Narrative Report on Hong Kong

Chart 1 - How Secretive?

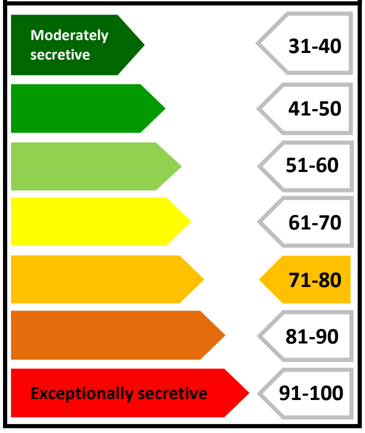
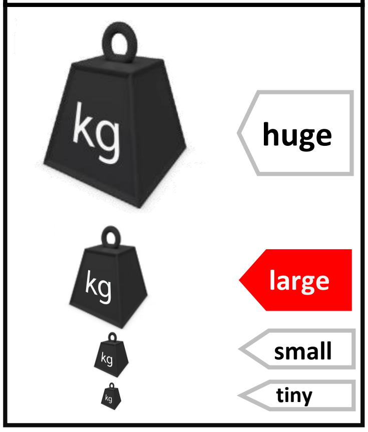


Chart 2 - How Big?



Hong Kong is in third position in the 2013 Financial Secrecy Index. This ranking is based on a combination of its secrecy score and a scale weighting based on its share of the global market for offshore financial services.

Hong Kong has been assessed with 72 secrecy points out of 100, placing it at the higher end of the secrecy scale (see *chart 1*).

Hong Kong accounts for over 4 per cent of the global market for offshore financial services, making it a large player compared with other secrecy jurisdictions (see *chart 2*), comparable to Singapore – though not on the same scale as huge players such as Luxembourg, UK and the USA.

Part 1: Telling the story

Hong Kong as an Offshore Financial Centre: History and Background

Hong Kong is one of the world's fastest growing secrecy jurisdictions or tax havens today. Its growth is based largely on the fact that it is the premier offshore centre for a fast-growing China, as well as rapid growth more generally in Asia - and also, to a lesser extent, because of the displacement to Hong Kong of some secrecy-based activity from Europe and North America, amid limited crackdowns there since 2009.

Hong Kong's official designation as a "Special Administrative Region" of China, and its Basic Law stating that it enjoys 'a high degree of autonomy' from China in all matters except foreign relations and defence, points clearly to its 'offshore' status. Indeed, China has supported Hong Kong's secrecy facilities in the face of international pressure[1]. In this and other respects the Hong Kong-China link resembles Britain's links with its three crown dependencies and 14 overseas territories – of which 10 are recognised secrecy jurisdictions: partly independent from Britain yet also partly linked to and supported by it.

Hong Kong built itself up over the decades on a spirit of extreme *laissez-faire* and anti-tax, and even anti-government attitudes: some called it 'the freest economy in the world.' However, as our report explains, all the evidence suggests that Hong Kong's financial success stems ultimately not from this, but partly from the fact of its world-class port geography and, more importantly, its partly-in, partly-out relationship with China. At least on paper, Hong Kong accounted for just under half of all foreign investment into China in 2011.

Hong Kong's secrecy score of 72 places puts it at the higher end of the secrecy scale, roughly on a par with Panama and Singapore. It offers a wide range of offshore services including tax exemptions, transfer pricing facilities, escape routes from Chinese exchange controls, and various forms of financial secrecy including the use of opaque companies and trusts that can assist tax evasion and other crimes.

The colonial roots of an offshore centre

Hong Kong was created in 1842 after Chinese rulers sought to crack down on the trade in opium, which British traders were then pushing hard into the Chinese market, even though it was banned. In response to the Chinese crackdown Britain sent a naval fleet which killed some 20,000 people and shattered the Chinese Empire, leading to the Treaty of Nanking in 1842 under which China ceded Hong Kong to Britain. From these ignoble beginnings the territory became Britain's commercial gateway to China.

Along with shipping and general trading, finance was a central ingredient of Hong Kong's economic success from the outset - and was also a pillar of British policy towards China, anchored in a collaboration between the Foreign Office and the Hong Kong-based Hong Kong and Shanghai Bank, the forerunner of today's HSBC[2].

In the 19th Century and for much of 20th Century, the "difficult" Chinese market never turned out to be the fabled source of riches that many British financiers had hoped, and even the City of London's limited role in funding Chinese infrastructure nurtured considerable resentment. As one Chinese revolutionary leader said in 1910 (ibid p441) "If [China] is not conquered by partition it will be lost by invisible financial control by foreign powers." After the Chinese revolution of 1911 China turned inwards, and although the turmoil did divert some trade to the relative stability of British Hong Kong, British opportunities were somewhat meagre. However the subsequent Chinese civil war of 1945-49 saw a new influx of Chinese refugees and capital to Hong Kong, setting the stage for rapid industrialisation.

Laissez-faire Hong Kong versus statist Singapore

As in many secrecy jurisdictions, British administrators in Hong Kong espoused a strong, and at times almost extremist, approach to *laissez-faire* capitalism and consequent high degree of tolerance for smuggling and other illegal commercial activities. This overall *laissez-faire* approach set the tone for future economic developments until today. In the 1860s Britain's Jardine Matheson and other trading houses even protested in London at British efforts to help the weakened Chinese state collect taxes; the Hong Kong government, for its part, wouldn't co-operate with the Chinese either.[3] A century later Sir John Cowperthwaite, Hong Kong's Financial Secretary from 1961-1971, had such stridently anti-government views that he even refused to collect official statistics for fear they would give government officials too much power. The economist Milton Friedman declared his love for Hong Kong's freewheeling free-marketism and cited this – as many have done since – as a key reason for the territory's undoubted economic success over the decades. Yet all the evidence strongly suggests otherwise for two big reasons: first, the reasons for Hong Kong's success lie elsewhere, and, second, it was never the free-market economy that that its cheerleaders claim.

Hong Kong has been an exception to a fast-growing Asian region characterised by heavily state-led industrialisation. The comparison with Singapore is particularly instructive here. The former Singaporean premier Lee Kuan Yew who visited Hong Kong regularly (*From Third World to First: The Singapore Story: 1965-2000,* p605) summarised the very different approaches:

> "In Hong Kong what is not expressly forbidden is permitted; in Singapore, what is not expressly permitted is forbidden."

This underpinned very different economic and social policies, as Lee continued:

> "The few trade unions they had did not fight market forces . . . There was no social contract between the colonial government and [Hong Kong's people.] Unlike Singaporeans they could not and did not defend themselves or their collective interests. They were not a nation – indeed, were not allowed to become a nation. China would not have permitted it, and the British never tried it."

Joe Studwell, founder of the *China Economic Quarterly*, summarises what is perhaps the core reason for both Hong Kong's and Singapore's success, and is worth quoting at length:

> "As relatively easily managed city states, Hong Kong and Singapore perform a simple economic trick: they arbitrage the relative economic inefficiency of their hinterlands . . . Since colonial inception they have offered tariff-free trade (with few or no questions asked about where the money came from) . . . the regional offshore roles of Hong Kong and Singapore have been absolute constants since their founding, and show no sign of change."[4]

Hong Kong's immediate hinterland is Southern China, though the closing of the mainland to most trade between 1949 and 1979 also made the city focus more than it otherwise would have on business with southeast Asia, giving it a broader regional and international spread. Studwell continues:

> Under Mr. Lee – who never much liked private businessmen – Singapore followed a statist model, with the government taking public control of most significant companies. Hong Kong pursued an apparently opposite free market model
> . . .
> At the end of the 20th Century, the result of ostensibly diametrically opposite approaches to economic management was GDP per capita in the two cities that varied by less than $1,000. The lesson? That a city state with a strategic deep water port in a region that has relatively higher levels of mismanagement, corruption and political uncertainty will prosper, with little reference to official economic philosophy.
> . . .
> Hong Kong and Singapore were destined to succeed. All they had to do was to be one degree more efficient, one degree more attractive to capital than surrounding countries."[5]

In practice, Hong Kong was never a free-marketeer's paradise. As historian Catherine Schenck notes, large public subsidies for housing and education meant that *"the reality was very different from the myth of complete laissez-faire."* Vital sectors such as land ownership are carved up, often through monolithic cross-sector corporate entities. In the ports, for example, container handling fees are among the world's highest, despite low labour costs[6]. Hong Kong does not even have a functioning competition law – and the first ever legislation on this, due to take effect in 2014, are full of exemptions. Hong Kong always was and is today, as Studwell put it, *"a patchwork of de facto cartels,"* whose roots lie in the colonial era. Historian Steven Tsang explained that behind the scenes,

> "the government remained the largest employer, the biggest developer of real estate, the leading constructor, the largest landlord, and the biggest provider of health and education services."

As a (more polemical) account puts it:

> "Friedman mistook Hong Kong's colonial economic system as a free market, despite Hong Kong's highly orchestrated colonial command economy.
> . . .
> Even during the best of times, the average local Chinese small and medium businesses had to operate under the dictates of British colonial policy and at the mercy of monopolistic British trading firms and banks, not to mention that the average worker never had it good at all. British monopolies needed an unregulated supply network of ruthless predatory competition to keep costs low.
> . . .
> The so-called rule of law, so frequently touted these post-colonial days in Hong

> Kong, merely meant that no local Chinese business ever won a case against any British trading firm in 150 years of colonial justice."

This goes a long way towards explaining how Hong Kong's great per capita wealth masks vast economic inequalities and outright poverty, as the subsequent sections show.

The Open Door, then the Handover

China's Open Door policy announced by Deng Xiaoping in 1978 opened the way for Hong Kong to emerge as a modern financial centre and secrecy jurisdiction. Visible trade grew by an astonishing 28 percent per year from 1978-1997, according to Schenck, and by the time of the British handover in 1997 an estimated 80 percent of foreign investment in China's rapidly industrialising Guangdong province was at least nominally from Hong Kong.

Long before the handover in 1997, Britain began to consult and negotiate policy changes with China in what was known locally as a "through train", to ensure continuity. Britain hoped this, and the fact of Hong Kong's legal system based on English common law, would help City of London financial interests retain the historical foothold they had always maintained in this gateway to China; and the City has had significant successes in this respect: today about half of all foreign financial claims on Hong Kong are from British banks.

When the handover came Hong Kong was given a wide degree of autonomy under its Basic Law, but with China taking over responsibility for defence and foreign relations, and gaining powers to appoint Hong Kong's chief executive and top officials. This set-up is remarkably similar to the arrangements that Britain has with its Crown Dependencies and Overseas Territories, most of which are secrecy jurisdictions: Britain also retains responsibility for defence and foreign relations, and appoints top officials. This very close similarity is no coincidence, given the history – China's competences today are roughly the same as those held by Britain – and the Chinese leadership's personal incentives with respect to Hong Kong certainly helped smooth the handover.

Hong Kong was always intended as a familiar, trusted and partly controlled offshore centre for the Chinese leadership and wider élites: a place where business can be conducted in a familiar, proximate and Chinese-speaking environment, but also significantly protected from mainland scrutiny. For added secrecy, Hong Kong structures are often combined with structures in other jurisdictions outside the Chinese orbit, particularly the British Virgin Islands. It is hardly surprising that Hong Kong has served as the prime turntable for Chinese bribery and other corrupt activities.

Hong Kong today: round tripping, trusts, and other offshore offerings

Hong Kong has for years served as a major 'round tripping' turntable for China and other countries. Round tripping involves Chinese investors shifting their money to Hong Kong, dressing it up in offshore secrecy, then returning it to China masquerading (illegally) as foreign investment, in order to obtain special privileges afforded to foreigners. The Asian Development Bank remarked in 2004 that "the scale of round tripping FDI in PRC [China] is very large" and the State Administration of Foreign Enterprises (SAFE) admitted recently that mainlanders, not foreigners, were very significantly behind the flow of speculative 'hot money' into China.

Round tripping activity largely explains the fact that of the total $1.9 trillion in nominal inward investment into China in 2011, over $850 billion was sourced (nominally) from Hong Kong. To put that $850 billion into perspective, it is 15 times the size of the $55 billion in recorded direct U.S. investment into China, but much of the investment originating from the US is also likely to be Chinese origin capital, routed via family links within the US-Chinese diaspora. As scholars have noted: *"the great majority of foreign direct investment in China has come from the Chinese diaspora."* The second largest 'investor' in China by far - at $298 billion - was the British Virgin Islands. Not only that, but large-scale illicit capital flows are attracted to Hong Kong from other developing countries, particularly those with increasing commercial ties to China.

Hong Kong hosts a range of sectors and intermediaries catering to offshore activities. Private banking, strongly reliant on secrecy, is among the most important. Since 2009, when G20 leaders declared that the "the era of banking secrecy is over" and promised a crackdown on secrecy (though relatively little has been delivered, to date) there has also been a significant displacement of corrupt, criminal and other abusive financial activities, both in terms of assets and also of the structures holding those assets – away from Western centres and towards Asian tax havens, notably to Singapore and Hong Kong. Hong Kong held nearly US$300bn in private banking assets in 2010, though this was eclipsed by Singapore's $500 bn. While these two secrecy jurisdictions are growing very fast, this activity is still eclipsed by Switzerland's private banking sector, with over $2.2 trillion in assets under management.

There is also a large trust administration industry in Hong Kong – an estimated HKD2.6 trillion (USD335bn) were held by Hong Kong trusts at the end of 2011 (around half the size of assets managed in the British tax haven of Jersey.) Hong Kong's Trust Law (Amendment) bill of 2013, while modernising the laws and making some improvements, also gives enhanced powers to settlors of trusts, which could create greater possibility for abuse by allowing them to pretend to give away assets (and thus creating an impenetrable secrecy wall) while still retaining a large degree of control.

Beyond secrecy, Hong Kong offers a range of other 'offshore' attractions, notably in the areas of tax and financial regulation. In 2009 China launched a pilot scheme in Hong Kong for the settlement of trade in Renminbi, rather than the U.S. dollar, first steps towards an eventual goal of seeing the Renminbi as a global reserve currency: a matter of potentially profound geo-strategic importance[7]. The market has grown significantly: the share of Chinese trade settled in Renminbi rose from less than one percent in 2010 to 12 percent in 2013. In September 2011 China and the UK agreed to start developing the City of London, via its age-old Hong Kong links, as another offshore Renminbi trading centre; by September 2013 nearly a third of offshore Renminbi transactions were conducted in London.

Tax is another powerful component of Hong Kong's offshore offering. Hong Kong does not tax capital gains, dividends or deposit interest, and has no inheritance taxes. In common with many secrecy jurisdictions, it adopts a 'territorial' principle which only taxes income arising in Hong Kong - while profits from overseas trading operations accruing to Hong Kong wealth managers are generally not taxed. Hong Kong is widely used as a base for transfer mispricing, where corporations shift profits offshore to escape tax.

As our database reports shows, Hong Kong has made some limited efforts to curb its worst secrecy excesses, in line with changing international norms, though its secrecy score has changed relatively little, from 73 in our last index in 2011 to 72 in 2013. China's dominant political position has enabled Hong Kong, to a greater degree than many other jurisdictions, to withstand international pressures for transparency.

The Financial Action Task Force reported on secrecy in 2008:

> "While Hong Kong has a workable and fairly comprehensive criminal confiscation regime, these measures are not available in all cases, do not extend to all predicate offences and the number of confiscations is relatively low. While legislative provisions have been enacted for confiscation of the proceeds of TF [Terrorist Financing], these provisions are not yet in force. [...] The preventive system for some non-core financial institutions does not incorporate adequate customer due diligence (CDD) requirements with respect to politically exposed persons."

Hong Kong: a lopsided economic success?

These offshore offerings have certainly drawn large amounts of wealth to Hong Kong from elsewhere, and the territory does enjoy very high per capita incomes relative to others in the region. However, this is not the end of the story, as the *Financial Times* notes:

> "There is a growing perception that Hong Kong's free market model is designed to benefit the wealthy. The city has the worst income disparity of all developed

> economies, according to a UN report, and one in five households lives below the poverty line."

According to the Boston Consulting Group, Hong Kong now has the world's highest density of billionaire households, at 15 per million – while median incomes have reportedly stagnated since at least 1999. This has happened while manufacturing, which began to plateau in about 1990, was eclipsed by a large growth in finance and services: from 1980-1997 employment in manufacturing share fell from 46 percent of total employment to just under ten percent. It seems likely that this dramatic fall is partly the result of 'finance curse' factors we have identified in other jurisdictions.

But perhaps the major reason for such extremes of wealth is the high ongoing cartelisation of the economy, as described above. One account, looking at rising protests in Hong Kong amid stagnant median incomes, summarises the underlying economic structure:

> "a handful of the richest families hold monopolies and duopolies on everything from supermarket chains and property developments to public transportation systems, electricity providers and public service companies."

Hong Kong's economic success is certainly real – but it is not at all what it seems.

Read more:

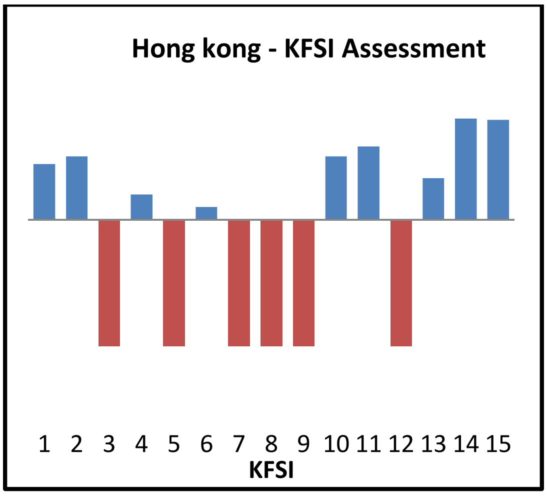
- Studwell, Joe, *Asian Godfathers: Money and Power in Hong Kong and southeast Asia*, Atlantic Monthly Press, 2007
- Cain, P.J and Hopkins (1993), A.G, *British Imperialism: Innovation and Expansion 1688-1914*, Longman Group: UK
- Capital Markets Law Journal, available at http://cmlj.oxfordjournals.org/content/6/1/104.full.pdf?keytype=ref&ijkey=Fy12OR3J2BVwY7M (06.09.2013).
- Hong Kong Monetary Authority, available at http://www.hkma.gov.hk/eng/index.shtml (06.09.2013).
- Lee, K.Y (2000), *From Third World to First: The Singapore Story: 1965-2000*, Harper: New York.
- Rovnick, Naomi, *South China Morning Post, '*Caribbean tax havens adds heat to China's hot money', available at http://www.scmp.com/article/968144/caribbean-tax-haven-adds-heat-chinas-hot-money (06.09.2013).
- Rovnick, Naomi, *South China Morning Post*, 'Sun, sand and lots of hot money', available at http://www.scmp.com/article/968175/sun-sand-and-lots-hot-money (06.09.2013).
- Schenk, Catherine, *Economic History of Hong Kong*, available at http://eh.net/encyclopedia/article/schenk.HongKong (06.09.2013).

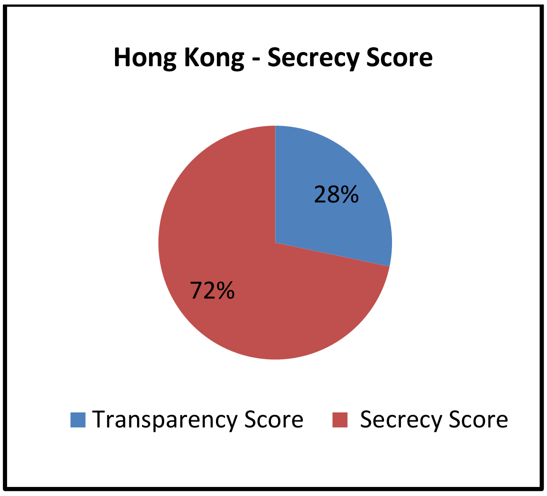
Next steps for Hong Kong

Hong Kong's 72 per cent secrecy score shows that it must still make major progress in offering satisfactory financial transparency. If it wishes to play a full part in the modern financial community and to impede and deter illicit financial flows, including flows originating from tax evasion, aggressive tax avoidance practices, corrupt practices and criminal activities, it should take action on the points noted where it falls short of acceptable international standards. See part 2 below for details of Hong Kong's shortcomings on transparency. See this link http://www.financialsecrecyindex.com/kfsi for an overview of how each of these shortcomings can be fixed.

Part 2: Secrecy Scores

The secrecy score of 72 per cent for Hong Kong has been computed by assessing the jurisdiction's performance on the 15 Key Financial Secrecy Indicators, listed below.





The numbers on the horizontal axis of the bar chart on the left refer to the Key Financial Secrecy Indicators (KFSI). The presence of a blue bar indicates a positive answer, as does blue text in the KFSI list below. The presence of a red bar indicates a negative answer as does red text in the KFSI list. Where the jurisdiction's performance partly, but not fully complies with a Key Financial Secrecy Indicator, the text is coloured violet in the list below (combination of red and blue).

This paper draws on key data collected on Hong Kong. Our data sources include regulatory reports, legislation, regulation and news available at 31.12.2012[8]. The full data set is available here[9]. Our assessment is based on the 15 Key Financial Secrecy Indicators (KFSIs, below), reflecting the legal and financial arrangements of Hong Kong. Details of these indicators are noted in the following table and all background data can be found on the Financial Secrecy Index website[10].

The Key Financial Secrecy Indicators and the performance of Hong Kong are:

TRANSPARENCY OF BENEFICIAL OWNERSHIP – Hong Kong	
1.	Banking Secrecy: Does the jurisdiction have banking secrecy? **Hong Kong does not adequately curtail banking secrecy**
2.	Trust and Foundations Register: Is there a public register of trusts/foundations, or are trusts/foundations prevented? **Hong Kong partly discloses or prevents trusts and private foundations**
3.	Recorded Company Ownership: Does the relevant authority obtain and keep updated details of the beneficial ownership of companies? **Hong Kong does not maintain company ownership details in official records**
KEY ASPECTS OF CORPORATE TRANSPARENCY REGULATION – Hong Kong	
4.	Public Company Ownership: Does the relevant authority make details of ownership of companies available on public record online for less than US$10/€10? **Hong Kong partly requires that company ownership details are publicly available online**
5.	Public Company Accounts: Does the relevant authority require that company accounts are made available for inspection by anyone for a fee of less than US$10/€10? **Hong Kong does not require that company accounts be available on public record**
6.	Country-by-Country Reporting: Are all companies required to comply with country-by-country financial reporting? **Hong Kong partly requires country-by-country financial reporting by some companies**

EFFICIENCY OF TAX AND FINANCIAL REGULATION – Hong Kong	
7.	Fit for Information Exchange: Are resident paying agents required to report to the domestic tax administration information on payments to non-residents? **Hong Kong does not require resident paying agents to tell the domestic tax authorities about payments to non-residents**
8.	Efficiency of Tax Administration: Does the tax administration use taxpayer identifiers for analysing information efficiently, and is there a large taxpayer unit? **Hong Kong does not use appropriate tools for efficiently analysing tax related information**
9.	Avoids Promoting Tax Evasion: Does the jurisdiction grant unilateral tax credits for foreign tax payments? **Hong Kong does not avoid promoting tax evasion via a tax credit system**
10.	Harmful Legal Vehicles: Does the jurisdiction allow cell companies and trusts with flee clauses? **Hong Kong partly allows harmful legal vehicles**
INTERNATIONAL STANDARDS AND COOPERATION – Hong Kong	
11.	Anti-Money Laundering: Does the jurisdiction comply with the FATF recommendations? **Hong Kong partly complies with international anti-money laundering standards**
12.	Automatic Information Exchange: Does the jurisdiction participate fully in Automatic Information Exchange such as the European Savings Tax Directive? **Hong Kong does not participate fully in Automatic Information Exchange**
13.	Bilateral Treaties: Does the jurisdiction have at least 46 bilateral treaties providing for information exchange upon request, or is it part of the European Council/OECD convention? **As of 31 May, 2012, Hong Kong had less than 46 tax information sharing agreements complying with basic OECD requirements**

14.	International Transparency Commitments: Has the jurisdiction ratified the five most relevant international treaties relating to financial transparency? **Hong Kong has partly ratified relevant international treaties relating to financial transparency**
15.	International Judicial Cooperation: Does the jurisdiction cooperate with other states on money laundering and other criminal issues? **Hong Kong partly cooperates with other states on money laundering and other criminal issues**

[1] For instance, when the OECD sought to prepare a 'blacklist' of tax havens in April 2009 at a G20 summit meeting in April 2009, Chinese Premier Hu Jintao worked hard behind the scenes – successfully – to keep Hong Kong and Macau, a much smaller Chinese-linked haven, off the OECD blacklist.

[2] See *British Imperialism: Innovation and Expansion 1688*-1914, the historians P.J. Cain and A.G. Hopkins (p424). A loan to China's Ch'ing dynasty in 1874 - the first ever foreign loan issued to China - helped cement the bank and Hong Kong as the key links between China and the City of London.

[3] Studwell, p34.

[4] Joe Studwell, *Asian Godfathers: money and power in Hong Kong and South East Asia*, Atlantic Monthly Press, 2007, pp33-34.

[5] Studwell, p36.

[6] Studwell p69.

[7] This new development in Hong Kong partly mirrors the period of the 1960s and 1970s, when the United States tolerated the existence of the fast-growing offshore "Eurodollar" market, partly because of its role in internationalising the U.S. dollar and cementing its status as a global reserve currency, allowing the United States to (among other things) fight the Vietnam war without having to worry about paying for it immediately.

[8] With the exception of KFSI 13 for which the cut-off date is 31.05.2013. For more details, look at the endnote number 2 in the corresponding KFSI-paper here: http://www.financialsecrecyindex.com/PDF/13-Bilateral-Treaties.pdf.

[9] That data is available here: http://www.financialsecrecyindex.com/database/menu.xml.

[10] http://www.financialsecrecyindex.com.