HONG KONG:
THE POLITICAL ECONOMY OF LAND

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Introduction

Known throughout the world as a bastion of free markets, private enterprise, and limited government, in its land and housing policy, Hong Kong, has historically pursued a highly interventionist approach. Whilst there are signs of a possible gradual shift in policy, it is far from clear in which direction it will go with a new quasi-ministerial system to be put in place on 1 July 2002,[1] and how well the various related aspects, such as planning, housing, transport and sustainability, will be coordinated.

It is, thus, useful to review the system in general as it currently stands in order to have a clearer perspective on what may serve the public interest better. This short paper provides a general introduction to the political economy of land in Hong Kong. How land is taxed and the way the HKSAR Government has increasingly transferred land development rights to public corporations provide a unique set of circumstances in Hong Kong that affects both the health of the economy as a whole as well as the style of governance. The surprising lack of understanding of these issues has contributed to disjointed decision-making on the part of the executive and the lack of legislative oversight of the decision-making process.

Furthermore, it is useful to compare how land policies in London, New York and Hong Kong have driven the shaping of the respective urban landscapes in the three cities. It is often overlooked that public policy drives how a city develops, affects how people actually live, and therefore determines the quality of living for the people to an important extent. Hong Kong aspires to be Asia's World City that offers an attractive lifestyle for its residents and can attract talented people from outside to live and work there. Hong Kong policy-makers need to appreciate that they play a critical role in determining the attractiveness of the urban environment. It is near impossible for Hong Kong to promote sustainable development without reshaping its land policy.

Interventionist land policy

The high degree of intervention has been facilitated by the fact that ownership of the superior title to all land is vested in the government. This is true before 1997, when Hong Kong was a British colony, and after 1997, with Hong Kong now being China's Special Administrative Region.

Leasehold is the only type of land tenure that exists in Hong Kong. Control over existing and future possible use of each and every piece of land is enforced through restrictive development covenants within each lease, as to type of use and plot ratios. This control is additionally supplemented by planning legislation that is based upon the British system of zoning and plot ratio requirements.

The financial benefit to be gained by a leaseholder from any alteration to a lease containing restrictive development covenants involves paying a premium to the government, prior to development, on the basis of the before and after value of the lease. It is this land premium mechanism that underlies a fair chunk of the government's annual income. Whilst the amount of revenue from this source has been greatly reduced since 1998, following the dramatic fall in property prices, nevertheless the 2002-2003 Budget shows that the HKSAR Government still expects it to be a key contributor for the foreseeable future.[2] Broadly speaking, if one included land premiums, land transaction taxes, property rates, taxes on mortgage portfolio profits, and profits tax on property development companies, up to 45% of the HKSAR

[1] The new system is officially known as the Principal Officials Accountability System.
[2] See Section 1 – Forecasting assumptions and budgetary criteria of the 2002-2003 Budget.

Government's annual revenue is based on land. These sources of income have facilitated the apparently low rates of direct taxation that Hong Kong is renowned for.[3]

Land premium system

This system of land taxation via payment of land premiums results in substantial sums of risk capital for the private property developers. Having paid a large premium upfront, the risk to developers is very high since they have limited ability to recoup subsequent development losses charged against corporate profits tax. The requirement of paying the land premium ahead of development – that is, by taxing a developer before he has earned a profit – has the effect of limiting the development market to fewer players. The large sums and high risks involved effectively discourage new entrants. The largest developers have substantial "land banks"[4] and are adept at timing their negotiations with the government to minimize the payments for lease conversions so as to maximize profits. Hong Kong's handful of large developers provide a relatively small proportion of units of the residential market, usually those at the middle and upper price range, and the government has had to provide low income housing for nearly 50% of Hong Kong households.

Lack of public oversight

The impact of this restrictive approach to land management is having increasingly important political ramifications. The fact that land is purely a contractual matter between the government (landlord) and private leaseholders means that there is no legislative control through appropriation votes over government action in this area. The HKSAR Government is free to dispose of its interests in land as it sees fit. Essentially, disposal of new development interests in land can be agreed at any price, and on any terms that the government (landlord) desires. If transferred at zero cost to another arm of government, for instance, there is no revenue or expenditure to appear in the government's financial accounts.

Accountability of government decisions

In the post-1997 environment, the HKSAR Government in general has seen increased scrutiny from an ever more demanding legislature and public. However, politicians, the media and the public have yet to really understand the political economy of land in Hong Kong to be an effective watchdog of executive decision-making. They continue to overlook the government's allocation of land rights to fund centrally mandated projects. In other words, the administration is able to allocate land rights without being called to account for its decisions. The Hong Kong public's apparent acceptance of this state of affairs probably stems from the fact that the government has always been able to make unilateral decisions and the people have gotten used to it as the normal state of affairs.

Indeed, the HKSAR Government's reliance on the land market is not limited to extracting income for the public purse. In fact, five of the largest government controlled corporations in Hong Kong have become reliant for their financial viability on "soft" land subsidies over the last five years. The route of allocating land rights has proved to be more politically expedient than attempting to argue for transparent user pay charges for public services.

[3] Many have argued that the Hong Kong government has an interest in keeping land prices high and that the high land values is a disguised form of taxation on the people.

[4] For example, as of May 2002, Sun Hung Kai Properties has 52 million sq ft land bank, Cheung Kong has 18.5 million sq ft, and Henderson Land has 20.7 million sq ft. Developers buy up say agricultural land and wait for the right time to negotiate the land premium for the change of use, usually when the market is soft, in order to maximize profits.

"Soft" land subsidies

The five public corporations that have become increasingly reliant on revenue from the sale of development interests, granted essentially free to them by the government, are: the Housing Authority (HA), Airport Authority (AA), Kowloon Canton Railway Corporation (KCRC), MTR Corporation (MTR) and Urban Renewal Authority (URA). In each case, the sale of the government-allocated development rights they received, with the exception of the HA,[5] to the private sector market, helped to subsidize the cost of capital and even recurrent expenditure on services that are uneconomically priced.

The scale of the HKSAR Government's and the entire economy's reliance on the price performance of the property market has consequently risen dramatically in the period since 1997, despite the official line to the contrary and despite softer prices.

For instance, the HA is probably the largest residential developer and landlord in the world. From 1997, it was envisaged that the HA would add 2.5% per annum to the entire completed residential stock every year for the next decade.[6] Seventy percent of that output was designated to be flats for sale to lower income groups, at half price, on " free", or (more accurately) un-priced, land. The HA's market share was expected to be 60% of all new residential developments in Hong Kong. The proceeds of sale were to be used for building more rental units for those who earn even less, where the monthly rental payments are not legally allowed to be more than 10% of their income.

The MTR had a minority stake listed on the local stock exchange in 2000. To avoid substantial fare increases, and to bolster returns and provide cash for new railway investment, the corporation was given pre-emptive development rights by the government on 70 million square feet of space. This is twice the size of the development portfolio of even the largest local developer.

The AA has been allocated over 100 hectares of land, which is three times the site area of Canary Wharf in London, waiting to be developed. The KCRC is to re-pay the government's equity injection for its West Rail project though the sale of 22 million square feet of developable floor area. Finally, the URA has been set up to acquire 200 large urban sites for re-development. About 35% of the total area to be acquired over the next twenty years is owned by the government, who will contribute the land free of payment.

Government critics

Criticisms of the HKSAR Government's land policy have come from various quarters in the last few years. Private sector developers were unhappy with the large government housing development plans as they competed with private sector developments. Private property owners, who have seen their property values decline by some 50%, believed the government's ambitious plan to build more residential units and its inability to retract its plan when the market fell, further depressed the market.

Others question why some public corporations, such as the URA, should be allowed to operate in competition with the private sector in commercial development on more advantages terms. Economists and public policy experts saw the government's land policy as engendering a vicious cycle of the government having to continuously inject more land (capital) to prop up the various public corporations. Furthermore, the land injection process

[5] The HA is different because it does not sell its land.

[6] *A Future of Excellence and Prosperity for All*, speech by the CE on 1/7/97, and *Building Hong Kong for a New Era,* CE's annual policy address on 8/10/97.

(which is off-budget financing) hid uneconomic pricing from public view. It is easy to dismiss property developers as a vested interest group, but taken together, the critics raise important issues of what role the government should play in the land market, which has enormous impact on the economy as a whole.

Overlooked area

Politicians, the media and the public do not appear to fully appreciate the effects government policy on land and housing have on the economy. The fact is that the ability of the government to fund public investments via allocating free land provides little opportunity for the public to scrutinize the economic efficiency and impacts of those arrangements. As such, there is no real accountability in the executive's decision-making. It is likely that many government officials charged with various responsibilities relating to land and housing do not fully understand the impacts of their decisions either.

Understanding the nature of the problem

We believe it is the very restrictions embedded in the regulatory regime controlling land rights that is causing the problem of a land market unable to adjust to changes in demand. We have highlighted the increased use of land development rights allocation to mask implicit subsidies for public corporations. But that is merely a subtle amplification of the government's longstanding reliance on direct and indirect revenues from land and property-related revenues that funds capital works and recurrent budgetary expenses.

A land market that operated differently, such as under a system that requires much broader planning approvals and without the need to pay for new lease conversions upfront prior to re-development, would probably result in structurally lower real asset prices but would also provide more choice for the population in terms of where and how they live and work. It is vital for Hong Kong to see how else the land system could operate and what overall benefits there could be. However, changing the land system will actually also impact on how the executive governs in Hong Kong. It has always controlled land supply and therefore the land market. It may be reluctant to change.

Myths about Hong Kong

However, the reality of the situation, despite the current cyclical downturn in asset prices, is that until fundamental reform of the supply side occurs, the real asset markets in Hong Kong will continue to be characterized by comparatively high prices coupled with price volatility. Equally certain is the fact that, as property is the most obvious manifestation of wealth, many casual observers will continue to characterize Hong Kong as having an economy that is overly dependent on property. In fact, Hong Kong is the world's largest urban service economy, which has unlimited potentials for growth and wealth generation and there is no need to think that high land prices is the best barometer for an economy's success.[7]

There is another myth about Hong Kong – that it has insufficient land. A common belief is that prices are high because there is a shortage of supply. The truth is that there is plenty of land if only the land market is more flexible for development and regeneration:

[7] Since 1993, Hong Kong's service sector has grown each year to support a dynamic light industrial manufacturing sector that has also been a key wealth generator, which had been reinvested in the Hong Kong property market over the years. Services now contribute 85% of Hong Kong's GDP.

- Firstly, remember the government controls land supply[8] as well controls all the land that it allocates to public corporations.

- Secondly, there is much developable land in the New Territories that are being used for building small houses.[9]

- Thirdly, there are vast tracks of dilapidated buildings in many prime locations, such as Wanchai, Mongkok, and Sham Shui Po, which have not been redeveloped due to inflexible land law.

- Fourthly, there is plenty of industrial space that could be converted for commercial and residential uses. Industry has long moved to cheaper locations across the border. Indeed, there is a lack of commercial space for Hong Kong's substantial services sector.

Comparing Hong Kong with London and New York

Hong Kong ranks alongside London and New York as one of the three great service entrepot cities in the world. The three cities are almost identical in their GDP, populations, labour force participation rates and the size of the resident populations. If the key economic statistics of the three cities were anonymously set out it would be difficult to work out which is which.

If one were asked to match the data with the cities in a quiz there are clues for the eagle-eyed contestant. The main clue is that on account of Hong Kong's manufacturing hinterland in South China, almost 30% of Hong Kong's GDP is generated from logistics handling services. Hong Kong's container port is the busiest in the world, whilst London and New York have seen their dockside activity dwindle dramatically. In London's case, with the Thames River being tidal, it was the first of the three to be assured of the early demise of its physical cargo handling role.
Despite the surprisingly similar key economic statistics across the cities, there are, however, some major qualitative differences that are not readily apparent from the numbers. The two principal ones being that Hong Kong, unlike London and New York, keep its entire tax revenue for itself. It is estimated that both of the other two cities pay up to US$30 billion per annum of tax revenue away to central government.[10]

The second key difference is that the "active" hinterlands of London and New York comprise over 20 million people. The term "active" is used in the sense that people commute to work and freely alter location from inner city locations to suburban locations during their lifetime, without regulatory barriers. On the other hand, Hong Kong has a hinterland that has a markedly different system of administration; where tax and legal regimes differ in a way that

[8] The government releases land for auction.
[9] The small house policy was devised in the 1970s to entice the New Territories villagers to sell land to the government for new town development in exchange for building small houses in designated areas. The policy allows the male indigenous villagers to build small houses of about 700 sq ft supposedly to enable them to maintain a rural lifestyle. Over the years, much of the small houses have been sold to non-indigenous villagers. There are currently over 10,000 villagers waiting to build small houses. These houses do not have to abide by normal building regulation. The policy have created inefficiencies in land use in the New Territories and raise a whole host of other issues as well, such as whether it is fair to continue this policy in perpetuity, and discrimination in not allowing the indigenous women to apply for small houses. The government set up a special committee to look at replacing the policy in 1997 but it has so far not released any further information.
[10] The Basic Law, Hong Kong's post-1997 constitution, provides that Hong Kong does not have to contribute to central government coffers.

is not to be found in either Greenwich or Guildford. There is no free flow of population between Hong Kong and its broader hinterland.[11]

The stories cities tell

Stepping back from the bare statistics, and the obvious differences in the accessibility of Hong Kong's hinterland, the most intriguing feature is that each city has a very different skyline, despite the similarity of economic activity and purpose. Urban form in the world's great cities is never a reflection of free market forces, but is always a reflection of the impact, over time, of various regulatory restrictions and the degree of freedom that land markets have been allowed.

Cities' built environments are a fascinating reflection of society's constraints on land development. As such, the different urban environments of cities are effectively coded reflections of individual historical ownership patterns representing a cumulative catalogue of regulatory decisions. The combination of all these interlocking strands dictate a city's physical appearance and its ability to facilitate adjustment to the cumulative impact of constantly changing economic and social requirements.

As a consequence, each city has its own very distinct skyline. The low rise structures of Tokyo's financial district have been dictated by the presence of the Imperial Palace, and the height restrictions that have been imposed because of requirements for privacy and, more importantly, as a sign of respect for royalty. The block on block high rises of Manhattan, monuments to an aggressive zoning policy adopted in 1916, stand in sharp contrast to the horizontal development seen in the subdued and modest skyline of London. London's skyline reflects its planners desire to keep open the vistas of the historic city, further enforced by a fair sprinkling of conservation orders. The high-rise density of midtown Manhattan is in sharp contrast to the outlying towers of Shinjuku in Tokyo and Canary Wharf in London.

Prices and space

Furthermore, the structure of each of the three entrepot cities' real estate markets is very different. The table below compares London and Hong Kong. New York has been left out because it has 1.3 million controlled tenancies. London and Hong Kong both have about 7 million inhabitants but London has over one million more households and one million more residential units. Gross household incomes in London are therefore substantially below those in Hong Kong. The discrepancy is even greater when net of tax incomes are arrived at.

[11] The physical separation post-1997 was designed to ensure that Hong Kong would not receive a flood of people from Mainland China. The system allows 150 one-way permit holders per day from the Mainland to move to settle in Hong Kong.

Tale of Two Cities

	London	Hong Kong
Macro Statistics		
Population (million)	7.187	6.974
GDP (US$ billion)	153.96	157.79
Households (million)	3.1	2.1
Workforce (million)	3.676	3.529
GDP per household (US$)	50,300	75,090
Av residential price (US$)**	250,000	225,000
Household GDP to residential price (x)*	5.0	3.1
Compensation to GDP (%)***	64.8	51.7
Compensation per household (US$)	32,586	38,820
Unemployment (%)	7.0	7.1
Residential Market		
No. of residential units (million)	3.04	2.13
Value of residential stock (US$billion)*	750	470
Value of stock/GDP (x)	5.0	3.1
Tenure (%)		
I. Owner occupied	56	55
II. Social rental	27	34
III. Private rental	17	10
Residential vacancy (%)	3.7	5.9
Office Market		
Office stock (sq ft million)	200	100
Value per sq ft (US$)	1,200	800
Value of stock/GDP (x)	1.5	0.5

Source: Focus 2000 on London, Corporation of London – London, New York Study, June 2000, and various HKSAR Government publications. All data relates to 1999 for Hong Kong except unemployment which represents May 2002 and current residential/office values are used. For London, 1997 numbers are used except for residential prices and office values, which are current.
* At full market value across all units
* * HM Land Registry, June 2000 for London and for Hong Kong the estimate is based on the average 550 sq ft private sector flat at HK$3,000 per sq ft.
*** Includes National Insurance contributions.

On the other hand, the average size of a residential unit is a mere 550 square feet in Hong Kong. It is therefore hardly a surprise that Hong Kong has some of the highest per square foot residential prices of any city.

Similarly, both have about 3.5 million people in a service sector dominated workforce. But Hong Kong has a mere 100 million square feet of office space, whereas in London there is in excess of 225 million square feet (New York tops the lot with an office stock well in excess of 400 million square feet). Once more Hong Kong has structurally high rents in the office sector, and per square foot usage is kept to less than 100 square feet per employee.

The picture postcard scenes of Hong Kong's soaring waterfront skyscrapers, so readily taken to be the city's unique signature, mask the complexity of its urban form. Anyone with an eye for urban detective work can readily spot the dichotomy of the urban areas, high rise office and residential buildings stand cheek by jowl next to decaying tenements and great clumps of decaying and economically redundant industrial buildings.

Equally, a brief journey to the areas outside the patchily high density urban core quickly brings one to country parks and agricultural land, with their accompanying new rural sprawl, taking the form of low rise three storey Spanish style villas[12] that stand adjacent to decaying historic Hakka villages.

A bit of history

Just as in all the best stories, the story of Hong Kong's urban landscape emerges from a complex plot. A colonial power comes to rule a distant piece of land. Different treaties govern different parts of a 400 square mile area, with some land designated as freehold land and some land held on a 99 year lease, with special provisions made for the protection of the existing land rights of the indigenous rural population.

Oddest of all, the little old Walled City of Kowloon, now demolished, was a sort of no man's land, regarded largely as a "no-go" area by the colonial authorities. All that was mixed in with the later adoption of planning regulations that controlled land use and plot ratios in the best traditions of Britain's 20th century restrictive town and country planning legislation.

The HKSAR Government's current and increasing, direct and indirect, dependency on land rights has its roots in the city's colonial past. Hong Kong Island and the southern part of the Kowloon Peninsula were granted in perpetuity to Britain but the cession of the much larger New Territories was for a 99-year lease. The colonial government owned the superior title to all the land in the new colony. There appeared to have been no legal claims for expropriation. For the period up until at least the early 1970's, the New Territories, where indigenous land rights had been recognized, were of marginal relevance to an almost entirely urban Hong Kong built upon the largely freehold land of Hong Kong Island and Kowloon.

At the outset, the administration decided that any interests in land sold to the private sector should be leasehold interests, rather than the freehold interests that could have been offered. The only practical way of releasing land was through auction and the first auctions were held in the 1840's. Commentators were already describing the frenetic bidding from the merchants and volatility of the market. To prevent abuse, the leasehold interests were granted with terms attached limiting the types of usage, which eventually became the key determinant in assessing the economic value of a piece of land.

In the initial years after the founding of the colony, there was some discussion back and forth with Whitehall over what interests in land should be sold, whether freehold land should be released, and whether auction was the correct approach. Some twenty years after Hong Kong's founding, an expedient decision was made. The British garrison in Hong Kong was

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[12] Many of the Spanish style villas or in fact small houses – see footnote 9.

not to be funded from Whitehall any longer, and government ownership of the land market in Hong Kong was proving to be a good revenue generator to help pay expenses.[13]

For a long time, Shanghai and Guangzhou were more important than Hong Kong but change happened quickly. In 1901, Hong Kong had a population of 380,000. By 1930, it had grown to 840,000. By the time of the Japanese invasion the population had soared to 1.6 million, only to collapse in the subsequent four years to 600,000 by the end of the war. The establishment of the People's Republic of China in 1949 marked a turning point. Hong Kong offered the only safe haven in a region in turmoil. By 1951, Hong Kong's population reached a staggering 2,360,000.

Post-war demands

This post war period marked an important junction for the administration of the land market in Hong Kong. The government had excess demand for shelter, and was soon to have excess demand for industrial activity, as the new immigrants needed work and at the same time they represented a cheap source of labour for the economy. The government needed to act. The decisions taken at that time proved to be pivotal in shaping the current physical structure, and political form, of Hong Kong.

The old system of restricting development activity through covenants in leases had lasted a century and appeared to have handled the land demands of that population in a satisfactory manner, whilst generating revenue for Hong Kong. There appeared little need for change. The government was to remain the owner, price setter and dominant player in the land market even though there were calls at the time for the freeing up of the land market.[14]

How the government became the largest housing provider

Furthermore, rent control had been introduced as an emergency measure in October 1945 but was not removed. It made subsequent development unappealing, as the rates of return on investment were poor. Despite some relaxation of the regulations to allow easier possession of buildings under some circumstances, the stifling impact of rent control had already killed off the chances of the rapid development of a formal private sector market with sufficient vibrancy to help house the massive influx of refugees from China.

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[13] In Canada, Australia and India, land was used as a source of revenue by the colonial power. There was a strong political motive in this approach. It leveraged the political power of the administration. The use of land revenue, instead of more overt forms of taxation, is cited by some academics as having been a direct response to the experience in America. Explicit taxation there had rapidly generated calls for representation. It was believed by Whitehall, correctly as it so appears, that the use of land as a source of revenue would not generate demands for democracy, at a time when only 10% of the population in Britain was allowed to vote anyway. Ironically, over 200 years on, the modern manifestation of this thought process has been expressed by a number of influential Hong Kong people, stating that democracy in Hong Kong would be inappropriate given the fact that the minority of citizens pays any direct income tax. Whatever, the rights and wrongs of this stance are, the fact is that all citizens have an equal interest in the land rights which the government disposes of, and all citizens have a stake in a significant proportion of the revenue generated by the administration.

[14] Richard Y C Wong noted that: "In 1947 most of the Unofficial members of Legislative Council were very critical of government impediments to private development and building and called on the government to remove all unnecessary regulatory barriers. The Unofficial members were representatives of property and business interests. In the 1947 debate there were demands for the lowering of crown rents and premiums, the relaxation of the high degree of control exercised by lease conditions over what developers built, and the speeding up of lease transferals within the administration". See *On Privatizing Public Housing,* The Hong Kong Economic Policy Studies Series, City University of Hong Kong Press 1998 pg. 21.

As the population swelled, the private sector became the key provider of informal, illegal, housing in the form of squatter villages.[15] The infamous squatter hut fire in Kowloon, which saw 53,000 people made homeless on Christmas Day in 1953, marked the day that the government got involved. The gradual move to clear squatter settlement areas required the government to provide permanent housing for the squatters. Hence, the public housing programme was born in 1964. For decades, the HA was the only government agency involved as principal. Thirty years later, some 45% of the population found itself in centrally allocated government housing. As with all subsidized initiatives, using bureaucratic delivery mechanisms, the scheme expanded, and its intent changed over time.

As of 2001, the HA had built over 1 million units, or 50% of the housing stock. Its product range from small flats for the elderly through to subsidized flats for sale, with people earning of up to US$75,000 per annum being eligible to apply to purchase flats at 50% discounts to the market price. Some idea of the scale of the HA's current operations is given by the fact that it has been estimated that the total subsidy involved in flats production alone was in excess of US$10 billion in the year 2000.

Despite the massive public housing programme, it should be noted that slum conditions have not disappear altogether. Hong Kong still has what are referred to as "bedspace apartments" and tenements with appalling living conditions. Unlike say Calcutta, you don't see Hong Kong's slums along the roadside, but they are there – upstairs in Hong Kong's older, dilapidated private buildings.

History of the Housing Authority

Whether with railways and the airport, or more recent projects, such as Cyberport and Disneyland, all of those initiatives have only been possible because of the fact that the HKSAR Government treats its ownership of land as a private contractual matter. The terms and conditions of land disposal are now the key to these projects proceeding. In that context, and given its importance as the unintended role model, the development of the HA from Acorn to Oak Tree is instructive.

For the first 10 years of its involvement, the Government only offered homes for those being re-settled from the squatter areas. Inevitably, the scope of involvement was expanded to catering for lower income groups as well. In 1973, after the riots of six years earlier, public housing was, for the first time, seen as a cornerstone of Hong Kong's social policy, offering the hope of providing stability to an immigrant society. A goal of building 350,000 new units in the next decade was tied to the opening up of the New Territories with six new towns built so that lower-income people could move into them as the first tenants.

The government's role as a housing provider expanded once again in 1976 to include a scheme for the sale of subsidized flats. It enabled rental tenants in the new towns to trade up into the ownership of a flat that they could not otherwise afford. It also provided a rung on the ladder for people too well off to qualify for rental subsidies, but unable to purchase in the private sector, as limited supply and rising economic activity was driving prices up. The

[15] Richard Y C Wong noted that: "A market solution was rendered impossible from the very beginning because of rent control. An interventionist solution in the form of a public housing programme soon appeared as a practical solution" (pg. 26) and that: "… the state was chiefly responsible for preventing the private sector from functioning properly. Had it not been for the private sector, many immigrants would not even have a squatter dwelling to call home" (pg.34). See *On Privatizing Public Housing,* The Hong Kong Economic Policy Studies Series, City University of Hong Kong Press 1998.

number of flats for sale was a limited and initially restricted to existing public rental tenants. Over the years, the scheme expanded and became opened to people who were in private sector accommodation within certain qualifying income levels, who had to take their chance of getting the subsidy through a ballot.

As the sums involved became larger, despite the land being booked to the HA at a very low cost, the issue of public finance came up. Were the construction costs to be included as a departmental expense along with normal government capital expenditure? In that case what about the revenues from the sale of discounted flats?

In 1988, the HA was reorganized and given a separate financial identity and autonomy with sufficient flexibility to implement the government's Long Term Housing Strategy. As demands on the Authority's resources grew and given its inability to increase the rents in its portfolio of 650,000 rental flats, the sale of discounted flats became the financial engine for the execution of its targets. The HA's problem was foreseen by the economist, F A Hayek, who warned in 1960 that:

> "… such limitation of public housing to the poorest families will generally be practicable only if the government does not attempt to supply dwellings that are both cheaper and substantially better than that class had before; otherwise the people assisted would be better housed than those immediately above them on the economic ladder; and pressure from the latter to be included in the scheme would become irresistible, a process that repeats itself and progressively brings in more and more people ".[16]

A circular dependency had grown up. High private sector property prices allowed the HA to have more cash available to build more rental flats and attempt to make inroads into the rental waiting list that, even after fifty years of building, stood at over 100,000 families. Rising asset prices enticed more low-income earners to apply to purchase discounted flats.

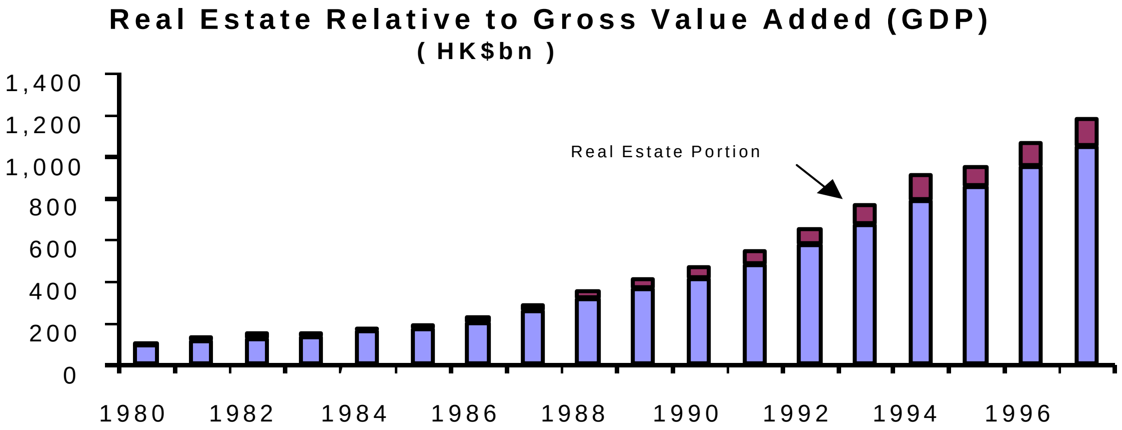
But the attraction of this circular dependency was the fact that there was now a mechanism allowing a separate government controlled entity to grow by the grant of land rights, without intrusive scrutiny by the legislature. The HA had evolved an elegant financing mechanism, one A that was to be soon adopted by the government to facilitate other public projects, such as railways and the airport.

Issues for public deliberation

Hong Kong's ambition to be Asia's World City that can provide a high quality of life in a clean environment can only be achieved if it has the right land policy to drive sustainable development. The basis of Hong Kong's political economy, entrenched in government control of private land rights, is a unique in the world. Reform of the land market is essential.

A first step could be to revise its current view that property is the key pillar of the economy. Senior government officials have described the pre-1997 economy as a "bubble economy", which is inaccurate. There was a property bubble but Hong Kong off-shore manufacturing and services sectors represented solid businesses. Whilst many people had made a lot of money in the past from property speculation and the government continues to rely on land revenues for its income, the growth of the service sector is what will be really important to Hong Kong. Since 1992, the service sector has grown substantially, turning Hong Kong into a full-service metropolitan service economy that serves much of the Mainland's needs as well.

[16] F A Hayek, *The Constitution of Liberty*, Routledge, pg.345, 1960.



A second step would be for the government to consider a profits tax surcharge levied on profits realized on completion, in compensation for the granting of planning permission, instead of staying with the current land premium system.[17] So far, the government has shown no interest in this direction. Revising the land premium system was not among the ideas that the tax review exercise in 2001-2002 included.[18]

We hope that with the new Principal Officials Accountability System in place by 1 July 2002, it could provide an appropriate time for a major comprehensive review of Hong Kong's land policy.

[17] See *Restructuring During Recession – A Silver Lining in the Clouds,* a shadow Budget by Citizens Party, 24/2/99 and *New Fiscal Structure for a World Class City,* a shadow budget by Citizens Party, 22/2/2000 where the idea of a land development tax were discussed, www.citizensparty.org

[18] The government appointed Advisory Committee on New Broad-based Taxes reported in February 2002 but did not consider land taxes.