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Hong Kong's Economic Freedom and Income Inequality

Emmett Choy
Claremont McKenna College

CLAREMONT MCKENNA COLLEGE

HONG KONG'S ECONOMIC FREEDOM AND INCOME INEQUALITY

SUBMITTED TO

PROFESSOR MINXIN PEI
AND
PROFESSOR EMILY CHAO

AND

DEAN NICHOLAS WARNER

BY

EMMETT CHOY

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ABSTRACT

Hong Kong is considered to be the most economically free country in the world, but also has the highest amount of income inequality of any developed country. The Hong Kong government is able to sustain laissez faire policies due to its monopoly on land supply. Maintaining high property values allows the government to maximize revenue from property tax, which acts as a hidden tax. A major contributor to income inequality is the formation of oligopolies in Hong Kong that creates an anticompetitive environment. The interests of the government and oligarchs are aligned as both obtain significant portions of revenue from the property sector. As globalization makes Hong Kong even more vulnerable to external shocks, the government faces the challenges of increasing competition, diversifying its revenue streams, and closing the income gap while standing by its principles in order maintain regional competitiveness as an international business hub.

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I. INTRODUCTION

Economic Freedom and Income Inequality

Hong Kong is often cited uncritically as the beacon of the benefits of laissez faire economic policy in ensuring rapid and flexible economic development. This view often contains an ideological undertone as it ignores the fact that other comparable Asian economics - such as Taiwan and Singapore - also experienced spectacular economic growth in the post-war period, but with significantly more governmental direction.[1] For the 19th consecutive year, Hong Kong has maintained its #1 position in the *2013 Index of Economic Freedom* published annually by the Wall Street Journal and the Heritage Foundation.[2] However according to The World Factbook developed by the U.S. Central Intelligence Agency, Hong Kong's Gini index, a measurement of distribution of family income, is ranked at #11 most unequal at 0.537. The only countries with more income inequality than Hong Kong are developing ones in Africa and Latin America. Singapore and Taiwan are ranked at #26 and #91 respectively.[3]

The reality exists that from 2001 to 2011, the average gross household income of the poorest decile of the population fell 16 percent to $280 a month. Furthermore, the income of richest decile jumped 12% to $17,738 a month.[4] Even Forbes increased their list of Hong Kong's 40 Richest in 2012 to 50 Richest in 2013. In September 2013, Chief Executive Leun Chun-ying released a report that said about 1.3 million people, or 19.6

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[1] Pooja Thakur, "Hong Kong Most Costly City for Rents, Savills Says," *Bloomberg* accessed October 25, 2013, http://www.bloomberg.com/news/2013-09-17/hong-kong-most-costly-city-for-office-home-rents-savills-says.html.
[2] "Hong Kong Leads World, Region in Economic Freedom, 2013 Index Shows," accessed October 8, 2013, http://www.heritage.org/index/press-release-asia-pacific.
[3] "Country Comparison :: Distribution of Family Income - Gini Index," n.d., https://www.cia.gov/library/publications/the-world-factbook/rankorder/2172rank.html.
[4] Census and Statistics Department, "2011 Populations Census: Thematic Report Houshold Income Distribution in Hong Kong," 2012, http://www.census2011.gov.hk/pdf/household-income.pdf.

percent of the population, was below the poverty line last year. The benchmark was determined at half of the city's median household income, excluding tax and welfare transfers. After cash benefits, this number drops to 1 million or 15.2 percent. The Gini coefficient (GC) in addition to these quantitative facts reflect growing discontent. Tens of thousands of people protested on July 1, the anniversary of Hong Kong's return to China, demanding that the government address inequality, which has been exacerbated by the more than doubling of home prices since early 2009.[5]

Census and Statistics Department Interprets High Gini Coefficient

The Half-yearly Economic Report 2012 published by the Census and Statistics Department in Hong Kong, attempts to explain the GC based on statistics from the 2011-Census. In the 1970s, the GC stood at around 0.430, and began to go up quite visibly since 1980s. Such rise further accelerated between 1986 and 1996, in which the GC increased from 0.453 to 0.518, sharply by 0.065. The increase of GC then showed considerable moderation, and its latest pick up in 2011 (up 0.004) was actually the smallest as compared to the previous 25 years. Briefly analyzing the GC in the past 40 years shows that while it continues to increase, the acceleration has slowed significantly since 1996. Also, the GC based on post-tax post-social transfer in 2011 was 0.475. The difference of 0.62 after taxes and social transfers shows that the government is pretty effective in mediating inequality.

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[5] Fox Hu and Michelle Yun, "Hong Kong Poverty Line Shows Wealth Gap With One in Five Poor," *Bloomberg*, accessed October 9, 2013, http://www.bloomberg.com/news/2013-09-29/hong-kong-poverty-line-shows-wealth-gap-with-one-in-five-poor.html.

The report also points out that while GC is a condensed singe measure of income disparity, the coefficient itself cannot express the socio-economic and demographic factors that contribute to it. Therefore it would be more meaningful to supplement the statistic with analysis of the economy to identify the factors accountable for the widening income gap. These four contributors were: the inflow of immigrants, economic restructuring, population aging, and smaller household size.

The huge inflow of immigrants from Mainland China before the 1980s created a sharp increase in total population. While a fresh source of manpower to support the fast economic growth of Hong Kong, this inevitably increased the number of low-income households as most of them were confined to low-paying jobs due to their relatively low education and skill levels. This explains the jump of GC between 1976 and 1981, and during the 1980s and 1990s.

To capitalize on the opportunities offered by the Mainland's open door policy since 1978, the Hong Kong's economy underwent rapid restructuring as manufacturers reallocated their production base to the Mainland. The primarily manufacturing based economy shifted to a remarkable increase in the high value-added, knowledge-based service employment. The process was found to be most intense during the 1980s and 1990s. Employment in manufacturing shrank form 41.2 percent to 18.9 percent while financing, insurance, real estate, and business services increased from 4.8 percent to 13.4 percent. This economic transformation created a large number of higher-skilled jobs in professional services leading to a more diversified labor market in comparison to the once relatively homogenous nature of work with simple pay.

Hong Kong is also facing an aging population issue, resulting in the growth of retiring elderly and economically inactive household with little or no employment income, thereby widening income disparity. The percentage of economically inactive households from 1986 to 2011 has increased from approximately 11.6 percent to 19.5 percent. However in opposition to these findings, 48.08 percent of the total population in Hong Kong is between the ages of 30-59 years suggesting increased unemployment and inactive households due to an aging population has not quite hit the economy yet.[6]

The last contributor to the widening GC is the ongoing change in family structure towards smaller and nuclear families. This has led to a decline in average household size from 3.3 in 1996 to 2.9 in 2011. Since household income depends partly on household size and in particular the number of working household members, a decline in average household size in combination with an aging populating would drag down household income in general.[7]

The Census and Statistics Department provides a valuable interpretation of data and attributes the high GC to different economic and demographic factors that paint a more meaningful picture of a compressed coefficient. However a major factor that is arguably the most important contributor to wealth inequality is the formation oligopolies whose source of revenue originated from real estate. Oligopolies are difficult to measure and quantify, but have certainly had a profound influence on the increase in the GC.

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[6] *Hong Kong Real Estate Report - Q4 2013* (London, United Kingdom: Business Monitor International, Fourth Quarter 2013), http://search.proquest.com/docview/1433935600/abstract/141E73F2DD45F4001A9/15?accountid=10141.

[7] Census and Statistics Department, “Half-Yearly Economic Report 2012: The Gini Coefficient of Hong Kong: Trends and Interpretations,” n.d., http://www.hkeconomy.gov.hk/en/pdf/box-12q2-5-2.pdf.

This study argues that while Hong Kong continues to be considered the most liberal political economy in the world, Adam Smith's invisible hand has not proven to be completely effective as the domestic non-traded sector of the economy is riddled with oligopolies, cartels, and interlocking conglomerate structures. Furthermore, the government monopoly on land has partially led to the anticompetitive environment today. Dismantling the oligopolies, which also have major real estate holdings, is a delicate issue since the government also relies heavily on the property sector for revenue. The Hong Kong government recognizes that the growing inequality between the rich and the poor poses a major challenge but so far has been ineffective solving the problem.

Overview

Hong Kong has very few legal barriers to entry in the domestic market. The Heritage Foundation states, "The trade regime remains one of the world's most competitive and efficient, with a zero tariff rate and minimal non-tariff barriers. A robust and transparent investment framework, in place for many years, continues to attract foreign investment."[8] It is true that there are no significant barriers to the import and export of capital and there are no legally restricted business sectors. While one might expect foreign capital to play a significant part in the capital-intensive domestic economy, the truth is that is not the case. Although multinational corporations locate their regional head offices in Hong Kong and major international investment banks have a large presence in Hong Kong, foreign corporations play a small role in the domestic economy overall. Local family-controlled conglomerates, most of which are ultimately

[8] "Hong Kong Economy: Population, Facts, GDP, Business, Trade, Inflation," accessed October 8, 2013, http://www.heritage.org/index/country/hongkong.

real estate developers, dominate most capital-intensive sectors. These include gas, electricity, bus and ferry services, the seaport, supermarkets, large retail chains, telecommunications services, and residential housing. The ultimate holding companies have broad cross-sector interests that tend to contract with other group companies, creating high barriers to entry that restrict competition. [9] The current market is a dichotomy between small-scale business that is largely competitive and large-scale business that often lacks robust competition. Even large overseas companies such as Walmart and Carrefour have failed to break the supermarket duopoly held by Wellcome and Park N'Shop. Consumers are left paying significantly more since prices for goods are not subject to competitive supply. [10] Ultimately, the government's land monopoly has contributed to why this web of conglomerates and their interlocking subsidiaries exist. To comprehend this relationship, it is necessary to understand the modern history of Hong Kong.

II. HONG KONG AS A PROPERTY STATE

Context

In 1841, the Treaty of Nanking ceded Hong Kong Island from China to Great Britain. The Crown was immediately faced with the problem of raising public revenue to finance its operations. Due to Hong Kong's advantageous regional location next to China, it was decided that to encourage trade, there would be no substantial import duties.

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[9] Mark Williams, *Competition Policy in Hong Kong: Present Conditions and Future Prospects*, SSRN Scholarly Paper (Rochester, NY: Social Science Research Network), accessed October 24, 2013, http://papers.ssrn.com/abstract=1075322.

[10] *HONG KONG: Oligarchs Hurt Domestic Competitiveness* (Oxford, United Kingdom: Oxford Analytica Ltd, December 5, 2000), http://search.proquest.com/docview/192434666/141E7E7E7307A44E4D5/4?accountid=10141.

Therefore, the first colonial government decided to use leaseholds as a source of funding which was also simpler than the complications of fixed property rights. Later in 1861, the Treaty of Peking ceded the New Territories and further land on the Kowloon peninsula on a 99-year lease that ran until 1997. It was not until the Sino-British Joint Declaration signed in 1984 that the United Kingdom declared it would hand over Hong Kong to the People's Republic of China with effect on July 1, 1997. Essentially, the Crown had laid the foundations for a complete land supply monopoly in Hong Kong.

The first colonial government began the sale of leasehold land rights, which became its primary source of funds. The system largely remains unchanged today as the government on average obtains approximately 30% of its revenue from land ownership. Land-based revenue has brought about the enrichment of not only the public sector, but also the major land development companies. Today, the Hong Kong government has no debt and huge fiscal reserves, and real estate developers who initially reaped enormous profits, reinvested domestically to diversify their revenue streams. Originally real estate investors and developers, these companies have evolved into multinational conglomerates.

To further tie the public and private sector together, between 1949 and 1978 during the Maoist regime in China, there was an influx of refugees in Hong Kong. Hong Kong banks supplied the hunger for mortgage lending to a population of immigrants that desired the security of tangible assets such as property, which had been allocated to Mainland Chinese and then usurped by the Chinese Communist Party. As a result, government and big businesses became dependent on each other because land developers relied on the monopoly supplier of land, and the government became dependent on the income generated by the land leasehold system.[11]

The motivation for acquiring Hong Kong was based on commerce therefore the founding ideology of the first colonial government was laissez faire. Direct tax on the population was kept low and even today salary tax is capped at 15 percent, there is a corporate profits tax of 16.5 percent, and there is no sales tax. The government has functioned like any good monopolist and slowly supplies the real estate market to ensure scarcity, maximize prices, and therefore its revenue. By utilizing this revenue model where high property prices and rent act as a hidden tax, Hong Kong has been able to maintain the appearance of being lean and taking a non-interventionist approach to economic affairs, which partially explains the high marks from the Heritage Foundation.

Capturing Land Value

The Hong Kong government is essentially the landlord of all land in Hong Kong Island and Kowloon, and the principal leaseholder of all land in New Kowloon and New Territories. Extensive public ownership of land not only allows the government to subsidize some types of land such as housing and industry, but also to capture the increased value of property. For example, in the U.S. if land values increase due to urban growth, speculative companies usually capture the increase. However in Hong Kong there is no middleman, so the value increment is divided between developers and the

[11] Steve Tsang and Inc ebrary, *A Modern History of Hong Kong.* (London; Gordonsville: I. B. Tauris & Company, Limited Macmillan [Distributor], 2007).

government.[12] The Hong Kong government has four mechanisms for capturing value under the leasehold system: initial land auctioning, contract modification, lease renewal, and the collection of land rent.[13] One example is developers must pay a premium to redevelop properties they already lease. If Cheung Kong Holdings wants to knock down an old 10-story building and replace it with a new 30-story one, the developer must negotiate a new lease and pay the difference in market value between the two.[14]

From 2009 to 2011, property prices have surged 76 percent (56% inflation-adjusted) propelled by very low interest rates and strong foreign demand, specifically from the mainland. Small-sized residential apartments have seen the largest increase. This sharp run-up in housing prices raises the risk of an abrupt correction. To curve speculation, the government has imposed two important polices: first is a 15 percent tax on property purchases made by foreigners, and second is an increase in transaction tax to as much as 20 percent on properties sold within three years of purchase.[15] While these tax policies are meant to stabilize the booming housing market, they are also examples of how the government captures land value.

Domestic Effects

Tight land supply policy has led to several significant economic effects. Real estate prices for commercial, industrial, and residential before 1997 rose almost

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[12] Anne Haila, "Real Estate in Global Cities: Singapore and Hong Kong as Property States," *Urban Studies* 37, no. 12 (November 2000): 2241–2256.
[13] Yu-Hung Hong, "Transaction Costs of Allocating Increased Land Value Under Public Leasehold Systems: Hong Kong," *Urban Studies* 35, no. 9 (August 1, 1998): 1577–1595, doi:10.1080/0042098984295.
[14] Anonymous, "Hong Kong's Property Bust," *Wall Street Journal (Online)*, April 2, 2012, sec. Opinion.
[15] Global Property Guide, "House Prices in Hong Kong | Hong Kong Real Estate Prices," Text, *Global Property Guide*, February 15, 2013, http://www.globalpropertyguide.com%2FAsia%2Fhong-kong%2FPrice-History.

continuously for decades fueled by an increasing population and expanding mainland commerce. Until the Asian financial crisis began, investing in real estate in Hong Kong was practically a sure bet. However the boom imploded and values hit rock bottom with a 61% drop in 2003 further exacerbated by the SARS epidemic.[16] In response, the government attempted to reverse expansionist public housing projects and halted all land sales. During this time, the Hong Kong government experienced current account deficits for four successive years for the first time (excluding wartime). In order to address the weak domestic economy, the Hong Kong government looked to the mainland. By adjusting mainland policies to boost inbound tourism, and encourage state-owned companies in China to conduct initial public offerings in Hong Kong, the government reversed its deficit since 2004 and now enjoys a high fiscal surplus.

Another adverse effect of the government's monopoly on land is the fact in 2011, 47.7 percent of Hong Kong's total population lived in public-subsidized housing.[17] During the Maoist era, many poor unskilled laborers immigrated to Hong Kong, some even swam. The government responded by creating an enormous number of public housing units and even new towns in the New Territories. Today, public housing rents must be highly subsidized and the difference in the cost of rent for a public housing unit and the cost of a mortgage down payment and loan repayments on a private sector apartment is massive. This disparity is a direct result of artificially constructed property value due to constrictive government land coupled with the increasing demand from the mainland.

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[16] "Pumped-Up Property Prices Lift The Fortunes Of Hong Kong's Richest," *Forbes*, accessed October 23, 2013, http://www.forbes.com/sites/russellflannery/2013/01/09/pumped-up-property-prices-lift-the-fortunes-of-hong-kongs-richest/.
[17] Guide, "House Prices in Hong Kong | Hong Kong Real Estate Prices."

Over the years, tacit collusion between developers and the government with respect to land auctions and the sale of completed apartments has long been suspected. Projects in Hong Kong require huge, upfront immediate payments that only the largest developers can afford to finance since most developments are large skyscraper apartments or office complexes. Furthermore, these projects often have a lag time before development begins. As a result, only a few companies have the capacity to acquire development sites and a tight oligopoly of local players has developed.[18]

Due to Hong Kong's strong capitalist ideology of a free economy, the government will not take a socialist approach to alleviating poverty and tackling the wealth gap problem. Instead, the government will likely try to create create an environment that allows for upward mobility, however established family oligarchies have resulted in a dichotomy between small-scale business that is largely competitive and large-scale business that often lacks robust competition.

III. OLIGOPOLIES DERIVED FROM REAL ESTATE

Real Estate Developers and the Hong Kong Stock Exchange

Hong Kong has become a major international finance center. In 2004, it had the 9th largest stock market in the world by market capitalization and today that stock market is ranked #4.[19] At the end of 2012, the total market capitalization of the Hong Kong Stock Exchange (HKSE) was $2.83 trillion, 25 percent higher than at the end of 2011. In the mid-1990s, real estate companies made a stunning contribution to market capitalization.

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[18] Williams, *Competition Policy in Hong Kong*.
[19] Josh Noble and Paul J. Davies in Hong Kong, "Hong Kong Battles to Liven up IPO Market," *Financial Times*, October 2, 2013, http://www.ft.com/cms/s/0/21d42b5e-2b16-11e3-ade3-00144feab7de.html#axzz2lpFgRRID.

In 1996, this contribution was as high as 45% of total stock market capitalization. Even in 2004, there were over 100 listed real estate companies in Hong Kong that represented 12.1 percent of total stock market capitalization, and six of the top twenty listed companies were real estate companies or strongly real estate related.[20] Since Hong Kong is a very attractive place for mainland companies to conduct initial public offerings, the number of real estate related companies has diluted to nine of the top fifty listed companies. Although the real estate sector does not dominate the HKSE as it once did, it is still the primary source of fortune for Hong Kong's richest.

Hong Kong Tycoons

The source of wealth for the four richest men in Hong Kong can all be traced to real estate. The following tycoons are the heads of multinational conglomerates and their family's control extends far wider than only the real estate sector. These four families certainly form an oligopoly in Hong Kong.

Also known as "the man who owns Hong Kong" is the #1 wealthiest person in Hong Kong and #8 in the world, Li Ka-sing. In 2000, the four main listed companies controlled by Li Ka-sing and the two listed companies controlled by his youngest son, Richard Li, accounted for over 18 percent of the stock market's total capitalization. In 2010, this number decreased slightly to 15 percent.[21] Li Ka-sing has a net worth of $31 billion as of March 2013, increasing his wealth by $8 billion this past year. He is

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[20] Graeme Newell et al., "Factors Influencing the Performance of Hong Kong Real Estate Companies," *Journal of Real Estate Portfolio Management* 13, no. 1 (March 2007): 75–86.
[21] "The Miracle Of Asia's Richest Man," *Forbes*, accessed October 27, 2013, http://www.forbes.com/2010/02/24/li-ka-shing-billionaire-hong-kong-richest-opinions-book-excerpt-michael-schuman.html.

chairman of both Cheung Kong Holdings and Hutchison Whampoa, two of Hong Kong's largest multinational conglomerates.[22] In 1950, Li Ka-sing started his own company, Cheung Kong Industries, which began as a plastics manufacturer then developed into a leading real estate investment company. Hutchison Whampoa was one of the old British trading housings that dominated the local economy with roots that can be traced back to 1828. In the 1970s, Hutchison fell on hard times and was bailed out by HSBC. Then in 1979, HSBC sold its controlling stake to Cheung Kong Holdings. Li Ka-sing's acquisition of Hutchison was a pivotal moment in Hong Kong's economic history as it symbolized the removal of the old British trading elite.[23] Besides being a dominant actor in the local property market, he also controls one of the duopolies in both the supply of electricity and supermarket retail. These are the Hong Kong Electric Company and Park N'Shop respectively. He also controls Hutchison Port Holdings, which in 2005 was the largest port operator in the world with 8.3 percent of world market share.[24] His youngest son, Richard Li, currently controls Hong Kong's largest telecommunications company, PCCW, and together with Li Ka-sing's Hutchison Telecommunications International, they have a combined 4.6 million users that represents about 60% of the local mobile phone market.

Second to the Li's is the Lee family. Lee Shau-kee is the #2 wealthiest person in Hong Kong and #24 in the world. He is the chairman of Henderson Land Development and this past year he bought shares in his own real estate developer, boosting his stake by 6.8 percentage points to 62.6 percent. Then, he watched the company stock rise 42

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[22] "Pumped-Up Property Prices Lift The Fortunes Of Hong Kong's Richest."
[23] "The Miracle Of Asia's Richest Man."
[24] Marie-Héléne Le Rossignol, "Global Terminal Operators: An Overview," April 2007, http://www.oas.org/cip/docs/areas_tecnicas/1_reformas_portuarias/15_global_terminal_operators.pdf.

percent boosting his net worth by $3 billion to $20.3 billion.[25] Henderson Land Development has large holdings in five subsidiary companies and together, all six make up Henderson Land Group. The subsidiary companies are the Hong Kong Ferry Company, Henderson Investment, Hong Kong and China Gas Company that holds a majority stake in Towngas, and Miramar Hotel.[26] When Henderson Land Development gained control of Towngas, analysts described it as "a dream come true" since Towngas is the sole operator of the local gas monopoly.[27] Most of the Lee holdings however are in the property sector, which accounts for roughly half of the family's fortune.[28]

The Lee family is closely connected with the Kwoks. Kwok Tak Seng, Lee Shau Kee, and Fung King Hey founded the real estate company, Sun Hung Kai Properties (SHKP) in 1963, and the financial services company, Sun Hung Kai & Co. in 1969. Fung acquired the financial services company in 1996, but SHKP, which is the largest property developer in Hong Kong, remains the base of the Kwok family's fortune.[29] SHKP's subsidiaries include SmarTone Telecommunications and Transport International Holdings, which is the parent company for a number of transportation services. It also operates toll roads, car parks, and ports.[30] The Kwok family is the #3 wealthiest family in Hong Kong, and #26 in the world with a net worth of $20 billion.[31] Kwok Tak Seng died

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[25] "Pumped-Up Property Prices Lift The Fortunes Of Hong Kong's Richest."
[26] Henderson Investment Limited, "Annual Report 2012," n.d., http://www.hilhk.com/en/pdf/investor/annual/2012/annualreport/hi_annual_2012.pdf.
[27] Victor Cheung, "Henderson Land Gets Control of Towngas," *The Standard*, December 8, 2007, http://www.thestandard.com.hk/news_detail.asp?pp_cat=1&art_id=58266&sid=16655998&con_type=1&d_str=20071208&sear_year=2007.
[28] "Pumped-Up Property Prices Lift The Fortunes Of Hong Kong's Richest."
[29] *HONG KONG*.
[30] "The Future of Hong Kong: Real Estate Tycoons and Monopoly," *Also Sprach Analyst*, accessed October 26, 2013, http://www.alsosprachanalyst.com/politics-society/the-future-of-hong-kong-real-estate-tycoons-and-monopoly.html.
[31] "Thomas & Raymond Kwok & Family," *Forbes*, accessed October 27, 2013, http://www.forbes.com/profile/thomas-raymond-kwok/.

in 1990 and left SHKP to his wife and sons. His two younger sons, Thomas and Raymond Kwok, are now co-chairmen and run the company. In March 2012, the co-chairmen were detained by the Independent Commission Against Corruption (ICAC) on allegations of paying Hong Kong's former No. 2 official, Rafael Hui, $4.5 million for undisclosed favors. All pleaded not guilty and the trial has been sent to the High Court as of May 2013.[32]

Comparable to Hong Kong's top three tycoons and their families, the Cheng family fortune also centers on property development. Cheng Yu-tung, the family patriarch, is the #4 wealthiest person in Hong Kong and #44 in the world with a net worth of $16 billion.[33] He founded the New World Development Company in 1970, which has become a multinational conglomerate whose subsidiaries include NWS Holdings, New World China Land, and New World Department Store. Combined, the conglomerate is engaged in property, hotel operations, infrastructure and service, department stores, and telecommunications.[34] Cheng Yu-tung is also the chairman of the Chow Tai Fook Jewelry Company which went public in 2011 and is now included in the Hang Seng 50 Index.[35] Cheng Yu-tung recently stepped down as chairman of both companies and his son, Henry Cheng, has taken over his role.

To put this oligopolistic control in perspective, imagine an ordinary Hong Kong resident who has just woken up in the morning. First she cooks herself breakfast on the

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[32] Kelvin Wong, "Billionaire Kwoks Plead Not Guilty to Corruption Charges," *Bloomberg*, accessed October 27, 2013, http://www.bloomberg.com/news/2013-03-08/billionaire-kwoks-plead-not-guilty-to-h-k-graft-charges.html.
[33] "Cheng Yu-Tung," *Forbes*, accessed October 28, 2013, http://www.forbes.com/profile/cheng-yu-tung/.
[34] New World Development Company Limited, "Annual Report 2013," n.d., http://www.nwd.com.hk/html/download/Report/ar2013e.pdf.
[35] Chow Tai Fook Jewellery Group Limited, "Annual Report 2013," n.d., http://corporate.chowtaifook.com/attachment/2013062706320100168217O_en.pdf.

stove using gas supplied by Towngas, which is ultimately controlled by Henderson Land. Before leaving her apartment that was developed by Cheung Kong Holdings, she turns off the lights provided by the Hong Kong Electric Company. Her first stop is at Watsons, which is part of the Hutchison Whampoa conglomerate, to pick up her prescription from the pharmacy and to buy more toothpaste. Her next stop is the supermarket, Park N'Shop, to buy fresh produce for dinner, which is also part of Hutchison Whampoa. Then she gets a call from her friend on her mobile phone, which uses PCCW as a service provider, and agrees to go shopping later. Her and her friend can't decide whether to shop at the IFC Mall in Central or WTC More in Causeway Bay, but regardless both of these shopping malls were developed by Sun Hung Kai Properties. As she looks at different products mostly manufactured in China, it is likely that some of them were shipped to Hong Kong via Hutchison Port Holdings. On her way home after saying goodbye to her friend, she passes Chow Tai Fook Jewelry and wonders if her boyfriend will propose using a ring from that exact store.

Li Ka-sing, Lee Shau-kee, the Kwok family, and Cheng Yu-tung are behind every aspect of this person's day. This example is not rare or coincidental but in fact very common. The cartelization of the local economy by the domination of a handful of oligarchical families raises the concerns that on a micro-level, the anticompetitive environment leads to unfair pricing for consumers across many different sectors; and on a macro-level, Hong Kong may lose its competitive edge over Shanghai, Singapore, Taiwan, or South Korea as a regional business headquarters and location for foreign investment in the future.

Land Distribution Strengths and Weaknesses

The current system of public land ownership involving leaseholds and land auctions has important effects. Beginning with the strengths of the system, public land ownership prevents development companies from hoarding large land reserves as a basis for a monopoly position. The significance of this point is not that developers in Hong Kong are unable to hold large land banks, it is that the leasehold system prevents them from obtaining a monopoly position. The second strength is that the auction system makes firms bid for land and compete with each other, thus maximizing revenue for the government. Thirdly, the length of the lease and prearranged agreement both have the effect of decreasing the possibility for speculation with assets thus allowing tight control of market prices. In such conditions, rather than speculate on land values and lean on a monopoly position, developers search for new markets abroad to grow. Interestingly, the extensive ownership of land does not result in a type of collective or common form of ownership. Instead, it is a system in which the government allocates land as a private commodity through the market mechanism. The current system makes state property more akin to private corporate property.[36]

While these points are all valid, the reality created by the land distribution system in Hong Kong is less positive as there are also major weaknesses in it. First, while it is true that the public land ownership has prevented a single development company from establishing a monopoly, an family oligopolies has still been developed. Only very well-capitalized developers can play the leasehold system to their advantage by negotiating land premiums (the fees developers pay to redevelop their leased land) when the market

[36] Williams, *Competition Policy in Hong Kong*.

is depressed then holding them in their land banks for years waiting for the market to bounce back. The major real estate players in Hong Kong have been in the game for a long enough to have huge land banks in addition to being very well capitalized, which creates an extremely high barrier of entry.

The second weakness is that developers' profits depend on their sharp negotiating skills. Since the Independent Commission Against Corruption (ICAC) in Hong Kong is watching vigilantly, outright bribes are not common; rather a form of regulatory capture is occurring. Civil servants who lack incentives to drive a hard bargain represent the government during negotiations. A tradition of "I'll scratch your back if you scratch mine" has grown more apparent as firms offer lucrative employment opportunities to former civil servants. In 1997, Chief Executive Tung Chee Hwa undertook a reform to safeguard the quality of governance by introducing a principal-agent accountability system in which top policy makers are liable to lose their jobs if they failed to ensure their department's performance. However in 2010, Civil Service Minister Denise Yue was found guilty of a "grave error of judgment" that damaged the government's credibility by allowing a former Lands Development official to take a high-paying job with New World Development, the same developer that benefited from a decision he made that increased the value of one plot by $410 million. In the end, Denise Yue still kept her job signifying the lack of enforcement behind the principle-agent policy.[37] Government collusion with big business is a growing concern in Hong Kong, especially with the arrest of the Kwok family. Ultimately, there is an inherent issue of aligned interests between the government and developers with high real estate prices, which has

[37] Anonymous, "Hong Kong's Property Bust."

contributed to the growth of powerful oligopolies and high real estate prices that culminated in the protests on July 1, 2013.

IV. GOVERNMENT ROLE

Globalization Increases Economic Insecurity

With the rise of globalization making Hong Kong increasingly susceptible to external economic shocks, Chief Executive Donald Tsang said in his 2008 policy address, "The government's role is increasingly important and needs to be refined… We should be ready to take decisive action to help stabilize the economy and rebuild people's confidence to ride out the difficulties."[38] However there is academic debate whether globalization should reduce the state's role in providing social welfare protection. According to the neoliberal view of the "efficiency hypothesis", the welfare state is regarded as uncompetitive because of "increasing competition in international good and services markets and the ability of holders of capital to move money and production around the world in search of higher rates of return." However, the competing "compensation hypothesis" argues that "globalization may increase demands on governments to cushion market-generated inequality and insecurity by welfare state expansion" in order to maintain support for globalization (Garret and Mitchell - Tsunami). History shows that during economic crises, strong political leadership and the development of social protection systems can be a key driver in recovery. For example, U.S. President Franklin D. Roosevelt set up a comprehensive social protection scheme in 1934 to alleviate the negative consequences of the Great Depression. Social policy

[38] Hong Kong SAR Government (2008) *2008-2009 Policy Address: Embracing new challenges,* Hong Kong: Hong Kong Government, http://www.policyaddress.gov.k/08-09/eng/docs/policy.pdf

response by affected countries during the Asian financial crisis is further evidence. The International Labor Organization (ILO) notes that countries such as Korea, Taiwan, and Thailand significantly expanded their social protection measures during the crisis but other countries such as Singapore, Malaysia, Indonesia and the Philippines reacted with an emphasis on strengthening values of economic growth by introducing temporary means of social assistance. The ILO finds that the former countries were significantly better off both in terms of mitigating rising poverty and unemployment, and in terms of the speed with which they recovered from the economic crisis.

Social Protection System: Short-term and Long-term

The Hong Kong government continues to respond to social and political challenges in an ad hoc way by temporarily implementing market-intervening policies to help people survive an economic crisis. For example in regards to income transfer programs, the government increased rates and granted one additional month of Comprehensive Social Security Assistance (CSSA), Disability Allowance, and the Old Age Allowance. The government has also paid the basic rent for 700,000 public housing estate tenants for two months and provided a one-off grant for $1,000 for each student receiving CSSA or student financial assistance. These are examples of reactive, short-term relief policies that are necessary for providing social protection against external shocks.[39]

[39] Tom Holland, "ParknShop Merger Will Prove Hong Kong's Competition Law a Joke," *South China Morning Post*, August 23, 2013, http://www.asiancompetitionforum.org/component/k2/94-latest-news-developments/parknshop-merger-will-prove-hong-kong-s-competition-law-a-joke.html.

While it has been argued that the government should take a more proactive approach in establishing a social protection system, the government certainly has long-term strategies for providing economic security and social protection. In 2010, Secretary for Labor and Welfare Matthew Cheung said Hong Kong's long-term strategies for social protection were to develop the economy, create employment opportunities, invest in education, and provide a viable social-security system. Expenditure on education alone now takes up 23% of the government recurrent expenditure, which is the largest share among all policy areas. This reflects the government's underlying belief that education and training are fundamental to enhancing social mobility and combating poverty, which symbolizes the principle of creating an environment of social mobility instead of state dependency. Besides Hong Kong's 12-year free education, heavily subsidized healthcare system, and massive public housing program making up the social safety net, social security and direct welfare services exist as well.[40]

Tax System

While it is up for debate whether the Hong Kong government should take on a larger role in implementing long-term social transfer programs to reduce inequality, the government's reliance on property tax has been widely criticized. Hong Kong has always drawn praise for its low and simple tax regime from organization such as the Heritage Foundation, however this paper has argued a more nuanced view. The territory can only operate on such a lenient tax regime because it relies on the city's property market for so

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[40] Anonymous, "Social Protection Strategy Flexible, Sustainable," *Info - Prod Research (Middle East)*, June 10, 2010, http://search.proquest.com.ccl.idm.oclc.org/docview/366375920/1420FFB7B9B17371A61/2?accountid=10141.

much of its revenue. Income from land sales, land premiums, property rates, and stamp duties on real estate transactions are estimated to make up around 25-30 percent of the government's revenue. If the 16.5 percent corporate profit tax paid by developers and the tax on their salaried employees is added, then the contribution of the property sector reaches close to 50 percent of government income.[41] High property prices and rents act as a hidden tax, which makes Hong Kong less attractive than the Heritage Foundation indicates.

The negative effects of relying heavily on a single source of revenue are pronounced because Hong Kong's exchange rate is pegged to the U.S. dollar. This introduces a cyclical element to government's revenue model. Since the Fed is currently maintaining extremely low interest rates in an attempt to stimulate the economy, the property market in Hong Kong has also been booming and generating an enormous fiscal surplus. However when interest rates inevitably rise again and the economy slows, property prices may plunge in Hong Kong, land revenues would then evaporate, and the government would slide into a deficit. Fortunately, the Hong Kong government has reserves amounting to around $200 billion stashed way for a rainy day in order to ride through a cyclical downturn, but relying on plan B is never a smart strategy.

Hong Kong needs to broaden its tax base in order to stabilize the government's revenue stream so recurrent expenditure is funded by sustainable revenue. In 2005, Chief Executive Donald Tsang attempted to introduce a universal goods and services tax (GST). However opposition to Tsang's proposal was so vehement that he was forced to

[41] "It's Time for Some Big Thinking about Hong Kong's Tax System," *South China Morning Post*, accessed October 26, 2013, http://www.scmp.com/business/article/1294524/its-time-some-big-thinking-about-hong-kongs-tax-system.

abandon it.[42] One strong counterargument is the idea that a GST falls disproportionately on the poor. For example, under a GST, a household earning $1,500 a month must spend close to 100 percent of its wages on living expenses. In contrast, a wealthier household that makes $15,000 a month and spends only half of its earnings is only taxed on half of its income.

Another option is changing the way the government raises money from the property market. In 2012, it raised approximately 20% of its total revenue from property sales and land premiums alone. The government classifies this income as capital revenue insisting it can only be spent on capital project, which leads to vast sums of money either locked away or spent on expensive superfluous projects. To alter this train of thought, one recommendation is to reconfigure the up-front lump sum that the government collects from developers to a steady revenue stream over the lifetime of a property project. To implement this idea, the government must abandon lump sum land premium payments in favor of collecting regular rental income from leaseholders. This would continue to act as a hidden tax so it would not affect ordinary Hong Kong residents. In addition, the removal of lump sums would lower the barrier of entry to the real estate market increasing competition and thus reduce housing prices. Finally, implementing a regular rental income from leaseholders would secure a steady revenue stream that would be

[42] Tom Holland, "It's Time for Some Big Thinking about Hong Kong's Tax System," *South China Morning Post*, August 6, 2013, file://localhost/Users/emchoy65/Library/Application%20Support/Zotero/Profiles/2nvvc9po.default/zotero/storage/XQAD5SJT/its-time-some-big-thinking-about-hong-kongs-tax-system.html.

mostly immune to fluctuations in the economic cycle because the terms would be fixed in advance.[43]

Competition Law

i. Context

The Hong Kong Legislative Council passed the region's first comprehensive Competition Bill on June 14, 2012. Until its passage, Hong Kong was one of the few remaining developed countries in the world without a general competition law. While Hong Kong was still under British rule between 1993 and 1996, the administration commissioned a series of studies on the state of competition in Hong Kong. When the handover to Chinese rule on July 1, 1997 took place, the new regime concluded that there was no compelling reason to introduce a general competition law. Instead, the government adopted a sector-by-sector approach. The Competition Policy Advisory Group (COMPAG) was established to review competition-related complaints, and the government's general approach was soft in that it discouraged anticompetitive conduct through voluntary compliance by businesses to adhere to administrative guidelines. Not surprisingly, this approach has not been effective in addressing growing public concerns over alleged cases of anticompetitive conduct. The main power COMPAG lacked was the ability to conduct thorough investigations, but even if anticompetitive conduct was clear, COMPAG had no power to impose sanctions or deter recurrence of the misconduct. In 2006, COMPAG published a report recommending the introduction of a cross-sector

[43] Tom Holland, "Hong Kong Government Must Change the Way It Taxes Propert," *South China Morning Post*, August 15, 2103, http://www.scmp.com/business/article/1296772/hong-kong-government-must-change-way-it-taxes-property?page=1#comments.

competition law in Hong Kong. On July 14, 2010 the Competition Bill was finally introduced to the Legislative Council and after almost two years of debates, the Bill was finally passed by a weak majority of lawmakers.

ii. Competition Rules

The Ordinance provides general prohibition in three areas of anticompetitive conduct. The First Conduct Rule prohibits anticompetitive agreements, practices, and decisions. This rule identifies four specific types of conduct that it deems, "Serious Anticompetitive Conduct:" (i) price fixing, (ii) territorial or customer allocation, (iii) output control or restriction, and (iv) bid rigging. A violation of this rule is subject to a full range of enforcement options one being now warning is required before legal proceedings may be brought against the accused parties. The Second Conduct Rule prohibits the abuse of market power that has the effect of distorting competition. Factors considered in determining this rule include but are not limited to: (i) market share, (ii) power to make pricing decisions, and (iii) barrier to entry into the market. Two types of behaviors are identified as specific types of conduct that may constitute an abuse of market power which are: (i) predatory behavior toward competitors, and (ii) limiting producing, markets, or technical development to the detriment of consumers. The third is the Merger Rule, which prohibits mergers that are likely to substantially lesson competition, however it only applies to the telecommunications sector.[44]

The effectiveness of the new Competition Law remains to be seen but the first signs of its weakness have recently been revealed when Li Ka-sing put Park N'Shop up

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[44] Charles River Associates, "CRA Insights: China Highlights," October 2012, http://www.crai.com/uploadedFiles/Publications/CRA-Insights-China-Highlights-1012.pdf.

for sale in June, 2013. One of the final bidders in the running was China Resources Enterprise who owns Vanguard, which has 8 percent of the grocery retail market in Hong Kong. If Vanguard and Park N'Shop were to merge, China Resources Enterprise would dominate approaching 50 percent of the market share. In other developed economies, a deal of this nature would quickly attract the attention of competition regulators who would question whether the formation of such a massive player was in the customer's best interests. However no alarm has been raised by Hong Kong's newly appointed competition commissioners who would likely have let the merger continue. This is partially because the Competition Ordinance has yet to come into full force. Lawyers do not expect operations to begin before the middle of 2015 at the earliest.[45]

The supermarket retail sector has been criticized as one of the most anticompetitive markets in Hong Kong with the established duopoly between Wellcome and Park N'Shop who are ultimately owned by the powerful British conglomerate Jardine Matheson and Li Ka-sing's Hutchison Whampoa respectively. Even if Jardine were to acquire Park N'Shop to control somewhere around 75 percent of the market, the new regulators would not interfere because the Merger Rule only applies to the telecommunications sector. Fortunately for regulators, Li Ka-sing decided not to self Park N'Shop after concluding the private sale at this time would not deliver maximum value to shareholders in October, 2013.[46]

V. GLOBAL COMPETITIVENESS

[45] Tom Holland, "ParknShop Merger Will Prove Hong Kong's Competition Law a Joke."
[46] Prudence ho, "Hutchison Stops Shopping ParknShop," *Wall Street Journal (Online)*, October 19, 2013, http://online.wsj.com/news/articles/SB10001424052702304384104579143342398492638.

Transparency with High Barrier of Entry

The price of land in Hong Kong is much higher than if the supply was subject to market forces. In the long run, the higher costs may affect Hong Kong's international competitiveness. According to Savills PLC, a global real estate services provider based in London, Hong Kong is the most expensive city in the world to rent business and residential space. It would cost $1.63 million per year for a 14-person team to set up in Hong Kong. Total costs are calculated for two teams of seven people each, one located in a prime financial location, while the other is in a secondary area.[47] While the Heritage Foundation states the overall all entrepreneurial environment in Hong Kong remains one of the world's most transparent and the business start-up process is straightforward, the reality is the extremely expensive rent on Hong Kong Island in particular prices out many small to medium sized businesses discouraging competition.

Reliance on Mainland China

Hong Kong's economy is becoming increasingly reliant on China. There are a total of 1,547 companies listed on the HKSE and 46.6 percent of these are mainland enterprises that constitute 57 percent of market capitalization.[48] Now a primarily service-based economy with over 90 percent of its GDP arising from the services sector, most manufacturing has migrated to the mainland due to much lower land labor costs. Most trade ports in Hong Kong are occupied by the trans-shipment of goods with the mainland, airport cargo and passenger sectors are increasingly China-related markets, and the

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[47] Prudence ho, "Hutchison Stops Shopping ParknShop," *Wall Street Journal (Online)*, October 19, 2013, http://online.wsj.com/news/articles/SB10001424052702304384104579143342398492638.
[48] "HKEx Fact Book - 2012," http://www.hkex.com.hk/eng/index.html.

banking, financial services, legal, and accounting sectors that are Hong Kong's flagship services, are heavily dependent on the mainland economy.[49] In addition, China is the source of the vast majority of tourism in Hong Kong. The noticeable influx of Mainland Chinese has more recently become a source of ethnic tension in Hong Kong as "mainlanders" pollute the metro, sidewalks, and restaurants of the already congested city. Social tension aside, the Mainland Chinese are also buying up residential housing increasing the demand and therefore price of apartments, and consuming goods in Hong Kong's streets and shopping malls which are considered to be better quality.

Survival of the Domestic Non-traded Sector

The explosive GDP growth in China has certainly changed the landscape of Hong Kong's economy and the ever-increasing dependence has raised the issue of whether Hong Kong's domestic, non-traded sector can survive and function in the future. Unlike the U.S., which is the hub for technological innovation containing many fortune 500 pharmaceutical companies and world-class higher education intuitions that all attract a global market, Hong Kong has not developed research-intensive, high-technology industries such as electronics or biomedicine. Additionally, healthcare and educational services are primarily inward-focused. While a surge in foreign applications to Hong Kong's institutions was seen from 10.27 percent in 2007-2008 to 14.22 percent in 2012-2013, a closer look reveals that nearly 63 percent of this growth came from enrollments from Mainland students. While Hong Kong has made efforts to build its reputation by increasing scholarship funding for foreign students, doubling quota limits on international

[49] Williams, *Competition Policy in Hong Kong*.

students from 10 to 20 percent, relaxing visa regulations, and redesigning the British-inspired three-year programs to American-style four-year degrees, the reality is the sharp growth in foreign applicants is only increasing Hong Kong's dependency on Mainland China making Hong Kong more vulnerable to external shocks.[50] Besides the financial sector, Hong Kong has not quite developed its capacity to become a preeminent center of excellence to attract large numbers of high-skilled human capital. One method of beginning to establish this recognition is by attracting top foreign students and producing high-skilled human capital. This will become a matter of considerable concern as maintaining a competitive edge over regional rivals such as Shanghai and Singapore will be increasingly difficult.

VI. CONCLUSION

Hong Kong is widely acknowledged as the most economically free country, but less known is the level of income inequality. The Census and Statistics Department cites four factors in explanation of the high Gini coefficient, but fails to describe the potentially most important contributor, the formation of oligopolies. Oligopolies in Hong Kong contribute to the high Gini coefficient because they create an anticompetitive environment preventing small businesses from growing and therefore individuals from increasing their income. The oligarchs' main source of revenue can be traced to their land development and real estate holdings. The history of the government monopoly over land supply in combination with the nature of land development in Hong Kong has naturally

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[50] "Foreign Applications to Hong Kong Universities up Sharply This Year," *ICEF Monitor - Market Intelligence for International Student Recruitment*, accessed October 26, 2013, http://monitor.icef.com/2012/07/foreign-applications-to-hong-kong-universities-up-sharply-this-year/.

led to the growth of a few powerful developers that reinvested domestically and evolved into multinational conglomerates. These conglomerates span across many different sectors absorbing diverse revenue streams and have the capital to push others out of the market without any forms of regulation from the government. While a general Competition Bill was passed in 2012, it has not yet proven to be effective in dismantling or preventing cartels.

Further complicating the issue is the fact that the government is heavily reliant on the property sector for a significant portion of its revenue. Hong Kong is able to maintain its position as the most economically free country because the tax on high property prices functions as a “hidden” tax. The current tax system needs to be restructured to create more sustainable or diverse streams of revenue in order to lower property prices, increase competition, and decrease the government’s vulnerability to external shocks. The inherent alignment of values between big businesses and the government creates a conflict of interest between pro-business and pro-market practices, which has been perceived negatively by the public and ultimately led to the large-scale protests in July 2013.

As globalization breaks down borders and increases economic vulnerability to external shocks, it is becoming increasingly essential for domestic economies to be self-sustainable in order to ride through turbulent times. This presents formidable challenges for Hong Kong, which is proud of its history of laissez faire policy while also being an international hub of commerce situated adjacent to the 2nd largest economy in the world based on GDP, China. While the international traded sector of the market remains highly competitive, the survival of the domestic non-traded sector raises concern, as both are necessary for Hong Kong to compete with regional rivals. Ultimately, the challenge for the Hong Kong government is to reduce income inequality in an oligopolistic market while maintaining a non-interventionist approach and diversifying revenue streams to guard against the effects of globalization. These are major concerns as Hong Kong competes with Shanghai and the Four Asian Tigers as an international hub of business.

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