LINE OF FIRE

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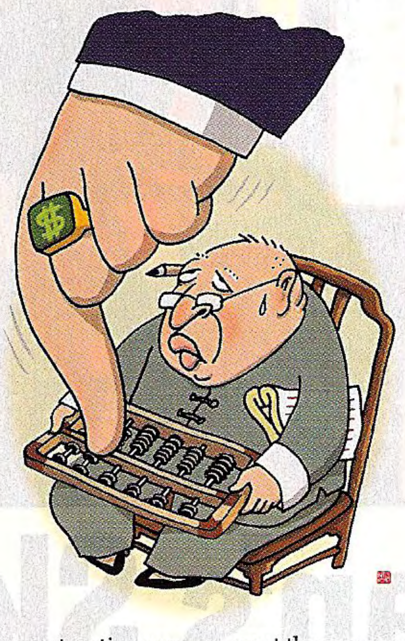
A Dangerous Miscalculation

Hong Kong's fixation on property is an obstacle to economic recovery

THE HONG KONG ECONOMY IS IN DEEP TROUBLE. GDP FELL about 5.6% last year, the worst decline on record. Unemployment is nearly 6% and rising. Worse, the cost of living remains steep by international standards, even though asset prices are down substantially from their peak. Last month, Chief Executive Tung Chee-hwa sought help from an advisory panel of 11 prominent international businessmen. Their collective wisdom: Hong Kong's future is bright—but only if the territory does several things: lower the cost of doing business, raise education levels, reduce investor-repellent pollution, diversify the economy and make brand-name products that can command higher profit margins. The barons avoided, by design or ignorance, the central issue. Hong Kong's high cost structure is due to lofty property prices, which in turn depend largely on how much land the government decides to sell. Many other prices, especially wages, reflect past and anticipated property values. In Hong Kong, real estate and related activities account for no less than 40% of GDP.

It is a myth that Hong Kong is a low-tax haven, as there is a steep implicit tax in the form of artificially high land prices that the government engineers by limiting the amount of land sold to the community. Hong Kong's famous fiscal reserves are nothing but cumulative land-tax revenues. No government elsewhere relies as much on real estate for its income.



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The root cause of Hong Kong's problems is its land policy. It has nurtured a system in which a few developers are given the privilege of underwriting, directly and indirectly, the 40% of government revenue that derives from real estate. The developers serve as both de facto tax collectors and as a construction arm for the government, for which they receive profit margins and privileges few monopolists dare dream of. Sure, the tycoons make their money fairly, playing by the book. But in concert, the handful of developers can exacerbate a housing shortage by slowing down construction because they and the government are the only two builders in town. It's legitimate because no rules forbid it. It's rational because they want to maximize profit. Developers sit on an inventory of land sufficient for at least five years of private production of space. The government expects them to provide more than 40% of total living space in the next several years, but the actual quantity of supply is in the hands of the developers.

In the United States, prosecutors are aggressively pursuing Microsoft's Bill Gates for earning "monopolistic" profits. But Bill's "evil" gains seem modest compared with those of Hong Kong's developers. The software giant's pre-tax profit margin averaged 42% over the past five years, compared with 133% for Cheung Kong and 71% for Henderson Land, two of Hong Kong's largest developers. Microsoft pays an average of 35% profit tax, compared with 12% for Cheung Kong and 15% for Henderson. While Gates has to worry about antitrust suits brought by the government, Hong Kong's property tycoons serve as the government's proxy. Hong Kong depends on them to house a growing population. As a result, if you want to understand the territory's politics, look less at Beijing and more at the real-estate sector.

When Cheung Kong's chairman, multibillionaire Li Ka-shing, complained recently about a deterioration in the investment climate, Chief Executive Tung had to issue a public statement to soothe his ire. Ronnie Chan, another superrich realtor, lambasted the city's democratically elected politicians as "communists"—perhaps unaware of how ironic that must sound to his communist patrons in Beijing.

The Hong Kong government, meanwhile, faces a fiscal dilemma. If it decreases its dependence on property income, it has just two options. It can slow the pace of public spending, which has grown 13% a year for the past five years, far outpacing economic growth and revenue intake. Or it can increase income-tax revenue by hiking the tax rate or slapping on an additional levy, such as a VAT. Instead, it has chosen to save the property sector by freezing land sales. It justifies this by raising the specter of a banking crisis, arguing that a further fall in property values would cause bank runs. That was the favored rationale of local property and banking tycoons last year, despite a lack of evidence that Hong Kong's well-capitalized banks would crash. Now the tycoons have changed their tune and want the government to resume land sales. Even they realize a new bubble could result if the freeze remains—making a mockery of the government's original decision.

The government must stop following the orders of the tycoons (even though they helped elect the Chief Executive). Tung must act as the leader of all of Hong Kong's 6.6 million people. Economic rationale requires that the returns on property be close to the cost of capital. The latter is about 11%, while the yield on holding a property is not more than 5%. This suggests property prices must fall an additional 55% to make economic sense. Lower property prices translate into a huge Reaganite supply-side tax cut and will induce wage earners to accept lower salaries because mortgage payments will be reduced. Lower costs will also attract investors. People in Hong Kong cannot just keep selling property to one another, turn a profit in the process and call it prosperity. Property profits have no intellectual content—and without that, Hong Kong does not have a future, let alone a bright one. ■