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Big government the danger

BUSINESS SCHOOL by EDWIN LAI LUN-CHEUNG

The Chief Executive's Policy Address has been faulted by many critics. Most notably, people have criticised Tung Chee-hwa's new economic initiatives as being way too weak to give any substantive help to meet the needs of the people, especially the unemployed and those with negative assets. They expect more help from the Government.

I think these new economic policy initiatives are by and large wise ones. And I believe most of my economist colleagues would agree with me.

To see why, we must look at the economic role of the state in a modern society as viewed by mainstream economics. Most economists believe that the market is usually the most efficient way to organise economic activities. Supply and demand determine the price, which serves as a market signal to individual buyers and sellers to let them determine whether and how much to buy and sell.

When the markets are competitive, this mechanism allows efficient allocation of resources in the various sectors of the economy. The market gives incentives to innovative firms to introduce new products and create new industries to replace old firms and old industries in a process named "creative destruction" by Austrian economist Joseph Schumpeter. The government is quite powerless in these processes, except to act as a referee and an enhancer of the functioning of the market.

But there are exceptions, due to "market failure". One important kind of market failure is caused by the presence of "externalities", where buyers or sellers fail to capture all the benefits or bear all the costs from their market action.

In this case, there is a role for the government to play as a co-ordinator. Government investment in infrastructure, education and research, and provision of rule of law, competition policy, protection of property rights and protection of the environment are examples of this role.

Recent academic research indicates that government investment in "human capital" formation and knowledge creation (education and research) can have beneficial impacts on economic growth of a country. The experience of Taiwan is a case in point.

Judging from the above criteria, it is correct for the

Government to focus on investing in education, life-long learning, training and re-training of workers, building roads to the Pearl River Delta, and so on. Indeed, in the long run, the Government should do more to enhance the proper functioning of the market.

For example, it should introduce competition laws to outlaw collusion between firms so as to allow more competition in the various sectors. It should make it a goal to allow 24-hour border crossing.

In the long run, the Government should consider relinquishing the building of low-income housing and replacing it with cash subsidies; subsidy-receivers should be allowed to live north of the border if they so choose.

In higher education, the Government can convert one or more universities into private ones to introduce more market elements in the sector. In the labour market, the Government should continue importing talent from abroad.

In industrial policy, the Government should not favour any particular industry by picking the winner, unless the industry clearly provides "spillovers" to the rest of the economy.

Nine years ago, the McKinsey Global Institute conducted a study on the productivity of the leading economies of the world. They found that the United States was a distinct productivity leader in both the manufacturing and service sectors.

For example, US overall manufacturing productivity was 25 per cent higher than those of Europe and Japan. As a result, the living standard in the US was the highest among the countries.

The primary reason for the high productivity of the US was that the market worked most efficiently there. Europe's productivity was hurt by laws that discouraged lay-offs of workers and protected job security, while Japan's productivity was hurt by the many protectionist measures.

This study lends support to my point above that the market is usually the best way to organise economic activities, and the government should only have a limited, albeit important, role to play.

This is not to deny that the government should re-distribute income for equity reasons. Society, however, has to understand that there is a trade off between economic efficiency and equity, since any income redistribution is bound to distort the market in some way.

The extent to which society should trade efficiency for equity ought to be decided by a democratic process. The building of a civic society and a well-informed citizenry is the key to the success of this process. This, again, is the co-ordinator role the government should play.

This is a very difficult time for Hong Kong. We are hit by a concurrence of unfavourable events. The open-door policy of China, together with its much cheaper labour and land, led to structural transformation of the Hong Kong economy at an unprecedented rate.

The Asian financial crisis followed by the current US recession is another blow to Hong Kong. We are suffering from "double jeopardy".

It is in difficult times that people are tempted to ask the Government to do this or that to revive the economy or give handouts. The fact is, in a small open economy with a currency board like Hong Kong, the Government can do very little to reverse the structural transformation or fight against business cycles. Market forces are too powerful to resist.

There is not very much a government like Hong Kong's can do to relieve people from such a "double jeopardy", except to offer some temporary assistance and to ensure that a minimal social safety net for households is functioning well.

I fear that when people ask too much from the Government, we would gradually develop an "entitlement" culture, and possibly a big government. This can be a dangerous trend.

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