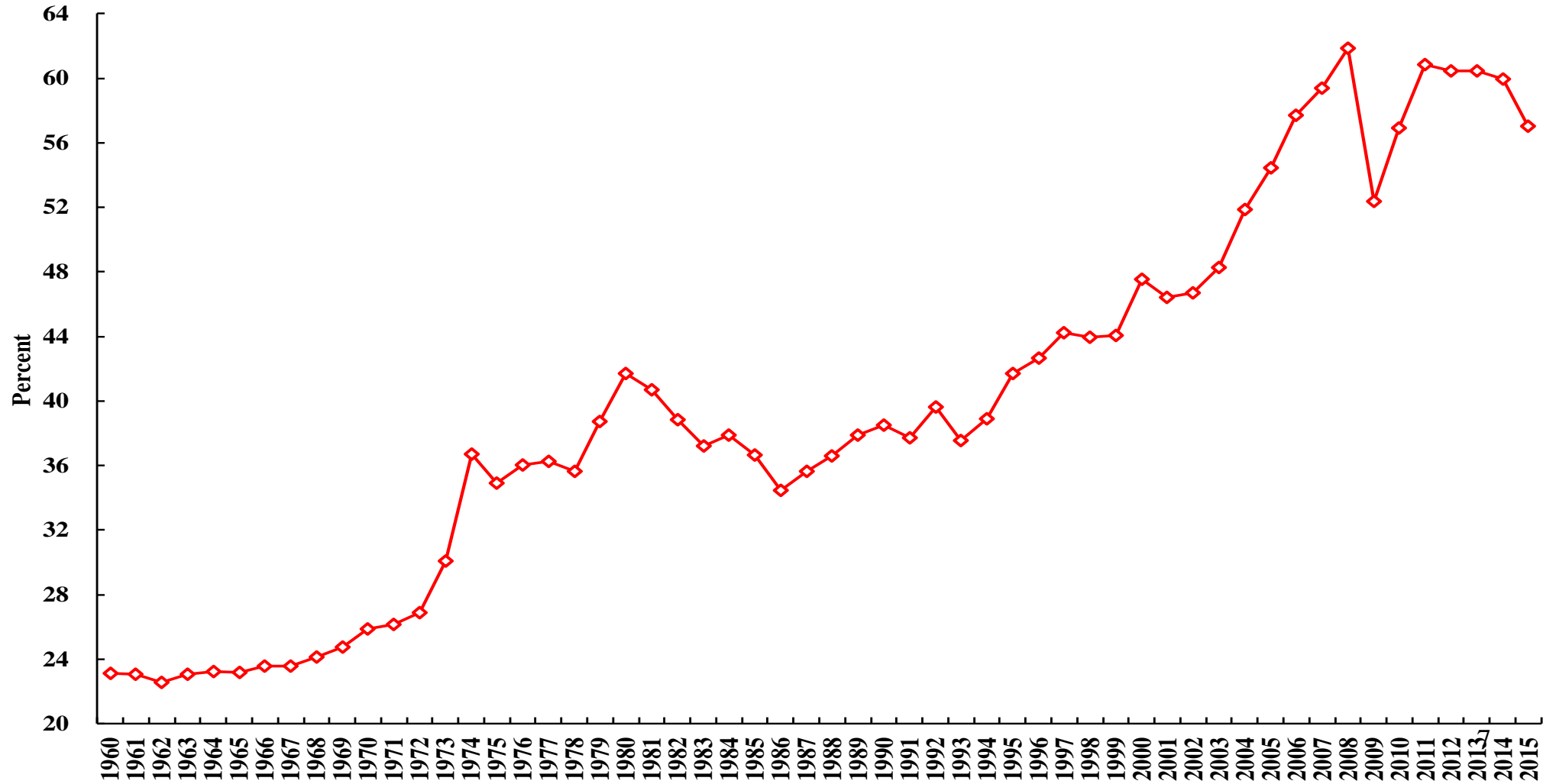


Global and Mainland Economic Development Trends

- ◆ The rates of growth of the real GDP and real total trade of the world has slowed down significantly since 2008.
- ◆ Cross-border trade and direct investment are no longer the drivers of world economic growth.
- ◆ Protectionism, isolationism and populism are rearing their heads and the entire world faces the risks of trade wars and economic de-globalization.

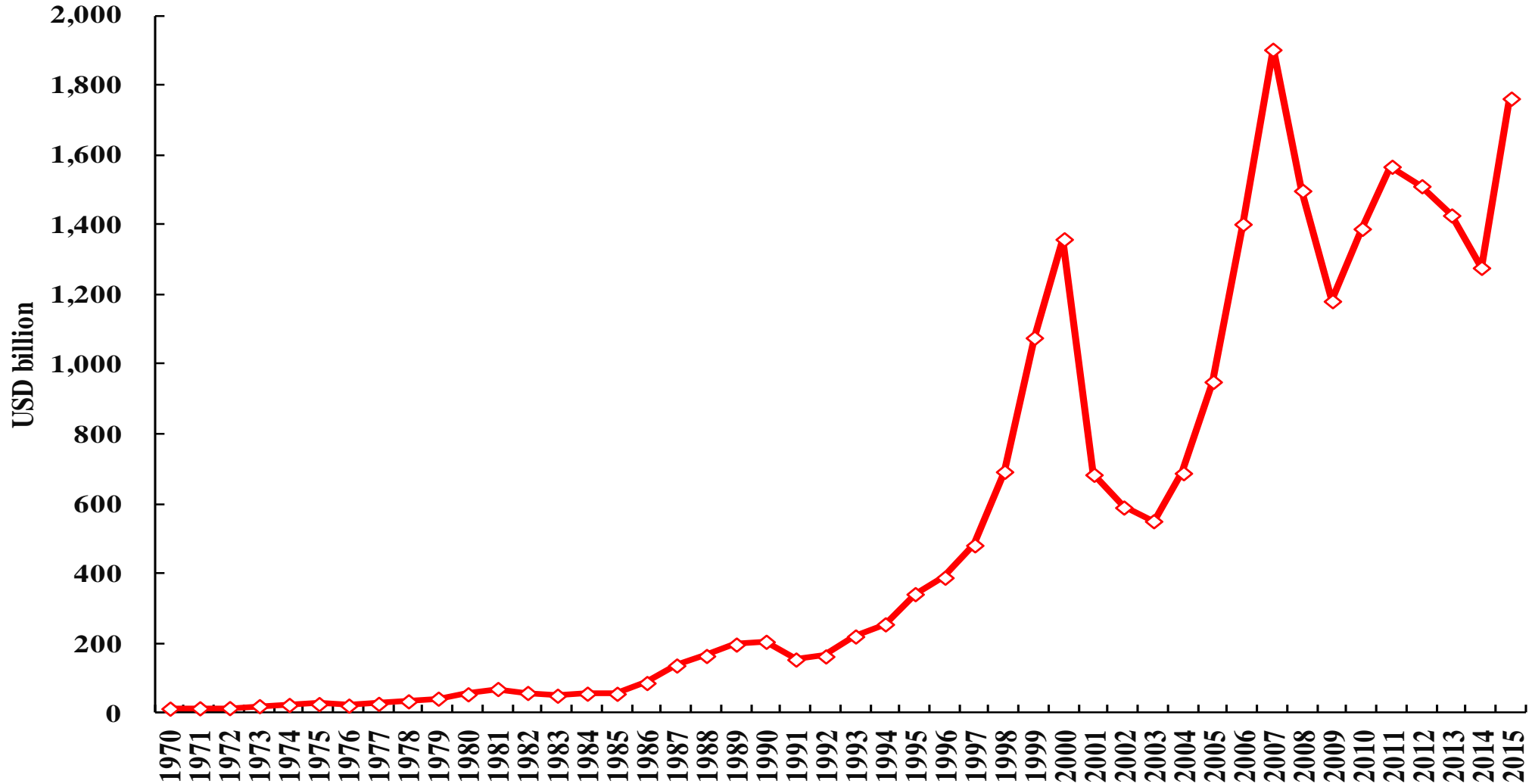
Total World Trade in Goods and Services as a Percentage of World GDP since 1960

Total World Trade in Goods and Services as a Percentage of World GDP since 1960



Total World Foreign Direct Investment (FDI), billion US\$

World total FDI inward flows , annual, 1970-2015



Global and Mainland Economic Development Trends

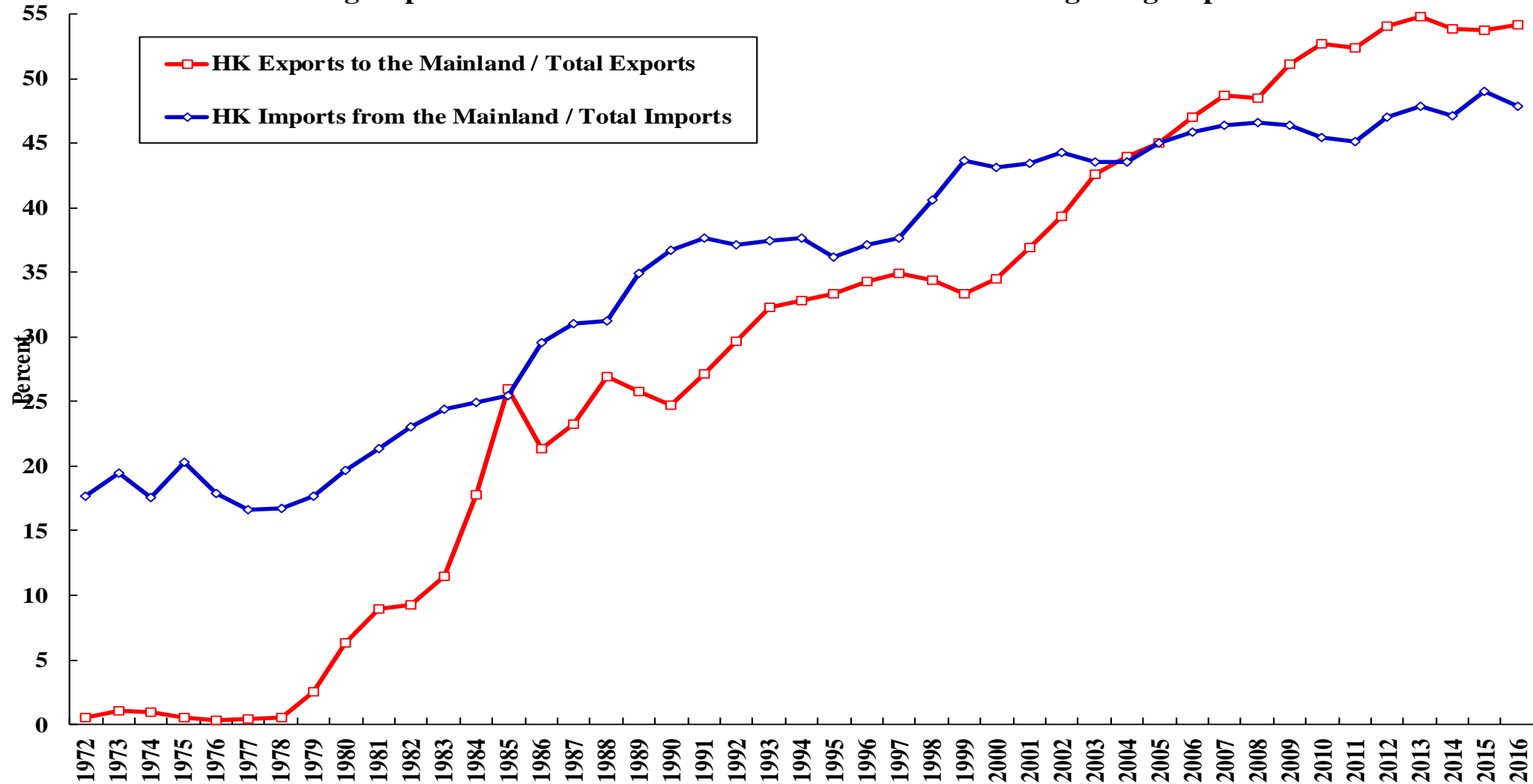
- ◆ The Mainland economy has transitioned to a “new normal”, with a rate of growth stabilized around 6.5%. It no longer relies on export growth, but has shifted towards internal demand as the principal economic driver.
- ◆ However, the national saving rate remains high. But because of the on-going supply side structural reform and the serious excess production capacities in many industries, the rate of growth of fixed assets investment has been declining, resulting in significant excess domestic savings which need to be deployed abroad.
- ◆ Today, foreign direct investment (FDI) into the Mainland constitutes only approximately 2.5% of total gross domestic investment on the Mainland and is quantitatively no longer important.

The Hong Kong Economy at a Turning Point

- ◆ The Mainland is Hong Kong's most important export destination and most important import origin (accounting for 52.8% and 46.7% respectively as of March 2017).
- ◆ Mainland annual direct investment in Hong Kong constitutes approximately half of annual total foreign direct investment in Hong Kong.
- ◆ The Mainland is the most important source of tourists to Hong Kong, accounting for more than 70%.
- ◆ Mainland enterprises are the mainstay of the Hong Kong Stock Exchange.

Hong Kong Exports to and Imports from the M'land as % of Total HK Exports and Imports

Hong Kong Exports to the Mainland as a Percent of Total Hong Kong Exports and Hong Kong Imports from the Mainland as a Percent of Total Hong Kong Imports

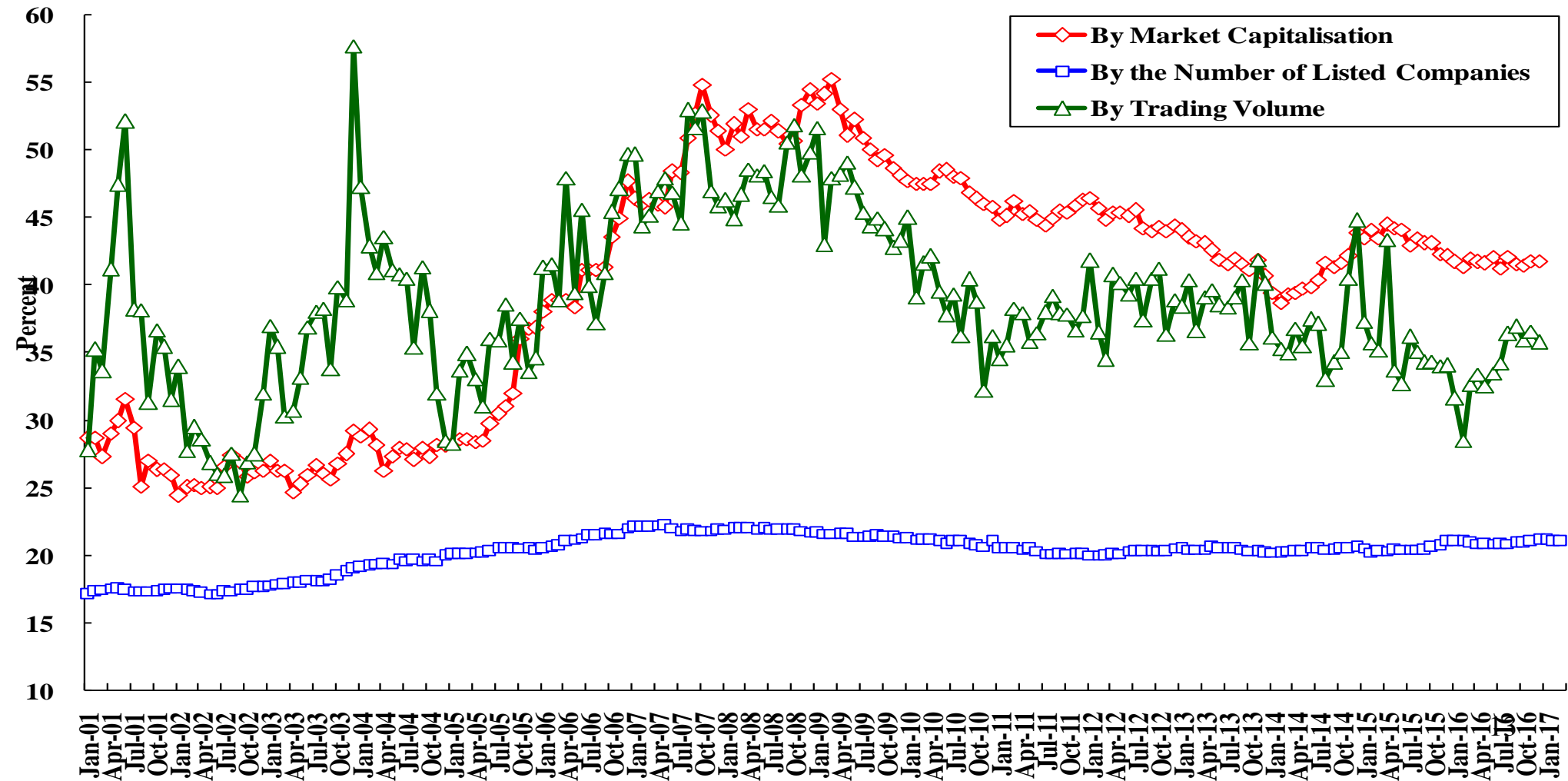


The Hong Kong Economy at a Turning Point

- ◆ Although Mainland enterprises constitute only 20% of the listed enterprises on the Hong Kong Stock Exchange by number, they constitute over 35% of the daily turnover on average and over 40% by market capitalization.
- ◆ They also account for and constitute half of the 50 enterprises included in the Hang Seng Index.
- ◆ From the point of view of IPO volume at the Hong Kong Stock Exchange, with the exception of the years of the Global Financial Crisis, Mainland enterprises account for way over 50%.

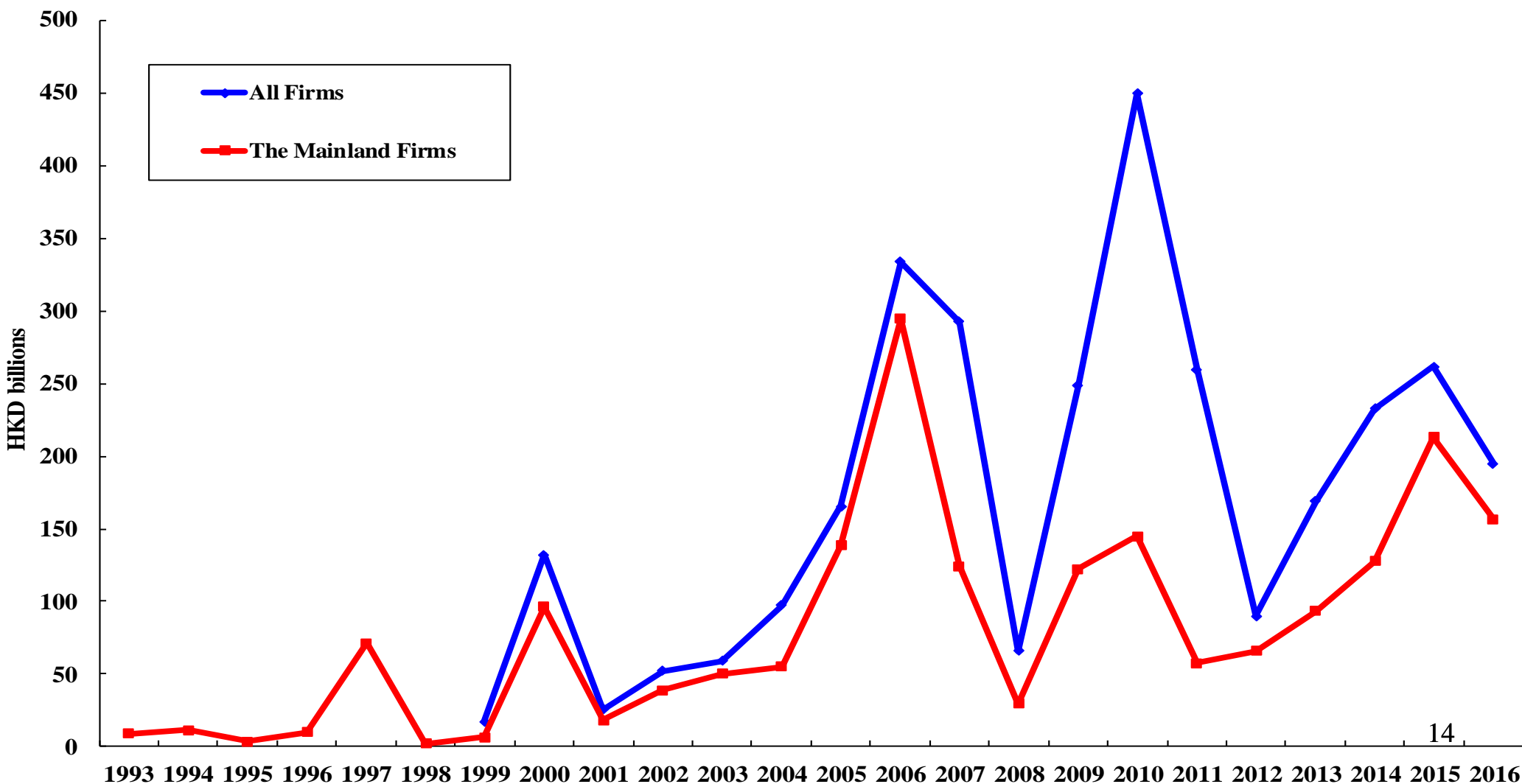
The Share of Mainland Enterprises on the Hong Kong Stock Exchange

The Share of Mainland Enterprises on the Hong Kong Stock Exchange by Market Capitalization, Trading Volume and the Number of Listed Enterprises



Annual IPO Value of Mainland and All Firms on Hong Kong Stock Exchange

Annual IPO Value of Mainland and All Firms on Hong Kong Stock Exchange

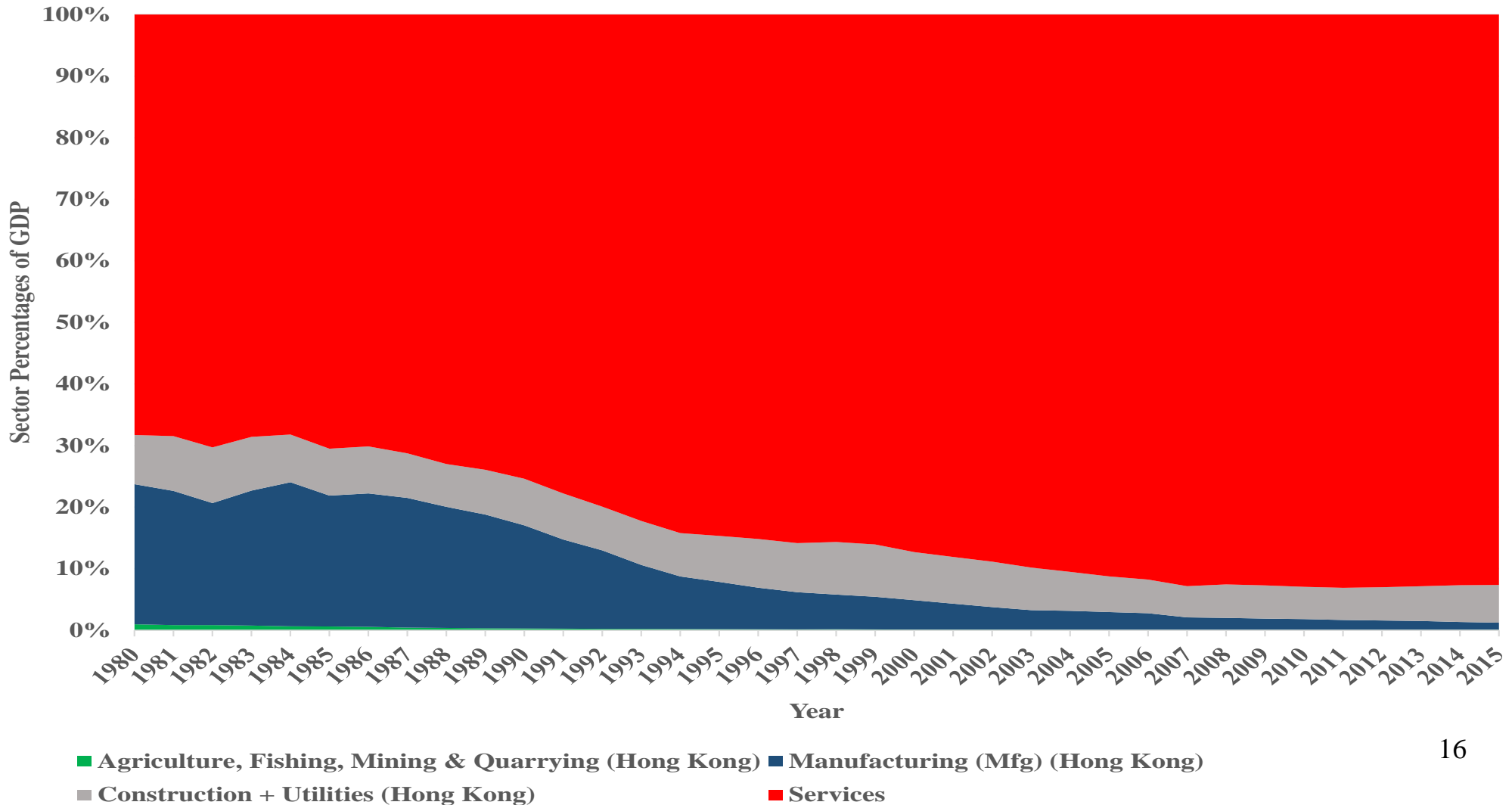


The Hong Kong Economy at a Turning Point

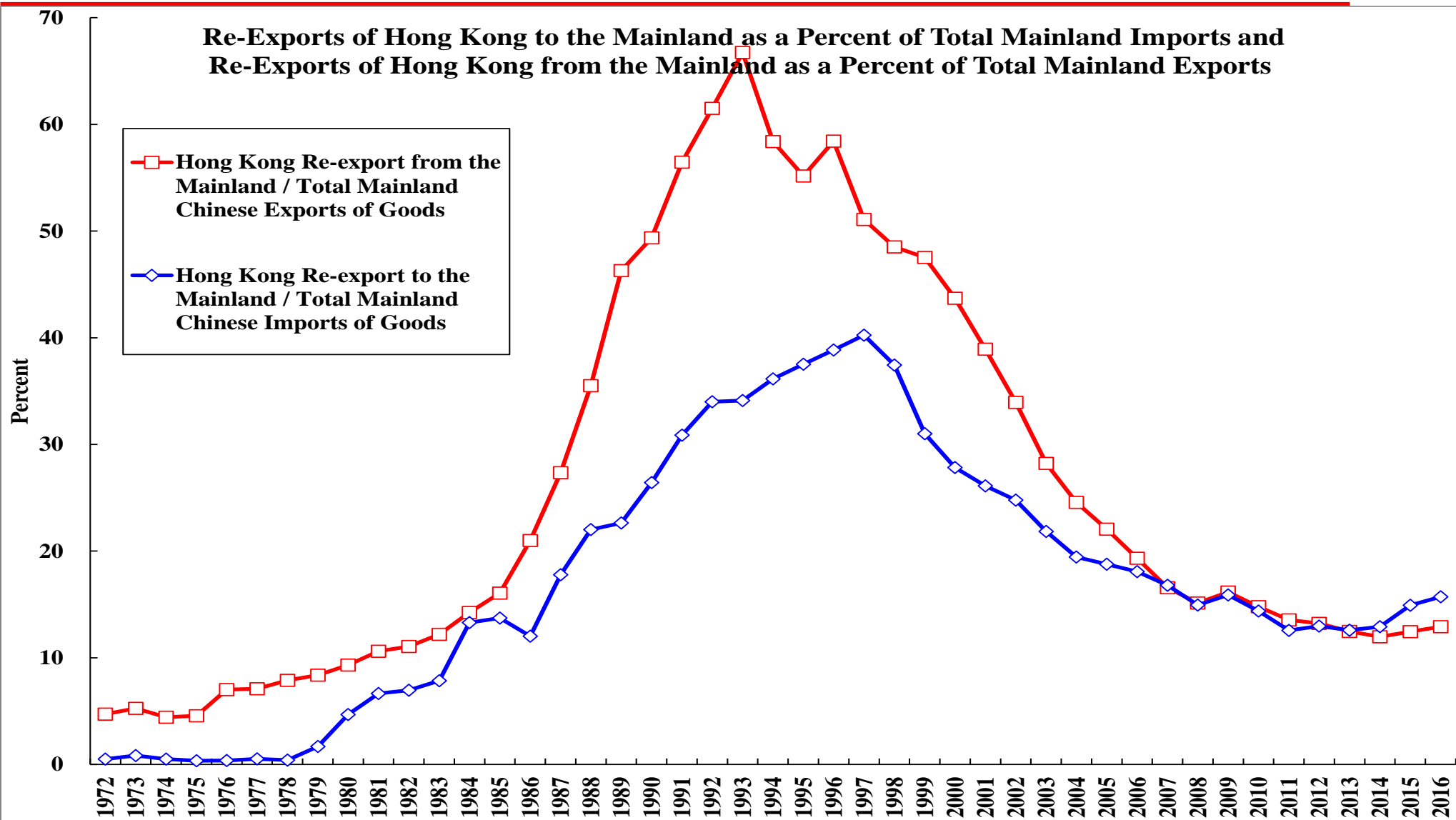
- ◆ The share of manufacturing in GDP has declined from 22.4% in 1980 to 1.1% in 2015. The share of the service sector already exceeds 93%.
- ◆ The combined share of the four traditional key service industries in Hong Kong—financial services, tourism, trading and logistics and professional services—in GDP has declined from its peak of 60.3% in 2007 to 57.2% in 2016 and their share of employment has not been growing in recent years.
- ◆ For various reasons, the incentive for Mainland enterprises to list their shares in Hong Kong has diminished. That is why Hong Kong has to try to attract potential listings from other economies. The tourist arrivals from the Mainland have already peaked. The value-added of trading and logistics as a percent of GDP has been declining since 2005.
- ◆ The competition from Mainland ports, in addition to the slowdown in the growth of world trade, has caused the proportion of re-exports through Hong Kong in total Mainland trade to decline substantially.

The Shares of the Four Production Sectors in Hong Kong GDP

Distribution of Hong Kong GDP by Sectors since 1980



HK Re-Exports to and from the Mainland as a Percent of Mainland Imports and Exports



The Hong Kong Economy at a Turning Point

- ◆ Of the four traditional key industries, financial services and professional services still have growth potential. But Hong Kong must enhance its role as a conduit for the Mainland's outbound investments, to provide financial and professional services for the Mainland's growing outbound direct and portfolio investments.
- ◆ The six other selected industries are 1.Cultural and creative industries; 2.Medical services; 3.Educational services; 4.Innovation and technology; 5.Testing and certification; and 6.Environmental industries. In 2015, the shares of cultural and creative industries in GDP and employment reached 4.7% and 5.7% respectively, close to the shares of tourism (5% and 7% respectively), and it has significant growth potential. Innovation and technology will require government policy support before it can achieve a high rate of growth.
- ◆ Hong Kong must embark on new directions in order to continue to grow and prosper, developing new and sustainable industries to provide high value-added employment opportunities. Above all, it cannot afford to turn inward and must remain internationalised.

Possible Directions for Future Growth

- ◆ (1) Make Hong Kong into a comprehensive, full-service international financial centre;
- ◆ (2) Build Hong Kong into an all-encompassing international hub for innovation;
- ◆ (3) Develop the cultural and creative arts industry; and
- ◆ (4) Grasp the opportunities presented by the “Belt and Road” and the “Guangdong-Hong Kong-Macau Greater Bay Area” initiatives.

Make Hong Kong into a Comprehensive, Full-Service International Financial Center

- ◆ In addition to the Mainland, Hong Kong must also grasp opportunities to provide financial services to Belt and Road, including East Asian, countries.
- ◆ Hong Kong should develop the ability to trade on its markets in Hong Kong Dollar, U.S. Dollar and the Renminbi.
- ◆ Hong Kong must develop an active, broad, deep and liquid bond market for both long- and short-term bonds (including Islamic bonds), starting with sovereign and quasi-sovereign bonds (e.g., bonds issued by the Hong Kong Mortgage Corporation), with maturities ranging up to 50 years.
- ◆ Hong Kong should become a capital hub attracting simultaneously fund-raisers, investors and asset managers worldwide.
- ◆ Hong Kong is ideally placed to provide related professional services.

Make Hong Kong into a Comprehensive, Full-Service International Financial Center

- ◆ Develop infrastructure financing services to support Belt and Road infrastructure development.
- ◆ Attract listing of companies of the Belt and Road, including East Asian, countries, possibly as secondary listings, on the Hong Kong Stock Exchange.
- ◆ The huge buying power of the Mainland investors can provide the potential backing and attract these cross-border listings. In 2015, the annual transaction volume of the Mainland stock exchanges reached US\$41 trillion, exceeding the combined volume of New York Stock Exchange and NASDAQ of US\$30 trillion.
- ◆ Once Hong Kong succeeds in attracting listings of companies from different countries, it will be difficult for a stock exchange of another country or region to replace Hong Kong's.

Make Hong Kong into a Comprehensive, Full-Service International Financial Center

- ◆ Hong Kong can develop into a centre for corporate treasuries, asset management firms, wealth management firms, private equity funds, hedge funds and other funds and corporate regional and global headquarters.
- ◆ Hong Kong can also become an international centre for the issuance and trading of green bonds.
- ◆ Hong Kong is and will continue to be the offshore Renminbi centre of the first choice.
- ◆ Hong Kong should develop into an international re-insurance centre for East Asia, based on its many advantages.
- ◆ Hong Kong can become an international professional services centre, providing services in accountancy, law, arbitration, mediation and design, etc.

Build Hong Kong into an All-Encompassing International Hub for Innovation

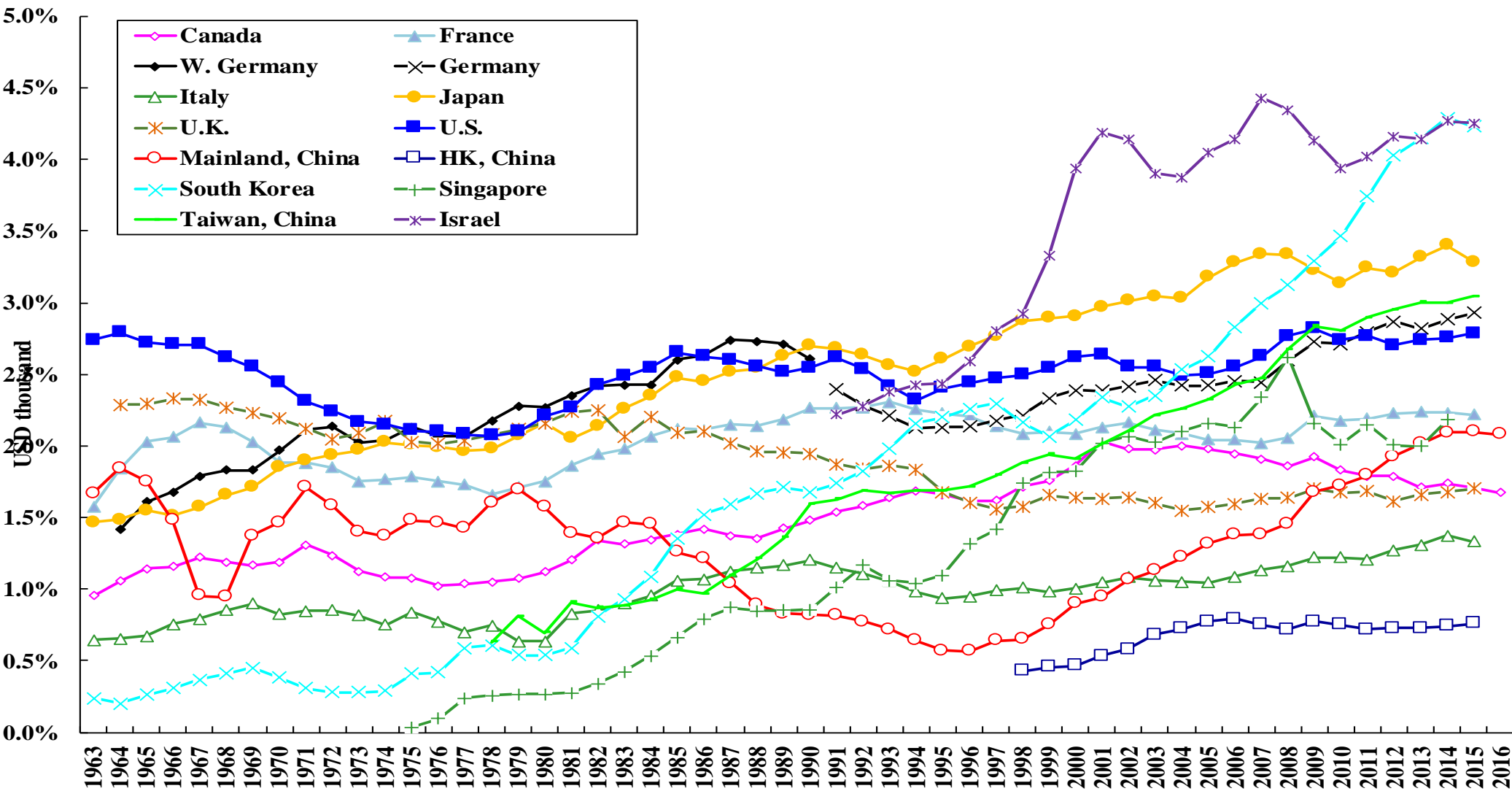
- ◆ In cooperation with Shenzhen, Hong Kong can develop into an international innovation hub that combines “Silicon Valley/Route 128)” and NASDAQ into one, serving not just Hong Kong and the Mainland but also the entire Belt and Road region. It will specialize in the creation of intangible capital and the capitalization of its commercial value through “Venture Capital”, “Initial Public Offerings (IPOs)” and “Mergers and Acquisitions (M&As)”.
- ◆ This requires a four-pronged approach: (1) increasing investment in human capital, specifically, in tertiary and research-based postgraduate education; (2) increasing investment in research and development (R&D); (3) creating a nurturing eco-system for venture capital; and (4) facilitating the IPO and M&A markets for successful start-up firms.
- ◆ The ultimate objective is to make Hong Kong/Shenzhen an international innovation hub, attracting inventors, entrepreneurs, venture capitalists and investment bankers to congregate to raise capital as well as to invest.

Build Hong Kong into an Int'l Innovation Hub—Increasing Intangible Investment

- ◆ Hong Kong should increase its tertiary education enrollment rate. In 2014-15, Hong Kong's enrollment rate was 32%, far below that of South Korea (over 90%) and Taiwan (over 100%). The Mainland's enrollment rate was over 30%.
- ◆ Hong Kong's R&D expenditure is only 0.73% of its GDP, the lowest of the four newly industrialised East Asian economies, and far below those of Beijing and Shenzhen.
- ◆ In 2015, South Korea, Taiwan and the Mainland were respectively granted 17,924, 11,690 and 8,166 patents in the U.S. By comparison, Hong Kong was granted only 601 patents.
- ◆ There is a strong positive correlation between the number of patents granted and the cumulative R&D capital.

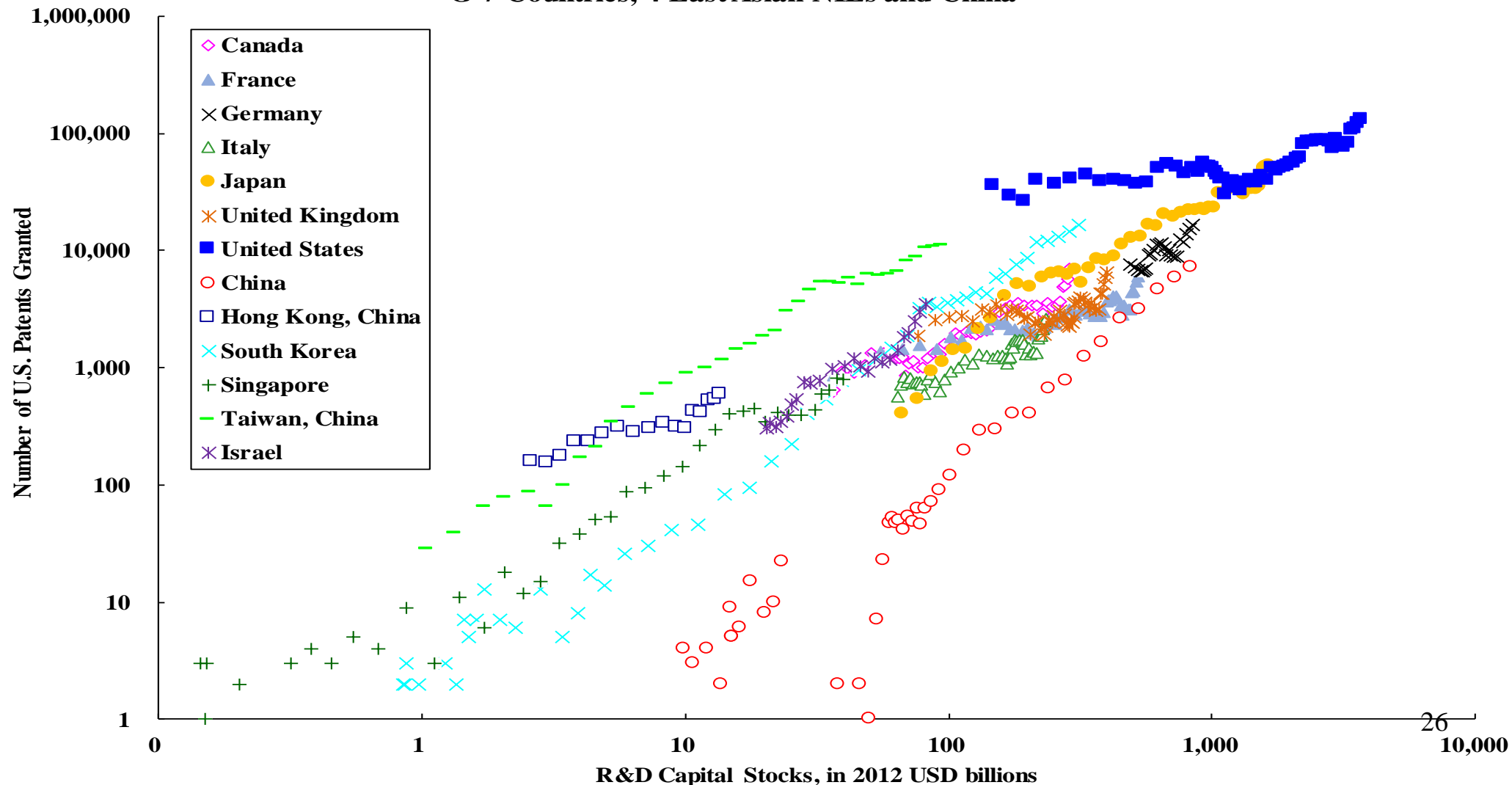
R&D Expenditures as a Ratio of GDP: G-7 Countries, 4 East Asian NIES, China & Israel

R&D Expenditure as a Percent of GDP: G-7 Countries, 4 East Asian NIES, China & Israel



U.S. Patents Granted and R&D Capital Stocks: G-7 Countries, 4 EANIIEs, China & Israel

U.S. Patents Granted and R&D Capital Stocks:
G-7 Countries, 4 East Asian NIEs and China



Develop the Cultural and Creative Arts Industry

- ◆ Hong Kong can develop into a centre like Hollywood, New York and Bollywood, where professionals serving the cultural and creative arts industry can congregate and develop projects.
- ◆ If Hong Kong can become a major regional hub for the cultural and creative arts industry, it will generate significant income and employment opportunities.
- ◆ The cinematic and video (not limited to television) audience has been growing by leaps and bounds on the Mainland and its cinema box receipts will soon surpass those of the U.S. to become the number one in the world.

Grasp the Opportunities Presented by the “B&R” and the “Greater Bay Area” Initiatives

- ◆ The financing of the Belt and Road and Guangdong-Hong Kong-Macau Greater Bay Area projects can help create an ample supply of different types of sovereign and quasi-sovereign as well as non-sovereign bonds.
- ◆ Belt and Road countries can provide the venture capital as well as the new markets for innovative products, supporting Hong Kong’s development into an international innovation hub.
- ◆ Hong Kong has signed double-tax agreements (DTAs) with 20 of the 72 Belt and Road countries. Hong Kong should seek to conclude DTAs with the remaining Belt and Road countries as soon as possible.

The Role of Fiscal and Taxation Policies

- ◆ Why should a government levy tax? It is to pay for activities for which the government must be responsible. These include:
- ◆ (1) the provision of public goods, such as public security, fire and basic hygienic services, drinking water, basic education and healthcare, basic infrastructure facilities, etc. These are recurrent expenditures that cannot be provided through the free market.
- ◆ (2) investment in the future, e.g., infrastructure projects such as roads, airports, railroads, high education and basic R&D. These are capital expenditures that are not normally provided through the free market.
- ◆ (3) appropriate levels of transfer payments to assist lower-income households.
- ◆ (4) counter-cyclical fiscal and taxation policies. This aspect is especially important for Hong Kong given that Hong Kong effectively has no monetary policy and no exchange rate policy with its linked exchange rate system.
- ◆ (5) the implementation of an industrial policy, using taxation or subsidy as an instrument, to enable an economy to continue to grow in a new external environment.

The Role of Fiscal and Taxation Policies

- ◆ The biggest difference between public finance and household finance is that a household needs to control its expenditures within the constraints of its income whereas a government can plan its revenue on the basis of its needs. The objective of a government is to maximize the welfare of the people, using fiscal and taxation policies as tools, and not to maximize tax revenue or its fiscal surplus.
- ◆ During economic downturns, a government should be able to run budget deficits. It is not necessary to balance the budget every year, so long as within a certain period (normally within an economic cycle), recurrent expenditures on average do not exceed recurrent revenue. This can be referred to as a “dynamically balanced budget”.
- ◆ Being frugal is a virtue; however, a government should not skim on necessary expenditures. During an economic downturn, a government should increase expenditures to stabilize the economy and employment, but it should not be wasteful.
- ◆ When a government achieves an unexpectedly large budget surplus, it may use it to settle against known future liabilities. For example, it can consider endowing an independent fund to pay for current and future civil service pension costs.

Concluding Remarks

- ◆ Hong Kong definitely has the potential to become the world's leading international financial centre and an international innovation hub. Once Hong Kong achieves these positions, it can use its first-mover advantage to remain in them indefinitely.
- ◆ However, to achieve these goals requires the HKSAR Government, the enterprises and the public to work together. Medium- to long-term strategies and pragmatic implementation plans must be put in place. Moreover, the HKSAR Government must also seek the help and support of the Central Government. The time for “laissez faire” or “positive non-interventionism” of the government is over.
- ◆ In order to become a comprehensive, full-service international financial centre, Hong Kong must work hard to develop an active and liquid bond market (including Islamic bonds), and an international equity market serving the entire Belt and Road region.

Concluding Remarks

- ◆ In order to become an international innovation hub, Hong Kong must vigorously promote higher education, especially post-graduate education, R&D and venture capital in Hong Kong and its surrounding areas.
- ◆ Hong Kong should take maximum advantage of the opportunities offered by the Belt and Road and the Guangdong-Hong Kong-Macau Greater Bay Area initiatives.
- ◆ Hong Kong must increase its land supply in order to reduce the high cost of office space and housing.
- ◆ Fiscal and taxation policies should be employed as tools for adjusting and re-directing the development of the economy so that it is sustainable in the long run. Appropriate tax policies can facilitate Hong Kong's efforts to become a comprehensive, full-service international financial centre, an international innovation hub, and a regional international centre for the cultural and creative arts industry³².