

A talk given at Free Exchange, November 15, 2003.
Presented here as unfinished notes, courtesy of the author, March 3, 2006.

THE CHAMPION OF HONG KONG' S FREEDOM

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Every year the Heritage Foundation and The Fraser Institute of Canada produce indices of Economic Freedom. They rank the countries of the world according to various criteria: property rights, human rights, economic policies, taxation etc. Since at least 1995 Hong Kong has always ranked number 1. On the Heritage scale (the lower the better) HK scored 1.3, Singapore 1.5, Ireland 1.65 Then there are a bunch of countries clustered around 1.8, including the US, the UK, Luxembourg. The highest ranking Latin American country is Chile scoring 2.00 Germany is number 20 on the list at 2.1 and France is #39 at 2.5. Israel is #54 at 2.75, only a pip ahead of Poland. Until the US conquest this year Iraq was down there in the bottom three with Libya and North Korea all with scores of about 5.

Milton Friedman more than twenty years ago said that if you want to see what a free market economy looks like, go to Hong Kong.

I expect many of you have been to Hong Kong. If you have, I am sure you will agree that it is a staggering place. Wonderful, awful, certainly not dull. Years ago Hong Kong was rudely described as a 'pimple on the backside of China'. A fiery irritant capitalist spot on the southern buttock of Communist China.

If you haven't been to Hong Kong, I think P.J. O'Rourke's description will give you a good impression of what it is like:

The people of Hong Kong have been free to do what they wanted, and what they wanted was, apparently, to create a stewing pandemonium: crowded, striving, ugly, and the most fabulous city on earth. It is a metropolis of amazing mess, an apparent stranger to zoning, a tumbling fuddle of streets too narrow and vendor chocked to walk along, slashed through with avenues too busy and broad to cross. It is a vertical city, rising 1,800 feet from Central District to Victoria Peak in less than a mile; so vertical that escalators run in place of side-

walks, and neighborhoods are named by altitude: Mid-Levels. Hong Kong is vertical in its buildings, too, and not just with glossy skyscrapers. Every tenement house and stack of commercial lofts sends an erection into the sky. Picture Wall Street on a Kilimanjaro slope, or, when it rains, picture a downhill Venice.

And rain it does for months. Hong Kong in monsoon season has a climate like boiled Ireland. Violent air-conditioning wars with humid heat in every home and place of business, producing a world with two temperatures: sauna and meat locker. The rainwater overwhelms the outgrown sewer system, which fumes and gurgles beneath streets ranged with limitless shopping. All the opulent goods of mankind are on display in an air of shit and Chanel.

It is a filled-in city, turgid with buildings. The Sham Shui Po district of Kowloon claims a population density of more than 425,000 people per square mile—eighteen times as crowded as New York... There is no space in Hong Kong for love or money, at least not for ordinary kinds of either. A three-bedroom apartment in Central rents for 1,000 \$/month, but there isn't room in any of these bedrooms to even have sex with yourself.

The question I would like to address this evening is Why is Hong Kong so free?

And I think the answer is threefold.

- A unique combination of historical accidents,
- the political realities of running a colony,
- and the character and abilities of one man.

First, the historical accidents. The truth is, that Hong Kong was rather like Gertrude Stein's Oakland: There was no There, There. Until Britain took over the barren rock in the 1840s, there were only a few fishing villages. There was no long established substantial civilization on Hong Kong with a legacy of entrenched institutions and interests. Everybody who came to Hong Kong was an opportunist or refugee. It started with a clean slate. It was established as a British trading post just at the time when Britain itself was scrapping agricultural protectionism and moving to free trade. It was formed just at the right moment in the tide of political fashion.

From the beginning it was a free trade port. Hong Kong has a deep water natural harbour. The ocean currents flush through the harbour, keeping it crystal blue, in sharp contrast to the muddy brown effluent of the Pearl River which flows out to sea just a few miles to the west. Hong Kong means 'Fragrant Harbour' in Chinese, and it was an excellent anchorage for British trading ships.

Apart from that it had little else going for it.

Hong Kong Island and the neighboring mainland are mountainous: there was virtually no flat land at all when the island was acquired by the British 'in perpetuity' in 1842. (What flat land there was was promptly set aside for the cricket pitch and the race course). There were a few fishing villages, but not much else. London didn't really want it at all, grumbling that their local man on the spot had exceeded his authority in adding it to the British Empire.

In 1844, the British colonial treasurer in Hong Kong, Robert Montgomery Martin, predicted, "There does not appear the slightest probability that, under any circumstances, Hong Kong will ever become a place of trade." His miscalculation was to overlook the importance of the rule of law and other institutions that have made Hong Kong the freest economy in the world. He looked only at physical resources at the time.

One of the first proclamations of the British administration promised that Hong Kong's inhabitants would be 'secured in the free exercise of their religious rites, ceremonies and social customs.' And all Chinese trade was to be exempt from any charge or duty of any kind to the British government.

Almost immediately real estate speculation developed. Property protected by British Law in a free trade port had obvious attractions. Not only British merchants but also thousands of Chinese rushed in. In a matter of months more than 12,000 Chinese were living on the island attracted by the construction boom.

For the first hundred years of its life Hong Kong grew and prospered, an island of civility and stability next to turbulent China. In 1862 a small piece of the mainland was added, the Kowloon peninsula, and in 1898 a much larger chunk, the New Territories, was leased from China for 99 years. In total it came to just over 400 square miles (making it only 40% of the size of Rhode Island.)

As mainland China became increasingly unstable, more and more people moved into Hong Kong. The population of the colony doubled in the nineteen thirties, to over 1.6 million people.

The Japanese occupied Hong Kong during World War 2 and by the time a British military administration was re-established in the summer of 1945 the population had fallen to only 600,000. Within months the people of southern China were flocking back into the British territory, obviously relieved to be out of the Great East Asia Co-Prosperity Sphere and back under the yoke of Western colonial exploitation once more.

Which brings me to the second historical accident which contributed to Hong Kong's freedom. At a time when the intellectual fashion in the mother country was swinging strongly towards socialism, under Clement Atlee's labour party, Hong Kong was being swamped with refugees. In the late forties as the Communist swept southward the flow of Chinese refugees into Hong Kong became a tidal wave. By 1948 the population had risen back up to 1.8 million.

Austin Coates, was a British government official arriving 1949. He described the scene....

Hong Kong presented and extraordinary spectacle.... The place was already overcrowded when the communist putsch began. In the past few weeks, about half a million refugees had poured in from China by air, by train, by steamer and junk, and on foot: and as the months passed, well over another half- million arrived. By early 1950 the population stood at the alarming figure of 2,350,000.

It really seemed as if half Shanghai had descended upon the place, together with all the gold bars in China. Money was flying about..... Apartment blocks, shops and houses, many of them illegal and sub-standard, were going up at staggering speed, but still not fast enough. All over the rocky hillsides near the urban area, tens of thousands of ramshackle little huts were sprouting day and night, built of packing cases, sacks, kerosene tins, linoleum, worn-out rubber tyres, anything anyone could lay their hands on, tied together with bits of wire and even with rice straw.

Entire shanty towns were going up in a matter of days. In the streets.... Hundreds of maimed and wounded Nationalist soldiers, who had somehow managed to beg their way south, hobbled or lay about begging alms, sleeping at night where they lay by day, many of them unable to speak Cantonese, utterly uncared for, futureless and helpless. ... it was a situation verging on the chaotic.

(and) Nowhere, as I quickly discovered, was the state of crisis more apparent than in the offices of the government, most of which were severely understaffed to meet the extraordinary conditions prevailing. ...

The red tide of communism swept all before it. In the autumn of 1949 Canton fell, and a few days later contingents of the Chinese Red Army reached the Hong Kong border.

And there, they stopped.. The unexpected happened. The communist regime left Hong Kong alone. They sealed the border and relations between Hong Kong and the mainland became virtually non-existent. Air communications with China, formerly excellent, came to a stop, as did river steamer services to Canton. Trains were no longer allowed to run through from Kowloon to Canton, as they once had.

There was an eerie silence.

Hong Kong was left in peace, but also in terrible isolation. I say terrible isolation because Hong Kong was now deprived of its original reason d'etre.. to be a trading post for China. So there they sat, two and a half million people, barely believing they had survived and were alive, but wondering what on earth they were going to do next.

You can understand from all this that the Hong Kong government was simply not capable of grand socialist designs. It was totally overwhelmed by a demographic deluge.. "All of a sudden, you had the best people shoved into this tiny place," says Daniel Ng, executive chairman of McDonald's Restaurants (Hong Kong). *"I suppose we are fortunate the government didn't have time to react. It was simply overwhelmed."*

Even if the British Government had sought to impose grand New Society plans on Hong Kong in the post war period, its administration was so stretched and resources so scarce that it was out of the question. In fact the British government didn't even try. Colonies were things to be got rid of, to be ashamed of, not places for ideological ambition. Socialism began and ended at home. The British government was financially overstretched as it was, so the only thing it required of Hong Kong was that it not be a drain on the mother country. The Hong Kong administration was in fact financially self sufficient by 1947. Although the Hong Kong people were desperately poor and undoubtedly worthy of foreign aid, the only amount of money they ever received was \$44 million..... from the United States.

So, at key moments in Hong Kong's history, when it was established in the 1840s and when free markets were ideologically most under threat in the nineteen forties, Hong Kong squeaked through unscathed.

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So those were the historical accidents. **The second factor was the political realities of running a colony.** Unlike a democratically elected government, a colonial administration is under sufferance. That a few thousand white folk could rule several million Chinese, is a con trick. They could only get away with it by being seen to be fair, impartial and non-intrusive, or at least better in these respects than the alternative, which in this case was a brutal communist regime just north of the border. They had no mandate to mould or change the local people. Socialism, which is the process of robbing Peter to pay Paul, by its nature is going to upset Peter. Best not to rock the boat.

Also, the reality of the situation was that the British were there first. The vast majority of the Chinese population only pitched up after the Union Jack had been hoisted, and indeed most of them didn't arrive until after WWII, when the British had been in possession for more than a hundred years.

The psychology of the Chinese in the post war decades was that Hong Kong was a port in a storm, a (hopefully) temporary refuge. They did not feel themselves to be citizens, with a stake in Hong Kong's future. They felt only too lucky to be let in at all. Only with the passage of time has the sense of belonging and with it the pressure for democratic representation emerged.

Because government officials were appointed, not elected, they had no temptation to court short term popularity with bread and circuses, they took the long view. Because government officials were not elected but appointed it was possible for some quite unlikely types of people to rise to positions of great authority. It was in this manner that someone with ardently libertarian beliefs came to be one of the most powerful people in the government in the nineteen-sixties.

His name was John James Cowperthwaite.

Son of a tax collector, John James Cowperthwaite was born in Edinburgh, Scotland in 1916. He attended a fine traditional private school, Merchiston Castle School, then went to the University of St Andrew's (where Prince William is studying today). He then took his Masters Degree at Christ's College, Cambridge. At the age of 25 he married a Scottish girl and in the same year (1941) joined the Colonial Office which posted him to Hong Kong.

His ship stopped in Cape Town, South Africa on the way, where he received the news that Hong Kong had fallen to the Japanese and London telegraphed him to re-route to Sierra Leone (a British possession on the west coast of Africa), where he and his wife sat out the war. To keep themselves occupied, they produced a baby boy, Hamish.

In early 1945 he was summoned back to London where he was part of the team being assembled to implement the repossession of Hong Kong. When he finally arrived in Hong Kong in November he began work in the Trade and Economic Affairs Department. In due order he was promoted and in 1952 he became the assistant Financial Secretary. Then on the retirement of Arthur Clarke in 1961, he stepped up to become the Financial Secretary of Hong Kong - a position he held until his retirement in 1971 at the age of 55, the usual age for retirement from the Colonial Service.

(As is the custom in Britain, senior civil servants are honoured towards the end of their career. Together with the early retirement and fulsome pension, the titles are some recompense for the life in exile, the modest salaries and obligations of Duty expected in the Colonial Service. He received the Order of the British Empire in the late fifties. He received the OMC (Order of St Michael and St George) in 1964 and became a Knight Commander of the Order of the British Empire (KBE) in 1968. So today it is *Sir John* Cowperthwaite who lives quietly in retirement with his wife in St Andrews, Scotland.)

Let me say now, that Sir John would not approve of this talk tonight. He has always been reluctant to grant interviews, and would shudder at the thought of being made into some totem pole of radical libertarian philosophy. He protests that he is neither an economist nor a politician. He has said that the policies he followed in Hong Kong were merely the outcome of the application of simple common sense.

Listen to what one person who has met him has to say:

Sir John is a member of the dying breed of British colonial administrators, for whom duty came above all else. It is very difficult to appreciate [the] character of these people in modern times.

They had their faults, but the administration they provided was relatively efficient and free of corruption. Consider what happened in Africa after they left..

When they retired (and like the rest of them, Sir John retired at the age of 55) they closed the doors of their modest houses and content with their modest pensions, they slipped into oblivion. This is how I recall my first impression of him. Modesty and self-deprecation, both personal and professional, define his personality.

The fact that he does not give interviews fits into this ancient civil service mould. What he did in the colony was the past to be discussed only in general terms. Under no circumstances, however, was one to derive any advantage (either through speaking engagements or writing) from it. Discretion above all else.

A Chinese person who knew Sir John socially in Hong Kong describes him as a "Tall [he was 6'4"] gentle guy, bald headed and his wife was a very elegant lady, wearing fancy hats etc."

He was clearly fond of his two dogs. He liked to play golf. He didn't smoke.

And that is about it on the personal side.

Certainly Sir John Cowperthwaite was no **deft charismatic public performer**. He was awkward in front of the cameras and could at times be startlingly terse. The story goes that on one occasion he stepped off the plane from London to be surrounded by a gaggle of journalists.

Sir John, could you tell us about your talks in London?

"I hardly think that is an appropriate question."

"Well, Sir John, what do you think we should be asking you about?"

"It is not for me to tell you how to do your jobs."

End of interview.

Such treatment did not endear him to the press.

Recently a journalist researching for a book wrote to Sir John and asked him three innocent questions of fact about his activities in 1961. Sir John's replies were typically expansive: "**no, no and no**".

But underneath this image of a self-effacing, honorable civil servant there was more. So much more, in fact that over thirty years after Sir John's retirement, Yeung Way Hong, publisher of Hong Kong's most popular Chinese language magazine, *Next*, has suggested erecting an heroic-scale statue of John Cowperthwaite.

'I am absolutely certain that his personality and upbringing are responsible for Hong Kong's prosperity.' was the verdict of one observer.

More than a few of the muttered criticisms and comments made about Sir John Cowperthwaite over the years can be attributed to the irritating fact that he was *nearly always right*. Perhaps there were debates and arguments he lost, but I am not aware of them.

" Perhaps his most striking attribute is his protean grasp of the many problems which this government has faced. I have yet to find an aspect of Government's responsibilities on which Sir John's knowledge and advice have not been both penetrating and valuable."

On his retirement a colleague paid tribute to his 'austere wisdom'.

Sir John always had to have the last word, he had to be right. Professor Alvin Rabushka in the preface to his book 'Value for Money, the Hong Kong budgetary process' thanked Sir John Cowperthwaite for 'making {his} life miserable and making the book better by correcting numerous matters of fact'. Professor Rabushka had been locked in an exhaustingly long correspondence with the newly retired Sir John who relentlessly followed up on every fact and assertion in Professor Rabushka's manuscript.

The editor of the Far Eastern Economic Review (Sept 21, 1967) remarked grimly that 'the Financial Secretary ... is a man of such personality and intellectual stature as to constitute a frightening opponent, even to a governor.'

This was a man who in his budget speech playfully referred to the tax policies of the Roman emperor Vespasian, and on other occasions made references to a greek poets.

Professor Alvin Rabushka, described Cowperthwaite thus: '[He was] brilliant, well-trained in economics, suffered no fools, and was highly principled. He wouldn't have lasted five minutes in a similar post in Britain, since he was not predisposed to compromise any of his principles- only the constitutional structure of Hong Kong allowed him that power.'

And what exactly were those principles? Again, I quote:

" True to the ethics of Scottish Protestantism, he hates to spend money - especially if it belongs to someone else (like the taxpayer). For example, he never spent any money on the upgrade of his official residence in HK. Though he had a budget to do so, he refused. His successor turned [the official residence] into a palace, because -as he said to Sir John-, "he believed in luxury". Sir John did not. For him his job was a duty, not a ticket to luxury and riches.'

So there we have it: 'true to the ethics of Scottish Protestantism'. This man was a philosophical son of another Scotsman, Adam Smith.

He was not running for election. His job was secure, he did not need to court popularity. Both Governors he served under, Sir Robert Black (1958-64) and Sir David Trench (1964-71) were sympathetic to his policies, which were also enthusiastically supported by the business community.

The Legislative Council of Hong Kong which voted on matters of financial policy was stacked with government officials. Furthermore, Sir John Cowperthwaite controlled the agenda. Policy was hammered out behind closed doors before being presented for airing at the meeting, and only he decided precisely which topics should be presented for Legco's Finance Committee's scrutiny.

Technically the Financial Secretary ranked number three in the administration, after the Governor and the Colonial Secretary, but in fact by controlling the purse strings the Financial Secretary had an all pervasive effect on how the government was run.

Frank Welsh in his *'A Borrowed Place' The history of Hong Kong (1993) p 460* describes him:

... Sir John was able to exercise complete control of the colony's finances. An anonymous colleague reported that 'Apart from Burgess {Claude Burgess, Colonial Secretary 1958-63}, no one could keep Sir John Cowperthwaite in line. His brilliance and argumentation prevailed and he thus made policy by ruling on all items of expenditure.'A political economist in the tradition of Glad-

stone or John Stuart Mill, Sir John personified what might be called the Hong Kong school of economists, unreconstructed Manchester-school free-traders.

In general terms, Sir John spent his time saying "No, no and no" to various proposals from activist colleagues and members of the Legislative Council. Since the Legislative Council was purely advisory, this was merely a matter of due process. The proceedings of Legco are on public record and from its annals we can garner the 'The Collected Wit and Wisdom' of Sir John Cowperthwaite.

When businessmen in the 1960s asked for special treatment for their industries, which they claimed were crucial to the colony's well-being, Sir John Cowperthwaite replied that *"I should have thought that a desirable industry was, almost by definition, one which could establish itself and thrive without special assistance in ordinary market conditions."*

"I believe government should not presume to tell any businessman or industrialist what he should or should not do, far less what he may or may not do--and no matter how it may be dressed up, that is what planning is."

"In the long run, the aggregate of decisions of individual businessmen, exercising individual judgment in a free economy, even if often mistaken, is less likely to do harm than the centralized decisions of a government, and certainly the harm is likely to be counteracted faster. . . . Over a wide field of our economy it is still the better course to rely on the 19th century's 'hidden hand' than to thrust clumsy bureaucratic fingers into its sensitive mechanism."

Fending off the activists in Legco was one thing. He **also thwarted attempts from London to change HK's economic system.** By stonewalling and procrastinating, he avoided many damaging

"reforms" - such as minimum wage laws. By the time London really put its foot down, the wages in HK were already high due to simple free market process and growth of wealth.

I would like to give one example here of 'intervention' from London, and how he dealt with it.

Hong Kong was unusual in that the government hardly intervened at all in the banking system. There was no central bank and, indeed the Hong Kong government didn't even issue the bank notes, leaving it to the major commercial banks to print their own. As a result of this laissez faire, competition among the hundreds of banks was fierce and periodically there would be a 'banking crisis' when one or other of the

banks would collapse. There was one such crisis when a bank collapsed in 1961, the year Sir John became financial secretary As a result....

Various senior bankers agitated for the government to introduce banking regulations and banking supervision. The colonial government (ie. Sir John) virtually ignored them. In exasperation the manager of the largest bank, the Hong Kong & Shanghai Bank, himself began to draft proposed legislation, and lobbied the Bank of England to get involved. A representative from the Bank of England was invited to visit Hong Kong and prepare new banking legislation in 1962. The representative, H.J. Tomkins, got no encouragement from the financial secretary, whom he described as 'near doctrinaire "laissez-faire" '. Tomkins was particularly critical of the fact that the Hong Kong government made no attempt to restrict the number of commercial banks, a restraint which he thought was essential to prevent 'excessive competition.' He also said it was a shame the HK government seemed to regard all advice from bankers with suspicion, since in this way it deprived itself of a large reservoir of experience and technical expertise.

(Cowperthwaite had certainly read Adam Smith, who famously observed that whenever businessmen get together they collude to restrict trade.)

Nevertheless Tomkins pushed ahead. Draft legislation was published, and then debated, with the Hong Kong government unenthusiastic about implementing it (because it was too restrictive) and the colonial office in London complaining that it was still far too lax. The banks in Hong Kong having initially pushed for legislation, did an about-face (since the banking crisis was now over!). Eventually a weaker form of the legislation was introduced in 1964, but even then Cowperthwaite objected to the principle of spot checks on banks to see that they were in compliance, believing that such intrusions would be unpopular among the Chinese banks. Spot checks were against the principle of the presumption of innocence, fundamental to common law.

Of course Regulation and invasion of privacy are not the only intrusions of government. The most notorious burden is taxation.

Hong Kong had almost no tariffs on trade, no sales tax and no capital gains tax. It had no salaries or profits tax at all until 1947. The salaries and profits tax were introduced at a flat rate of 10%. This was raised to 12.5% in 1951 and to 15% in 1966 and the rate remains at a flat 15% today. That is 37 years with virtually no significant change in the tax system.

Furthermore I would like to emphasize that this is a salary and profit tax, *not* an income tax - a distinction which is now almost wholly forgotten. An income tax is a tax on all income from any source. Basically the government says, tell us about all the money you made, now send us X% of that amount. This is a sort of financial strip search. A salary tax is however more narrowly defined: if you receive a dividend, you don't report it; if you receive a capital gain, you don't report it. And in Hong Kong you only have to report salaries earned from *Hong Kong* sources. There is no probing into your world wide sources of income.

Listen to Sir John on the subject;

" My honourable friend Mr. Li has once again, in connexion with our need for increased revenues to match increased expenditure, had the political courage to advocate a full income tax system and has asked me how I came to descend from that previous state of innocence in which I was inclined to agree with him. I do not propose to make a full confession, but merely mention one or two factors in my lapse from grace. One of these is an increased awareness of the benefits to our economy, [particularly in terms of investment and enterprise, both local and overseas,] of not having the inquisitorial type of tax system inevitably associated with a full income tax."

Here again, as with spot checks on banks, he was wary of unwarranted government intrusion.

Under this light touch, Hong Kong grew explosively. As proxies for economic growth, just consider that electricity consumption quadrupled in the sixties, the number of telephones in use quintupled and the number of automobiles more than tripled.

I use these proxies for economic growth, because Hong Kong did not collect GDP statistics. Neither did the government collect 'balance of payments' statistics. Here again, the blame for the lack of statistics can be placed at Sir John's feet. He believed that the activities associated with compiling GDP statistics were unduly intrusive, as well as placing a burden on businessmen by making them waste time filling out forms and questionnaires. If academics wanted such numbers, let them collect them themselves, was his rebuttal. They were of little use in planning government budgets because tax revenues came in well *before* any plausible GDP estimates could be compiled from which to estimate the tax revenue. He went on to estimate the cost to the tax payer of compiling the statistics (about HK\$500,000 in 1970), with the implication that he did not believe he had the mandate to waste such budgetary resources to satisfy academic curiosity.

But Sir John went further. *"we might indeed be right to be apprehensive lest the availability of such figures might lead, by a reversal of cause and effect, to policies designed to have a direct effect on the economy. I would myself deplore this."*

In other words, Sir John understood that 'knowledge is power'. Therefore the best way to limit the power of the government was to keep it ignorant. His resistance to 'an inquisitorial type of tax system' (an income tax) and his resistance to 'spot checks on banks' were part and parcel of the same philosophical stance. The government had no general 'right to know', and the less it knew, the better for a free society.

Incidentally, the Hong Kong government did decide to conduct a **census** for the year 1961. It was, after all, thirty years since the previous one. So it set up a Census Department in 1959 in order to prepare and conduct the census. But (and this, as students of government will realize, is the amazing thing), as soon as the census was completed, *they closed the department down.*

In response to criticisms of some of the obvious inequities of Hong Kong's patchy tax regime, where some quite obvious and large chunks of earnings went unrecorded and untaxed, Sir John resorted to pointing out that by their nature some types of earnings were very hard to trap: earnings in foreign currencies, intra family transactions etc. and the draconian measures required to nail them down would represent such a violation of the harmonious relationship between the government and the people as to be not worth the effort. In any case, whether or not you were caught in the tax net was not of such overwhelming importance when *the worst* the government could do would still leave you with over 85% of what you reported. Just by keeping the government small, the issue of who pays for it suddenly seems not so important.

I said the maximum rate of tax was 15%, but there were extremely generous personal exemptions. Because of these, in Cowperthwaite's day only *two* percent of the work force paid any salaries tax. (In 1970, the personal exemption in Hong Kong was nearly triple the exemption in the UK and double the exemption in the US, despite having average wages of less than half). Even in the eighties, only 10% paid salary taxes. (In 1997 it was up to 47%)

How small was, and is, the Hong Kong government? Well, Sir John's successor, did, unfortunately, sanction official government estimates of GDP and from those we can deduce that during the sixties the Hong Kong government probably accounted for about 13% of GDP, about a third the size of the US total of state and federal expenditure and less than a quarter the size of the British government. Government employees accounted for only 2% of the population, or perhaps 5% of the work-

force. (In 1970, Cowperthwaite's last year, total government expenditure came to 11.5% of GDP.)

There was virtually no government debt: in 1971 at the end of Sir John's reign, the gross government debt stood at a trivial US\$3 per head. Almost every year of the post war colonial period (ie. until 1997) the government ran budget surpluses, and it is a matter of some debate as to why this was so. The accumulated government surpluses were sometimes described as a rainy day fund, to cover short term declines in the economy. Well, that may have been the case, but they were more than ready for a spot of rain. At the end of Sir John's tenure the government had so much in its piggy bank that it could have run the entire government for almost a year without any tax revenue whatsoever. (That is the accumulated fiscal surpluses, leaving aside the very substantial foreign exchange reserves backing the currency).

Why did the government run persistent surpluses? I think the simplest explanation was that they were constantly surprised by the amount of revenue. Tax revenue rose so much faster than anybody expected because the economy grew so much faster than anybody expected. Perhaps Sir John's predecessor, Arthur Clarke put it best in 1961:

"And Sir, I expect, too, that my successor will make exactly the same mistake I have always made. He will under-estimate revenue. He will under-estimate his revenue, because, like me, like so many of us, he will never be able to comprehend how new and successful industries can be created overnight out of nothing, in the face of every possible handicap; how new trade can suddenly start up in some way that has never been thought of before; he, like me, will never be able to comprehend how on earth our enterprising, ingenious, hardworking people can ever manage to accomplish so much with so little."

It would be wrong to leave you with the impression that the Hong Kong government eschewed all welfare services. Certainly the government old age pension was, and is, pitifully low, but the government even in Sir John's day provided limited medical care and subsidized education and help for the handicapped. The scope of these services was small and only gradually expanded as the colony grew richer and the coffers filled.

Believe it or not Hong Kong did not have a free universal system of primary school education until the year of Sir John's retirement. The government did heavily subsidize schools, often by providing land at negligible cost, but also with direct grants of money, but most schools were privately run, and they all charged fees, albeit very low fees. However, progressive forces prevailed and in 1971, the year he retired, he reluc-

tantly announced that school fees for children up to the age of eleven would be scrapped. **'I cannot say', he added, 'that I myself am particularly happy to make this announcement'**. His objection: Those who can afford to pay primary school fees should not receive a subsidy from the tax payer. **"I hope that we shall be able to do something to limit free primary education, and possibly, for that matter, heavily subsidized primary education to the schools which do not cater for the affluent."**

In other words he did not see why tax payers money should go to subsidizing the large numbers of parents who *could* afford to pay school fees. For those in dire need, yes, a case could be made, but *universal* free education was, he thought a bad precedent.

Which brings me to another recurring theme in Sir John's speeches. He was a staunch defender of the little guy. A colleague noted that **"a kind heart beats under his severe exterior"**.

"... Like Gladstone, he had a sense of obligation towards the most unfortunate, which was combined with what he described as a traditionally Scottish reluctance to spend money without seeing a corresponding advantage. Importantly, he did not harbour supremacist attitudes towards the locals. He saw the Chinese for what they are - enterprising and hard working people. (This was never the case in Africa, where the local population never earned respect of the colonial administrators.)"

He saw himself as the careful housekeeper, defending the public purse from grasping knaves. He knew that businesses and powerful people were constantly working to bend the levers of government to their purposes.

A constant pre-occupation of Legco members was the provision of carparks. Would the government build more, to provide adequate parking spaces at a reasonable fee? Cowperthwaite thought this was a misuse of public funds. He pointed out that (at that time) only the affluent could afford cars, and it would be an abuse of public funds to use them to subsidize parking for the rich few. A parking space would cost about HK\$65,000 to construct, he estimated; the same amount of money would provide housing for 115 people.

In 1967, a Legco member proposed that mortgage interest be made deductible for the purposes of the salaries tax, (as it was in the UK and still is in the United States). No, that would not be a good idea replied Sir John, noting that this would benefit only

those who have substantial income. **"The man whose outcome is below tax level or who has bought a house for cash or who occupies a rented home would not benefit."** Of course, he was right, remember at that time only the richest 2% paid any tax at all.

And this in 1966:

My fear isthat we are developing public services which are too expensive per unit....and of too high a standard, for our means, if we are to extend them as they should be extended. Many of our services cost more than do similar services in Europe, because,... the decision takers and policy-makers, both inside and outside the Government....being themselves from the better-offsectors of our society, not only demand the highest standards of provision of public services to meet what they consider their own essential needs(for example in public car parks); but also find it difficult to think of provision for the rest of the population in terms of standards relative to our total real resources. We tend to the opposite situation to that made familiar by Professor Galbraith; we tend to public affluence and private squalor....

.....

There is one particular aspect of the situation which causes me considerable apprehension, the tendency to demand that subsidized services be extended, at these high standards, to all citizens irrespective of need. "

Note that here we have in effect a government official *complaining publicly that the standard of government services is in fact too high.*

Similarly businessmen proposed that a cross-harbour tunnel would be a vital government infrastructure project. Not so fast, replied Sir John retorting that, if they thought it was such a surefire great idea, then surely it would be a money spinner and why didn't they go ahead with the project themselves? In the event, it went ahead, as a substantially private enterprise but with the government taking a stake.

Sir John was an early and vocal advocate of the Laffer Curve, although, of course he didn't know that was what it was called, because Mr Laffer hadn't invented it yet. He put this key insight to good use. Although Hong Kong had no general tariffs, there were 'sin taxes' on alcohol and tobacco. It was common knowledge that an immense amount of tobacco was being smuggled in to evade the duties, so he decided to cut the tobacco tax by 40%. Within a year the tax revenue from tobacco jumped eleven-fold. He patiently explained on numerous occasions that low tax *rates* today, by stimu-

lating enterprise and investment, would greatly increase tax *revenues* in the years to come.

So, with the major exception of the property market - and it is a major exception- Hong Kong managed to get through the twentieth century with a blessedly Gladstonian efficient, minimal government. Despite having virtually no flat land, little water and no natural resources to speak of. Despite being desperately crowded and surrounded by Communists, (after China, the next closest country was North Vietnam), despite being a victim of U.N. trade sanctions on China in the fifties and textile and cutlery quotas slapped on by the ever generous United States from the sixties, despite being more than 8000 miles away from its two largest markets (the UK and the US), deprived of democratic institutions and foreign aid, Hong Kong boomed.

Despite the absence of minimum wage legislation, feeble trade unions and rapaciously greedy capitalists, real wages rose over 4% per year during Cowperthwaite's tenure, while the population grew by 3% per year. It has been estimated that in the late sixties industrial production was growing over 15% per year and GDP was growing over 12% per year. During the Cowperthwaite decade, 1961-71 domestic exports compounded at 13.8% per year. Total bank deposits grew 19% per year. Certainly something extraordinary was going on. Sir John Cowperthwaite in 1971 attempting to explain why, yet again, the government was running an enormous surplus said "*I defy anyone to say that he knew in advance that revenue would grow 45% over these last two years.*" Because of the phenomenal economic growth the government, quite literally had more money coming in than it knew what to do with (and this, remember with tax rates of only 15% and only 2% of the population paying salary tax).

Hong Kong's per capita GDP rose from less than a quarter that of Great Britain in 1960 to more than 20% higher than Britain's by 1997. Today, by virtually all qualitative parameters - the low crime rate, health, education and longevity - the people match the rich industrialized west.

"I myself have no doubt in the past tended to appear to many to be more concerned with the creation of wealth than with its distribution. I must confess that there is a degree of truth in this, but to the extent that it is true, it has been because of my conviction that the rapid growth of the economy, and the pressure that comes with it on demand for labour, both produces a rapid and substantial redistribution of income directly of itself and also makes it possible to assist more generously those who are not, from misfortune temporary or

permanent sharing in the general advance. The history of the last fifteen years or so demonstrates this conclusively." (proceedings of the Hong Kong Legislative Council, February 1969, p 104. as quoted in 'Hong Kong, Capitalist Paradise' by Jon Woronoff 1980, Heinemann)

Their wealth has been able to buy them a measure of security. The Hong Kong and Shanghai Bank, originally driven out of Shanghai in the forties, in the nineties invaded England taking over one of the largest banks in Britain. Hong Kong money has poured into the property markets of London, England, Sydney, Australia, and Vancouver, Canada to the extent that the city has been dubbed 'Hong Couver'. Hong Kong students flock to the campuses of Australia, the United States and Britain. (This summer I visited one of the oldest, famous and most expensive private schools in England, Winchester College, and was amused but not surprised to see that the plaque on the wall honouring the benefactors reads like a virtual Who's Who of Hong Kong society.)

The old joke is that the definition of a pervert in Hong Kong is a person who loves women rather than money.

When the last governor of Hong Kong, Chris Patten, took over in 1993 he was introduced to Sir John Cowperthwaite and as he shook his hand he said, "So, you are the architect of all this?"

"I did very little. All I did was to try to prevent some of the things that might undo it."

Over the years the Hong Kong government has become involved in various economic activities in spite of itself. Thus while Hong Kong is relatively free, it is by no means a pure case of Laissez Faire. For example, the government provides water, it owns the Kowloon-Canton railway, the post office, the airport, and most astounding of all, it is the biggest landlord, providing accommodation for over 40% of the households in Hong Kong.

During Sir John Cowperthwaite's tenure, he insisted that the government run these various activities in so far as possible, as profit-seeking businesses. In the mid sixties population growth outstripped the water supply and large areas were subjected to stringent rationing. Sir John forcefully advocated raising the price of water to help clear the market. He insisted that the Railway and the post office be run on a fully commercial basis, and they did indeed make profits.

But it is in the land and housing market that the Hong Kong government has made a comprehensive botch of things.

Surprisingly, initially the housing program was not seen as a welfare activity. It was a public health and safety issue. The impetus was a disastrous fire at Shek Kip Mei in December 1953 which made 53,000 people homeless. Squatter settlements on hillsides were fire traps, and also- they were trespassers. The Commissioner for Resettlement stated clearly that squatters were being re-housed "not simply because they need or deserve hygienic and fireproof houses: they are resettled because the community can no longer afford to carry the fire risk, health risk and threat to public order ... and because the community needs the land on which they illegally occupy." From 1954 until 1965 a total of 607,673 people were re-housed in government built housing projects. Hong Kong was well on the way to tidying up those dangerous insanitary squatter settlements. Or was it? A funny thing happened on the way to the socialist utopia. There were only about 300,000 squatters in 1954. The government had re-housed double that number, and yet the hillsides were packed worse than ever, with an estimated 600,000 perched in their shacks in 1965.

Of course what was going on was a consequence of the perverse incentives. Although very small, the government-built flats were let at substantially below market rates, at times the rent was estimated to be only one third of the free market level. Again, initially, setting rents below market was not primarily a 'welfare' benefit, it was instead an inducement or even compensation for the forcible eviction from their shanty towns. Also, the government had little idea how wealthy or poor the squatters were. Certainly they looked poor, and so presumably could only afford a very low rent. But of course, appearances can be deceptive, and everybody was getting richer very rapidly. Pretty soon people learned how to game the system.

In order to get one of the nice new housing units at a cheap rent you had to be a squatter, so people were quitting their private sector housing, moving onto the hillsides and then applying for government housing. In effect the government was rewarding squatters. In fact people went even further. The government had decided that urgent priority should be given to those poor people whose only accommodation were leaky wooden boats bobbing up and down in the Typhoon shelters. Not surprisingly therefore, there was an endless stream of people off the land onto the boats, and therefore straight to the head of the waiting list for public housing! Thus government policy had contributed to a doubling of the squatter population - an outcome absolutely 180 degrees away from their objective!

Clearly the policy wasn't working so they did what all governments do in such circumstances, they expanded the housing program, offering a better quality of the units and extending the benefit to a broader swathe of the population. Needless to say, Cowperthwaite was not happy:

"the better off a family is the higher the subsidy it tends to receive; which is surely absurd."

In the seventies, (by which time Sir John Cowperthwaite was safely out of the way, enjoying his retirement in Scotland) the government, under the new 'progressive' governor Sir Murray Macle hose announced ambitious targets to build hundreds of thousands of new government housing units per year. As with all such socialist five year plans the world over, this one failed miserably, the government built units at less than half the rate they had set as their goal. The whole grizzly thing had become an immense welfare program, both for the tenants and the construction companies. Richard Wong of Hong Kong University in a study published in 1998 showed that the whole system was riddled with flagrant abuse. The people living in government housing at subsidized rents were on the whole no poorer than people living in private sector accommodation, they were just better at working the system. There were examples of families holding on to units and subletting them to others at market rates, thereby growing rich at the government's expense.

Furthermore, the New Towns created in the New Territories in the seventies and eighties by government planners to accommodate the seemingly never-ending stream of people lengthened commuting times, increased congestion and baited people with below-market rents into living in logistically inefficient locations .

Even as they got richer, people chose to continue living in tiny government housing units. Naïve visitors to Hong Kong appalled by the cramped living conditions would all too readily assume the people could afford no better, whereas many of them could and in an undistorted free market would have chosen to live in bigger apartments. In effect the government was bribing them to stay crammed into their housing projects.

As with anything provided at less than half the free market price, places were allocated by rationing.

Waiting lists were long and bribery was rife.

The continual 'shortage' of housing was a constant source of complaint in Hong Kong. The gullible and economically illiterate would all too readily blame it on the incredibly high population density, which was of course not the government's fault. But

the so-called housing shortage was. It was caused not only by the persistence of below market rents but also by the fact that the government was slow to auction off land leases, severely limiting the supply of private sector building sites.

Although Hong Kong is in the Guinness Book of Records as one of the most densely populated places on earth, anyone who has been there can attest to the hundreds of square miles of green hillsides and woodlands. 70% of Hong Kong remains undeveloped (partly because Maclehoze designated no less than 40% of the Territory's area as park land. His nostalgia for the beloved barren highlands of his native Scotland apparently taking precedence over the desperate overcrowding of the local population).

It is no coincidence that the two widely perceived shortages of the sixties, drinking water and housing, were the two areas in which the government was the dominant supplier.

The government further helped to screw up the real estate market with rent controls and planning controls. In the fifties, the government enforced rent controls on *Pre War buildings only* and eased the planning controls to increase the allowed plot ratio on new buildings.

The rent controls made old buildings unprofitable for landlords and the eased plot ratio increased the profitability of replacing them with new construction. Thus this triggered a tremendous building boom.

In 1962 the government had second thoughts about the plot ratio, it was clearly leading to excessively high buildings creating extremely high population densities in congested urban areas, so they reduced the permitted plot ratio, but, and here is the real zinger, *they allowed a three year grace period before the law became effective.* The result was the mother of all building booms.

In the period 1962-65 landlords frantically demolished and rebuilt before the less profitable lower density planning code became effective. The result, surprise, surprise was an enormous glut in hastily built new apartments. Rents and prices plunged and the speculative bubble burst, precipitating a second banking crisis in the middle of the decade and the property market remained hung-over for five years.

Thus Hong Kong has a reputation for a violent and speculative property market. But that is not intrinsic to its laissez faire economy, but a result of ham-fisted interventions by the government.

I do not want to end this talk on a down beat, so it is best to leave the story there. Hong Kong today is not as free as it used to be, the seeds of a welfare state have been planted, and the administration finds itself sucked ever deeper into the quagmire of problems which come from over-commitment. The government provides virtually free universal healthcare and free public education. Today there are few private independent health facilities or schools and none of the seven universities are independent. Government revenues have been falling and economic growth has been stagnant for several consecutive years. Today the budget deficit is a massive 6% of GDP and the financial secretary has just announced increases in corporate and personal tax rates and is planning the introduction of a sales tax. Education, health and other social services now consume over half the budget and they grow relentlessly. The government has doubled as a percentage of GDP and unemployment has nearly tripled since Cowperthwaite's time.

Of course, not all the problems are self-inflicted: Hong Kong faces increasingly intense competition from mainland China, but the fact remains that the government has been slower to adjust to the new realities than the private sector.

Looking back in his retirement, Sir John averred that perhaps his biggest mistake was in 1966. In the economic slump of that year, the government ran a small deficit. Following the precepts of good housekeeping, to balance the books he decided to raise the standard tax rate from 12.5% to 15%. The recession was brief, the economy boomed and the government promptly returned to ever larger annual surpluses. He used the extra revenue to tidy up the tax code, abolishing several minor petty duties and fees, (the dance-hall tax, the radio license in 1967 and the TV license in 1972) and halving the 'stamp duty' and halving the estate (death) tax from a top rate of 40% to 20%. Nevertheless, with hindsight, he said, that small increase in taxes made the government too flush and provided the wherewithal for the more progressive elements to push their agendas. Perhaps the introduction of compulsory free primary education in 1971 was made that much easier.

Only a man of Sir John's integrity and principles could regard an increase in the maximum tax rate from 12.5% to 15% as a dreadful step along the Road to Serfdom.

Milton Friedman has compared Hong Kong to Israel. Both societies were in effect established by refugees at the end of World War II., and had roughly comparable populations. Both were subject to a virtually complete trade embargo by hostile neighbors. Both populations have a reputation for hard work and entrepreneurialism. Israel chose the socialist route and democracy. Hong Kong went the free market route with minimal government. Israel, of course had to pay for defense, but it has received over \$17 billion in foreign aid. Hong Kong on the other hand has received just \$44 million. The result is that Hong Kong enjoys a per capita income 60% higher than Israel today, although it started from a much lower base.

If you want to compare this British colony with an American, a comparison can be made with Puerto Rico, which with tax breaks and subsidies remains considerably poorer than the rest of the United States.

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