

The Allocation of Ultra Scarce Property Rights in Hong Kong – A Policy Evaluation

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Introduction

In recent years, natural resources have regained their luster, after languishing for two decades or so. Their buoyancy is attributable to a host of structural and cyclical factors, and manifests itself in price escalation on many fronts, notably oil and related commodities. The phenomenon has not been universally welcomed because it has reignited the flames of cost-push inflation, supposedly extinguished in the early 1980's, and has adversely affected consumers and producers alike in many countries. However, because the upward spiral in prices materialized in a global environment characterized by a robust and synchronized economic expansion, the reaction to the pressures that have surfaced has been generally muted, both at the grass-roots and policy level.

Relatively little attention has been accorded to the “losers,” whereas the “winners” have basked in the limelight. Since the recovery in the natural resources sector is believed to be merely the “tip of the iceberg,” or an early stage of a typical multi-year cycle, the potential gains to suppliers have been widely examined. Commodities are again viewed, at least in non-academic circles, as a strong wealth-generating mechanism and a reliable engine of economic growth. The role of labor has been de-emphasized, due to outsourcing to developing countries endowed with large, flexible, and reasonably well educated workforces, although institutional capabilities and technology have continued to loom comparatively large in public discourse.

The current preoccupation with natural resources obscures the fact that “competitiveness,” perhaps the key factor fueling economic dynamism, more often than not has its roots elsewhere and commodities alone are a marginal part of the picture. Ongoing institutional engineering and re-engineering, with enlightened policies as a by-product (“enlightened,” in this context, should not be equated with “interventionist”), to all appearances

remains the most effective strategic tool for consistently promoting economic development. The post-1978 Chinese experience is a telling case in point and Hong Kong, the vibrant capitalist enclave at the southern tip of Guangdong Province that has continued to thrive in a highly fluid international and regional political setting, possibly offers an even better illustration.

Hong Kong's history is one of remarkably swift and yet far-reaching adaptation to shifts in the external environment. From its establishment as a British colony in mid-19th century to the years of physical reconstruction and political consolidation following the Second World War, Hong Kong had functioned comfortably as an entrepot, capitalizing on its position as a pivotal link in the trade chain between China and its commercial partners. The eruption of hostilities on the Korean Peninsula in the early 1950's severely disrupted this pattern, due to the isolation imposed on China, and Hong Kong, taking advantage of the heavy inflows of cheap labor from across the border in the wake of communist-induced upheavals across the border, rapidly reinvented itself as a large-scale center for light industries. When China opened up in the late 1970's, Hong Kong opportunistically changed tack again, transferred its manufacturing base to Guangdong Province, and energetically refashioned itself as an outward-looking service center.

Today, Hong Kong operates as a "global metropolis," one of a handful of cities to have achieved this lofty status. It remains the focal meeting place for Chinese and foreign networks of capital, but now performs the intermediary role in a geographically broader and more multi-dimensional manner than during previous phases of its economic evolution (Meyer 2000). Hong Kong has been catapulted from relative obscurity into international prominence by virtue of its institutional vigor rather than natural resource endowments. This manifests itself in many spheres of social activity. Nevertheless, one factor has appropriately been singled out for its contribution to robust overall development and smooth structural transformation/cyclical adjustment: the deliberate restraint exercised by the government.

Laissez-Faire Underpinnings

This posture has led, according to an ardent supporter of local policy practices, to an institutional configuration allowing private agents to be guided in a highly effective fashion by a system aptly designated as an "automatic corrective mechanism." The latter is portrayed as a process

firmly anchored in an essentially free market economy that continuously alters internal costs and prices to bring them quickly into line with costs and prices in the rest of the world. The flexible movement of internal costs and prices with associated changes in output and employment, brings about internal and external equilibrium at all levels of world trade, and maximum economic growth (Rabushka 1973; Rabushka 1976; Rabushka 1979; de Mesquita, Newman, and Rabushka 1985; de Mesquita, Newman, and Rabushka 1996; Mushkat and Mushkat 2006a). This disciplined policy setting has been succinctly delineated by the author extolling the virtues of the model:

In Hong Kong, economic affairs are conducted in an environment of almost unfettered free enterprise. Government policy has long dictated a virtually hands-off approach toward the private sector, an approach that seems well-suited to Hong Kong's exposed and dependent economic and political situation. The philosophy that underlies government in Hong Kong can be summed up in a few short phrases: law and order, minimum interference in private affairs, and the creation of an environment conducive to profitable investment. Regulatory economic controls are held to a minimum, no restrictions are placed on the movement of capital, little protection and few subsidies are given to industry, and the few direct services provided by the government are operated on a commercial basis (Rabushka 1979: 44).

And the adaptability and dynamism that the policy gives rise to have neatly been captured by another scholar:

The government asserts that Hong Kong economy is a self-regulating one: it is the classical economist's dream. There is therefore no need for the government to intervene. The essence of the argument is that nowhere else in the world is the wage/price flexibility so high as it is in Hong Kong. When a recession occurs either from a fall in world trade or a decline in the construction industry, output and employment will fall as in the case of a recession in other countries. But, unlike other countries, the response of the Hong Kong economy to such a fall in employment and output will be fast. Such a response takes the form of a decrease in prices, as predicted in the classical macroeconomic model. As most of our manufactured goods are for export, the fall in prices will make our products more competitive in overseas markets. In this way, our exports and manufacturing output can be stimulated through this automatic mechanism. Moreover, it can also be argued that the fall in prices and wages will have the effect of increasing the real cash balance (i.e., the cash in the hands of the public in terms of constant prices). Any increase in the real cash balance will tend to make people feel richer than before and, in consequence, consumption will be stimulated and the recovery from a recession will be initiated (Chen 1984: 40).

This spirited depiction of the policy thrust and its impact on system-wide performance has not gone unchallenged. Mildly dissenting views have been offered periodically, highlighting selectively the descriptive limitations of

the picture constructed and its normative connotations. The reservations expressed by writers focusing on the normative side initially reflected Keynesian-style and broader liberal concerns about the implications of such a distinctly non-interventionist government stance and heavy reliance on market forces. It was argued that macroeconomic stabilization should be pursued with greater determination, where appropriate, and that strategies should be implemented, in a sensible fashion, to address micro-level market failure and economic deprivation/inequality (Cheng 1982; Chen 1984; Peebles 1988; Ho and Chau 1989; Mushkat and Mushkat 2006a).

The somewhat critical observations offered regarding the descriptive side have highlighted the divergences between the “ideal” – perhaps even to a certain extent ideologically-inspired – model and prevailing realities, albeit without overstating the wider ramifications of any such divergences. In the early stages of the evolution of the “debate” on the role of the government in the economy, students of the Hong Kong scene not firmly attached to *laissez-faire* principles sought to establish, at least in general terms, that the local authorities did not always follow practices entirely consistent with their strategic tenets or operate at all times in a manner often admiringly attributed to them by others. Specifically, it was pointed out that the government did not adopt an ambiguously passive posture but had explicitly pursued a policy of “positive non-interventionism,” endeavoring to enhance the working of market forces and taking complementary actions when necessary (Cheng 1982; Youngson 1982; Mushkat and Mushkat 2006a). This moderately revisionist fine-tuning did not culminate in any radical conclusions, yet the emphasis shifted from absolute values to relative ones:

One may, of course, quibble and complain that this is a weak and defective *laissez-faire*, since it has been contaminated by some concerns of present-day welfare. On the other hand, it is still as close to the real thing as one can come. If Hong Kong no longer boasts as much freedom as 18th century England or the free-wheeling days of 19th century Shanghai, it is still a far throw from the mixed economies of the West today, let alone socialist and communist regimes. Let us say it is early 20th century *laissez-faire*, although its critics might dispute the fact that it has gone so far. In some ways, it is even an improved form, as compared with the more spontaneous *laissez-faire* of earlier times, for the Hong Kong Government is following the policy consciously and purposefully, taking advantage of the benefits it does offer. But all that does not really matter. If one wishes to find a well-preserved and healthy specimen of an otherwise vanishing species, there is no other place to see and study *laissez-faire* than Hong Kong (Woronoff 1980: 41).

Increasing Government Activism

This re-adjustment of the analytical lens, to reflect the uniqueness of an institutional pattern compared to those witnessed elsewhere rather than its intrinsic merits, was appropriate and well-timed. Nevertheless, it was undertaken at a juncture preceding the emergence of a series of exogenous shocks that have resulted in greater government activism at the margin (the influx of immigrants from the mainland, induced by communist rule and Maoist excesses, materialized earlier and provided the catalyst for large-scale public sector supply of housing services). The prospect of British departure and resumption of sovereignty by China, the extreme currency volatility that ensued, leading to the establishment of the “linked exchange rate system”; the prolonged property market bust that crippled domestic demand from the late 1990’s to the middle of this decade; the global recession that followed the 2001 equity market collapse; and recurring serious environmental hazards (notably, bird flu and severe acute respiratory syndrome) have compelled the government to adopt counter-cyclical and regulatory measures exceeding the historical norm (Mushkat and Mushkat 2006a).

The effects of exogenous shocks do not necessarily dissipate over time. As argued and demonstrated by Peacock and Wiseman (1961), they may become entrenched and, *inter alia*, affect the long-term balance between the private sector and its public counterpart. The increase in government size witnessed in the past decade or so may partly be explained by invoking their theoretical framework. It may arguably also reflect processes encapsulated in “Wagner’s Law,” which posits that public expenditure is highly elastic with respect to national income (Bird 1971). Hong Kong’s growing affluence may have thus contributed to government expansion. Last but not least, it is possible to hypothesize, along the lines suggested by Baumol (1967), that healthy productivity gains seen in the private domain, in an environment characterized by rapid structural transformation (Sung 1991; Sung 2002; Mushkat and Mushkat 2006a), may have boosted the relative share of the economic pie of the inherently less efficient public sector.

It should be emphasized that, at around 20 percent of gross domestic product, this share remains distinctly modest by international standards. From a comparative perspective, Hong Kong continues to stand out as an externally open and internally unshackled economic entity, whose government does not make substantial claims on societal resources (Peebles 1988; Ho and Chau 1989; Mushkat 1990; Lethbridge and Ng 2000; Mushkat and Mushkat 2006a). Nevertheless, the persistent rise in public spending, particularly during a period characterized by moderate private sector activity, and government propensity to broaden its role both generally and in specific

policy areas, have prompted an analytical re-orientation from “excessive” bureaucratic restraint in the face of macro and micro strains toward “over-zealousness” in seeking to solve problems or capitalize on opportunities and the lack of discipline exhibited in the process. This new trend has been reinforced by concerns about potentially chronic fiscal deficits, serious challenges posed by aging, and possible post-1997 erosion of commitment to the strict management principles espoused by the colonial administration (Lethbridge and Ng 2000; Ash *et al.* 2003; Mushkat and Mushkat 2006a).

The corollary is that the phenomenon of “government failure” and potential responses thereto have begun to feature, in one form or another, more prominently in the policy literature than the inefficiencies/inequities that manifest themselves in the private marketplace and the public remedies assumed to be necessary to alleviate them (Scott and Burns 1988; Cheek-Milby 1995; Scott 2000; Lo 2002; Mushkat and Mushkat 2003; Burns 2004; Mushkat and Mushkat 2004; Mushkat and Mushkat 2005a; Mushkat and Mushkat 2005b; Mushkat and Mushkat 2005c; Scott 2005). The latter have not receded completely into the background because Hong Kong is confronting a number of very serious environmental challenges. Air pollution is at critical levels, seldom seen in countries resp. large metropolitan areas in the industrialized world. And bird flu constitutes a large threat of unthinkable proportions, capable of inflicting massive damage on the territory’s socio-economic fabric. Notwithstanding the severity of such problems, policy analysts are increasingly gravitating toward symptoms of malfunctioning in the public sector. This is consistent with the pattern observed in mature democracies and post-authoritarian industrializing countries in the past two decades or so (Mushkat and Mushkat 2006a).

Interestingly, those symptoms present themselves acutely in areas involving the management of “natural resources,” provided the term is defined broadly enough to encompass them. Air pollution, referred to in the preceding paragraph, should probably be placed at the top of the list. It has reached levels whereby it does not just pose a serious health hazard, but is also apparently beginning to exert a negative influence on Hong Kong’s ability to evolve as a vibrant global metropolis (Mushkat 2006). Water is, by default, another (i.e., like clean air) resource which is in distinctly short supply, at least potentially so, because of less than enlightened government strategies – although the difficulties confronting the community in this domain have not been thoroughly dissected and seem less intractable than those in the environmental sphere (Mushkat and Mushkat 2006b). Land is the third example worth highlighting here due to the pivotal role it plays in the territory’s economic development.

Again, that is a resource that has become “ultra scarce” as a result of public policies not always formulated and executed in an optimal fashion (although severe supply constraints in this case are partly attributable to deliberate government efforts, perhaps entirely “rational” in nature, to employ it as a powerful revenue-raising instrument and maintain a low-tax regime in the conventional sense of the word). The purpose of this paper is to use land administration, given the central position it occupies in overall economic management, as an analytical vehicle for bringing into focus the relatively fragile components of the policy façade. A general overview is offered, but a “demonstration effect” is mainly sought through a detailed examination of a specific public allocation mechanism. The principal objective is to draw attention to government failure and reinforce the idea that Hong Kong’s much-vaunted institutional infrastructure is not without flaws and cannot be taken for granted.

The specific public allocation mechanism dissected consists of a set of procedures relied upon in selling land to private developers. This is a key strategic tool for promoting economic growth whose recurrent use possesses substantial distributional ramifications. Issues of efficiency are paramount in this context, but questions of equity also loom large. Indeed, an overly rigid distinction between the two is not entirely appropriate as they impinge upon each other, both directly and indirectly. The matter under scrutiny thus displays the ingredients of a significant public policy problem. Moreover, it brings into focus government failure which originates in a less than satisfactory process or procedural configuration rather than merely a deficient strategic blueprint. This is a dimension of policy evaluation which arguably ought to feature more prominently in the academic literature, whether in Hong Kong or elsewhere.

Sector-Wide Policy Setting

Not unlike other global metropolises, notably London and New York, post-industrial, service-oriented, and outward-looking Hong Kong stands apart from its hinterland or, to express it more accurately, surrounding areas, both physically and in terms of its cultural dynamics (culture in this context is deemed to be a multi-dimensional concept encompassing economic, political, and social spheres of activity). This divergence between “center” and “periphery” manifests itself in many forms, including in the shape of intense pressures on highly restricted land supply from powerful forces on the demand side of the local, national, and global economies. For this reason, land and its “extensions” (e.g., real estate) may have played a more pivotal

role in the evolution of global metropolises and may have loomed larger on their policy agendas than may have been the case in other urban and non-urban areas.

This observation is particularly valid with respect to Hong Kong because of its unique historical circumstances and due to the government's strategic posture vis-à-vis land and housing. From a historical perspective, the territory has never been fully integrated with its hinterland and has consequently faced severe constraints in pursuing physical expansion in a challenging topographical environment. Indeed, during a long period of time from the establishment of the People's Republic in China in 1949 until the shedding of communist dogma in 1978 and beyond, cross-border cooperation was distinctly limited and Hong Kong had to chart its strategic course more or less independently. Land provision was thus a strictly domestic affair. The outbreak of war on the Korean peninsula in the 1950's and massive influx of refugees from the mainland, two exogenous "shocks" of serious proportions, resulted in extraordinarily rapid economic restructuring/industrialization and boosted dramatically the size of the population, straining greatly limited land supply. The opening of Communist China had a similar effect to that of the Korean War for it induced another bout of deep economic restructuring/de-industrialization, albeit one experienced in a favorable political climate.

Government overall philosophy, practical stance, and concrete action have also served as a crucial factor in propelling land into the center of the socio-economic arena. This has been consistently the pattern and is not necessarily the product of influences that have surfaced during developmental phases marked by growing policy interventionism. The colonial era began when Hong Kong Island was ceded to Great Britain in 1841 during the First Anglo-Chinese War. It gained momentum following the absorption on similar terms of the Kowloon Peninsula and Stonecutter's Island into the fledgling dominion in the aftermath of the Second Anglo-Chinese War in 1860. The last step in the process of territorial "enlargement" featured the acquisition via a lease of the New Territories and 235 islands from China for 99 years from July 1, 1898. The opportunity for Great Britain to pressure China into a third round of concessions presented itself in the wake of the latter's defeat by Japan in the war of 1894-95 (Miners 1996).

The new colonial masters were quick to recognize the importance of controlling land. As early as 1843, they proclaimed that all land was the preserve of the Crown and that private ownership would not be permitted. No freehold estates were thus granted. Instead, leases for building land were offered for 75 years (the length of time apparently needed to induce tenants to erect substantial buildings) and for land sought for other purposes for 21

years. Leases were sold at public auctions or granted directly for the payment of an annual rent. Dissatisfaction with the relatively short 75-year leases prompted the authorities to allow the extension of existing leases to 999 years in 1848. At that juncture, the practice of annual rents being fixed at auction was replaced with a system of nominal ground rent subject to the payment of a premium. During the next five decades, most land leases were granted for 999 years (Bristow 1984; Cruden 1999; Li 2006).

Following the incorporation of Kowloon Peninsula into the colony in 1860, new leases for 999 years were offered to Chinese owners of land who remained in possession and compensation was given to those who were dispossessed. In 1898, the Hong Kong governor was instructed by the relevant British authorities to shorten the lease period to 75 years and cease the practice of 999 year-long contractual agreements. This triggered a wave of protests that led to a compromise reaffirming the 75-year formula but featuring a concession in the form of a right of renewal for a further 75 years. That compromise had underpinned land lease policy throughout the colonial era (Bristow, 1984; Cruden, 1999; Li 2006).

Land tenure patterns in the New Territories had diverged from those elsewhere in the colony. Hong Kong Island and Kowloon were sparsely inhabited when they were ceded to the Crown. By contrast, when the New Territories were leased to Great Britain, a large area of land was already held by Chinese owners who had farmed it for centuries. A land court was subsequently established which granted rights to leases involving 354,227 lots after the completion of a survey. All unclaimed land was held by the Crown for disposal. The longest Crown leases in the New Territories expired three days before 30 June, 1997 (Bristow 1984; Cruden 1999; Li 2006).

In 1984, under Annex III of the Joint Declaration, the British and People's Republic of China governments agreed that all land leases which expired on or before June 27, 1997, would be renewed for another 50 years. Leaseholders were merely required to pay a new levy of rent set at three percent of the rental value of their properties. The Joint Declaration also limited the colonial government to total grants of new land not exceeding 50 hectares a year, and with leases for terms expiring no later than June 30, 2047. This restriction excluded land grants to the Hong Kong Housing Authority for public rental housing. Moreover, half of the premium income from land transactions had to be put aside for the then-future Chinese Special Administrative Region government to fund land investment and infrastructure spending after 1997. A Land Commission comprising officials from the two governments was established in 1985 to implement the provisions of Annex III. The Commission had the discretion to increase the 50 hectares annual limit, and proceeded to do so regularly (Li 2006).

Hong Kong's politico-economic climate is not entirely conducive to the systematic development of compulsory government planning powers. Formal town planning in the territory dates from 1939, when the Town Planning Ordinance was enacted. Its deep historical roots notwithstanding, this legal instrument has however not played a decisive role in the implementation of land policy, as it merely offers general guidelines and lacks effective enforcement mechanisms. Rather, the impetus for action in this domain stems from the Building Ordinance and contractual powers embodied in Crown leases (Bristow 1984; Cruden 1999; Li 2006).

As matters stand, the government leases land in accordance with its elaborate land contracting system. It collects healthy land premia from the initial land auctions, modifications of lease conditions, and contract renewals. Land leasing is a key tool in managing urban growth as well as generating public revenue in Hong Kong. The government stipulates the restrictions on uses, height, plot ratio, and building design in the Conditions of Sale when contracting to lease a parcel of land. The details are conveyed to all interested land developers who may bid for development rights in a public auction (Bristow 1984; Cruden 1999; Li 2006).

A leaseholder who subsequently wishes to modify any of the conditions has to apply to the Lands Department for official permission. The approval of the application requires the leaseholder to pay an additional premium which reflects the expected enhancement in the land value arising from planned modification. A new set of covenants is duly imposed on the modified contract in such circumstances. Lease renewals constitute another useful policy vehicle for land-value capture by the government in this sphere of public activity which has traditionally loomed distinctly large on the fiscal agenda (Bristow 1984; Cruden 1999; Li 2006).

Site-value taxation is not relied upon in Hong Kong. Owners of income-yielding land leases or buildings are charged a standard rate of 16 percent on the annual rental income of their properties. In addition, government rates, which can be regarded as a form of indirect (in the sense of "latent") taxation, are levied on landed property, whether income-yielding or not, and amount to 5 percent of the estimated annual rental value. Lease-owners of income-yielding landed property thus have to pay both property taxes on the actual yield and rates on the annual value. However, rates can be deducted to arrive at assessable value (actual rental yield minus rates paid and a 20 percent allowance for repairs and other outgoings). In the same vein, government rent at a rate equivalent to 3 percent of rateable value is payable from July 1, 1997, for all land leases granted on or after May 27, 1985, and on extension of renewable leases. Last but not least, the government is a

substantial property owner and generates rental income from its investment portfolio (Bristow 1984; Cruden 1999; Li 2006).

Income from land transactions is an important source of public revenue in Hong Kong. A study published in the mid-1990's, but apparently reflecting trends which remain broadly intact, has shown that the government was able to capture 39 percent of land value increments occurring between 1970 and 1991 from land leases in the 1970's. Land revenue from the initial auctions, rather than from lease modifications and renewals, was the most significant source of income from land transactions. This captured value financed an average of 55 percent of the annual infrastructure investment during the same period. The combined land-related revenues could recover, on average, as much as 79 percent of such outlays (Hong 1996).

As matters stand, the current profits tax rate for corporations is 17.5 percent. Profits from unincorporated businesses are taxed at 16 percent. Salaries tax rates range from two percent on the first HK\$35,000 each, respectively, and then to 20 percent on remaining net income, subject to the constraint that total tax paid shall not exceed 16 percent of gross income. Due to generous personal allowances, more than half of the labor force does not pay any salaries tax. The low level of tax rates and their lack of progressivity have contributed to the economic dynamism of Hong Kong, encouraging work effort, investment, and risk taking. The powerful land revenue generating mechanisms have played a crucial role in this process by allowing the fiscal authorities to exercise restraint on other fronts (Bristow 1984; Cruden 1999; Li 2006; Mushkat and Mushkat 2006a).

Less prominence has been accorded to the fact that, since 1973, the government has actively assisted selected industrial ventures by providing land for their development needs via private treaty instead of public auction. In 1997, the Industrial Estates Corporation was established to supply land at a price which reflects merely the cost of formation and servicing for industrial processes that could not readily be undertaken in multistory industrial buildings. The industries targeted have principally included land-intensive ones such as electricity, gas, oil refineries, and telecommunications. The land premia in these circumstances have been the product of negotiations rather than auctions, with the overarching goal being to foster industrial growth and promote effective infrastructure support (Bristow 1984; Cruden 1999; Li 2006).

A more salient feature of the policy thrust in that broad domain has been the provision of public housing on a distinctly large scale over several decades (roughly along the lines pursued by the apparently less reluctant to resort to interventionist measures Singapore government). At present,

approximately half of the population (whose exact size defies precise estimates) lives either in rental units or purchased flats (predominantly the former) made available through the public housing channel. This state of affairs is partly attributable to state ownership of land. The dimensions of public sector housing have expanded over the years, with the emphasis increasingly shifting from rental configurations to homeownership. Given that all land is state owned, the government does not have of course to purchase land from private landowners in order to build public housing for low income groups. In addition, it can offer grants and loans at concessionary interest rates to the Housing Authority for the same purpose (Bristow 1984; Cruden 1999; Li 2006).

There can be little doubt that land is a key element in the Hong Kong policy equation and one which impinges greatly on the quality of life at the grass-roots level. It is thus surprising to observe that relatively little analytical effort has been directed toward explicitly placing government behavior in this strategically vital sphere of public activity within a solid theoretical framework. A notable exception is a study by Ho (1992), who has addressed the issue selectively from a Ricardian perspective. He has posited that the government has relied on subsidized public housing as a vehicle to offset upward pressures on wages and hence to sustain private profits in a dynamic capitalist environment. This is broadly consistent with models portraying government as an “agent” of private interests (the “princepal”), albeit one acutely concerned with its own “utility maximization” (Mushkat and Mushkat 2005a).

While the theoretical dimension may have been de-emphasized, the policy facets of land management have attracted considerable attention. Much of it has centered on the chronic under supply of the resource, apparently motivated to some extent by government desire to boost its revenue (tantamount to utility maximization), or more broadly speaking to maintain a web of public-private interests deriving material benefits from chronically constrained demand. The consequent imbalances between the two sides of the picture have resulted in an “artificial” price escalation (occasionally interrupted by endogenous adjustments or exogenous shocks). This upward spiral, in turn, has proved costly for those not accommodated by the public housing schemes and has had a profoundly adverse effect on household well-being. Private property prices and rents are considered to be exorbitant by international standards and the quality of housing, proxied by typical apartment size, remains poor in this “world city” (Bristow 1984; Wong 1998; Cruden 1999; Li 2006).

The artificially inflated cost of land has made it difficult for new private developers to enter the market, which is dominated by a handful of large

operators. The latter generate hefty profits, with margins during the “bull” phases of the property cycle often climbing to 50 percent and beyond (even during cycle lows they seldom shrink to below 25 percent). The oligopolistic structure of the industry stifles competition and results in welfare losses to consumers. The powerful players that dominate it enjoy substantial political clout and access to the corridors of bureaucratic power (in public choice parlance, one may witness here the phenomenon of public institution “capture,” at least partial in nature, by private interests; Bristow 1984; Wong 1998; Mushkat and Mushkat 2005a; Li 2006).

The public housing segment of the market has also not escaped criticism, despite its historical origins (constituting an inevitable response to large-scale political upheaval/massive refugee flight from the mainland), social aspirations (to provide a safety valve for the underprivileged), and strategic *raison d'être* (to avert grass-roots unrest and threats to economic stability). The positive aspects of this somewhat anomalous operation in the Hong Kong context, and a massive one to boot, have not been overlooked, but it has been faulted for being financially challenging (for both the government and the community as a whole), a source of serious distortions (extending beyond its confines), and subject to widespread abuses (predominantly in the form of middle class “penetration”/“exploitation”). Policy makers have not been entirely oblivious to these criticisms and the government has pursued a policy of privatization, albeit not in a decisive fashion (Bristow 1984; Wong 1998; Cruden 1999; Li 2006).

The privatization of public housing in the appropriate manner and at the right pace is not the sole item featuring prominently on the agenda of practically-oriented researchers. *Inter alia*, they have explored ways to abandon state-ownership of land in favor of privately-driven supply (via a freehold mechanism), to rezone underutilized commercial/industrial space, to make military land available for other purposes, to rethink the commitment to an independent port infrastructure (land is less scarce and cheaper across the border), to embrace earnestly urban renewal initiatives, to adopt conservation as a strategic goal, to decentralize/revitalize urban planning structures, to enforce strictly zoning restrictions in the New Territories, to release agricultural land, and to build more elevated walkways in densely populated urban areas (Bristow 1984; Cruden 1999; Li 2006). Nevertheless, there is arguably considerable scope for undertaking further policy-focused research, particularly of the microeconomic variety, as highlighted in the following section.

Auction Imperfections

In the burgeoning literature on the practical dimensions of land management in Hong Kong, one study should perhaps be singled out for laying a solid foundation for addressing relevant issues in a well-defined and consistently systematic fashion. The work in question is a microscopic (rather than macroscopic) dissection by Li (1998) of zoning in the territory within a robust analytical framework firmly grounded in the concept of property rights (and, more broadly speaking, new institutional economics which, in turn, has its intellectual roots in neoclassical micro logic). Li's pioneering effort may have the effect of shifting the attention of researchers from the overall strategic architecture toward specific facets thereof (i.e., encourage them to examine problems from a "bottom-up," as distinct from a mostly "top-down," perspective) and pursue their inquiries in a manner conducive to the accumulation of theoretically pertinent knowledge (albeit with a definite policy slant).

Li sets out by positing that government intervention at the sector level needs to be guided by principles of Pigovian welfare economics which features the notion of market failure. The latter is generally attributable to difficulties inherent in specifying property rights and carrying out (costly) transactions in the marketplace which often lead to phenomena with potentially adverse consequences (from the standpoint of the community-at-large) such as externalities, public goods, asymmetric information, imperfect competition, and organizational malfunctioning. Active government response to this type of institutional breakdowns in the private domain can be normatively justified and inevitably involves the imposition of tangible constraints on market operations and, in the final analysis, individual liberties (Li 1998).

The case for zoning can be made by employing such reasoning. This regulatory mechanism entails government delineation and/or restriction of exclusive property rights over land within certain spatial confines. As such, it could limit rent dissipation (which is the product of the absorption of income derived from the use of certain goods, land in the present context, by the cost of unrestrained competition; the competitive behavior of the participants in the process is referred to as rent seeking), which might materialize under a system of common property under competition (a state of affairs characterized by competition over the use of a good that is not restrained by agreed rules) and at the same time facilitate market transactions. Theoretically, this could pave the way for the maximization of property value (Li 1998).

The overall benefits may be palpable despite the fact that zoning is a coercive government planning instrument attenuating private property rights over the best possible social uses of land through: (1) the removal and/or subtraction of assigned property rights over land entitlement and/or uses (whether they are specified or left unspecified initially) by the government act of downzoning and other development rights (like requirements for joint development, restrictions on subdivision – with/without taking, eminent domain, compulsory resumption/acquisitions, etc) made under the so-called process of “forward planning”; and (2) the superseding of private decision about the transfer, change, or resolution of conflict of rights over land entitlement and/or uses (whether they are specified or left unspecified initially) by government decision under the so-called process of “development control” (put another way, the supplanting of private formation of contracts by government edicts; Li 1998).

This benign view of far-reaching regulatory activity is a reflection of the “despotic benevolent government” model. Its exponents posit that the organs of the state are driven by a strong sense of public interest, seeking the “first best” allocation of resources in order to maximize social welfare by taking steps to offset specific instances of market failure. The underlying assumption is that the government is both omniscient and benevolent. It is well-informed to a point of knowing better than individual consumers what is best for them (it hence qualifies as “omniscient”) and it consistently makes decisions on behalf of its citizens to promote their interests (it may thus display “benevolence” of the despotic variety; Bailey 1996; Bailey 1999; Bailey 2004).

A diametrically opposed view of the dynamics characterizing the operations of state agencies is offered by microeconomists who subscribe to the ideas embodied in the “Leviathan” model of the public sector. According to their interpretation of bureaucratic reality, the government expands in a “monster”-like fashion (i.e., acquires the dimensions of a “Leviathan”) because it is believed to consist of utility-maximizing, self-serving politicians, civil servants, professional organizations, and other pressure groups (both within and without the public sector). It promotes its own rather than community-wide interests and there are normally few effective constitutional constraints on its parochial actions. Government failure consequently emerges perhaps as an even more serious concern than its market equivalent (Bailey 1995; Bailey 1999; Bailey 2004).

In a wide-ranging discussion, Li (1998) draws on the insights generated by scholars uneasy about Leviathan-style bureaucratic excesses. He highlights the inherent tension between Pigovian (in favor of regulation) and Coasian (supporting deregulation) perspectives and accords considerable

attention to the latter. The Coasian standpoint is well represented in the land management/real estate literature. Among those who embrace this alternative/complementary approach, it is common to find writers who consider zoning to be undesirable in general and unproductive in terms of enhancing efficiency/social welfare in particular. The corollary is that this form of public regulation should be abandoned and that “dezoning”/“non-zoning” should be pursued systematically (Li 1998).

The analytical path followed by Li may prove useful in addressing other problems facing forward planners and development controllers engaged in land management. The adoption of a property rights framework (incorporating a transaction costs component, if necessary) is the first step in this direction. The process should be extended by employing appropriate micro-economic tools in an effort to determine the efficiency gains/losses, or social costs/benefits, associated with various courses of action/institutional configurations. One may opt for a balanced strategy, blending the Pigovian and Coasian positions, or lean toward either market or government failure. In the remainder of this section, we focus on the deficiencies marking public auctions of land in Hong Kong since the dissection of the negative side of the picture is arguably a more fruitful exercise, both in the theoretical and practical sense of the term.

At the outset, it should be noted that, perceptions to the contrary notwithstanding, this is a policy domain where allocative mechanisms are not structured in a uniform fashion. Specifically, four basic types of auctions are relied upon in a variety of institutional settings: the ascending-bid auction (also referred to as the open, oral or English auction), the descending-bid auction (used in the sale of flowers in the Netherlands and categorized as the Dutch auction by economists), the first-price sealed-bid auction), and the second-price sealed-bid auction (or one known, in technical parlance, as the Vickrey auction; Klemperer 2000; Krishna 2002; Klemperer 2004; Milgrom 2004; Menezes and Monteiro 2005).

In the ascending auction, the price is successively raised until only one bidder remains, and that party obtains the object sought at the final price. This form of auction can be run by having the seller announce prices, by having the bidders call out prices themselves, or by having bids submitted electronically with the best current bid posted. In the model featuring most prominently in the academic literature, the price rises continuously while the bidders gradually leave the auction (this orderly pattern is equated with Japanese-style progression). Bidders observe when their competitors quit, and once a party disengages, it cannot re-enter the competition. Nor is it possible for any party to pre-empt the process by making a large “jump bid”

(Klemperer 2000; Krishna 2002; Klemperer 2004; Milgrom 2004; Menezes and Monteiro 2005).

The descending auction operates in exactly the opposite manner. The auctioneer starts at a very high price and then lowers it continuously. The first bidder who calls out that the current price is acceptable obtains the object sought at that price. In the first-price sealed-bid auction, each party submits independently a single bid, without observing those put forward by other parties, and the object sought is sold to the one or “first” price bid). In the second-price sealed-bid auction, each party also submits independently a single bid, without observing those put forward by other parties, and the object sought is sold to the one making the highest bid. However, the price paid in this case is the second-highest bidder’s offer, or “second” price (Klemperer 2000; Krishna 2002; Klemperer 2004; Milgrom 2004; Menezes and Monteiro 2005).

Before 1999, land auctions in Hong Kong followed the conventional English model. In that context, bidders made offers in a transparent fashion, while within sight of each other, and the highest bid would prevail, subject to a reserve price set by the government. The auctions were held on a quarterly basis and reflected official assessment of market needs, whether proactive or reactive in nature (at times the latter rather than the former in that an effective medium/long-term trend extrapolation, let alone a genuine forward-looking forecast, often proved to be an elusive target). This pattern had remained largely intact for a long period of time and had not been seriously challenged by professional observers and relevant stakeholders (Bristow 1984; Poon and Chan 1998; Cruden 1999; Fu and Ching 2001; Tse, Hui, and Chan 2001; Li 2006).

The severe economic downturn experienced by Asian countries in the wake of the 1997/98 financial crisis unleashed intense pressures which manifested themselves across the policy spectrum, including in the highly strategic land management domain. Property prices plummeted and developers responded by adopting ultra conservative price tactics at land auctions. A vicious cycle thus unfolded, with a steep slide in property prices prompting developer caution and auction participant distinct lack of enthusiasm further undermining fragile market sentiment. The government faced the prospect of disposing of a valuable resource at depressed prices or withdrawing parcels of land made available for potential development. The temptation to pursue the second course of action turned out to be too strong to resist on occasion, upsetting the fundamental balance between the forces of demand and supply (Poon and Chan 1998; Cruden 1999; Fu and Ching 2001; Tse, Hui, and Chan 2001; Li 2006).

In 1999, beleaguered policy makers addressed the challenge in a concrete fashion by formulating a “Land Sale Program.” Within this framework, the Lands Department currently publishes a list of sites that can be offered for sale upon application (the “application list”). Developers may then express their interest (the “expressed interest”) in purchasing a particular site on the list and indicate a price that they would be willing to pay for it (the “named price”). A deposit equal to 10 percent of that amount, subject to a ceiling of HKD 50 million, is required in such circumstances in order to signal that the commitment is serious in nature and deter parties inclined merely to “test the water” (Fu and Chin 2001; Tse, Hui, and Chan 2001; Li 2006). At the time of writing, developers are lobbying aggressively to secure a revocation of this requirement, claiming that they incur substantial opportunity costs (in the form of interest income foregone) as a result.

On its side, the government sets a variant of a minimum price (the “base price”) that is consistent with its perception of underlying value and desire to avoid market instability (particularly downward, as distinct from upward, pressures). If the named price matches or exceeds the base price, an auction for the site is organized within seven weeks of receipt of the expressed interest. The 10 percent deposit is forfeited when the site made available is not sold at the auction at or above the named price (a safeguard against unproductive potential buyer maneuvers), but it is returned to the developer if he/she is unable to acquire the parcel of land sought (Fu and Chin 2001; Tse, Hui, and Chan 2001; Li 2006).

As a rule, the base price is not disclosed. The named price is disclosed only if it exceeds the base price and triggers an auction. When the named price does not match or exceed the base price, the government normally acknowledges (occasionally in an *ad hoc* manner, but always as a feature of its monthly reports) receipt of expressed interest and its rejection of the preliminary offer. In that event, neither the base price nor the named price (or the gap between the two) is disclosed either, although the Hong Kong rumour factory is often capable of producing the relevant information (some fine-tuning of the relationship between the named price and the base price has recently taken place, but it has no material implications in this context; Fu and Chin 2001; Tse, Hui, and Chan 2001; Li 2006).

Microeconomists draw a distinction between search and experience goods. A good falls into the former category if consumers can determine its characteristics with certainty prior to purchase (e.g., a pair of shoes). A good qualifies as an experience good if consumers can determine its characteristics only following purchase (e.g., a book). This classification may be extended by adding post-experience goods to the set. In the case of the

latter, users are not able to assess quality even after beginning consumption. This is an increasingly common phenomenon in post-industrial societies (e.g., it may take a long time to evaluate the impact of many medical treatments routinely administered to patients in contemporary settings; Nelson 1970; Weimer and Vining 2005).

Transactions between sellers and buyers involving search goods can be pursued efficiently through market channels in normal circumstances because the parties share virtually the same information regarding the products to be exchanged. On the other hand, experience and post-experience goods, by definition, give rise to information asymmetries in that they pit less knowledgeable buyers against more knowledgeable sellers (after all, the former are not in a position to determine product characteristics in advance, whereas the latter are better-equipped to do so, even though their insight may at times be less than perfect; e.g., medical doctors, while possessing superior knowledge to that of their patients, cannot be entirely certain about the consequences of their professional actions). Information asymmetries of this nature (the generalization is valid with respect to situations – e.g., some forms of insurance – where the buyer may outmaneuver the seller due to the latter's limited access to relevant facts) are a source of market disruptions and lead to a loss of efficiency (Nelson 1970; Weimer and Vining 2005).

Land sold in Hong Kong qualifies, to all intents and purposes, as a search good. The development potential can readily be assessed by all parties. Zoning specifications and lease conditions largely define the quantitative and qualitative dimensions of the project to be undertaken on the site made available. Any deviations from the norms (usually restrictions) are clearly stipulated. There is some scope for interpreting regulations in one way or another, but this does not necessarily handicap developers who are often able to flex their muscles in encounters with bureaucrats. Information regarding potential costs of development (even when generated by government) can also be accessed by all parties on an equal basis. There is doubtless a degree of uncertainty insofar as market prospects are concerned but, again, this affects sellers resp. government and buyers resp. developers to the same extent (Bristow 1984; Poon and Chan 1998; Cruden 1999; Li 2006).

Procedural distortions reflecting fundamental flaws introduced by institutional architects in 1999 arguably render this a less than satisfactory configuration from a microeconomic perspective, however. The principal concern highlighted in this context stems from the tilting of the allocative mechanism in favor of the seller in a not entirely realistic attempt to stabilize the market, or establish a floor under it. As matters stand, the government possesses full knowledge of price signals emanating from all sides. It single-

handedly sets the base price and opts not to disclose it. The underlying rationale presumably is that this indicator lies at the low end of the range of the official estimates of inherent value and that disclosure might thus convey the impression that the site offered is not as attractive as market players would conclude otherwise.

While keeping potential buyers in the dark with respect to its intentions, the government effectively puts them in a situation whereby they are compelled to engage in activities which carry substantial transaction costs. It does not strain credulity to conjure up a scenario in which developers invest heavily to prepare submissions of expressed interest only to be advised that they have done so in vain. No meaningful feedback is provided in the event of a rejection and any party willing to persist with its efforts faces virtually the same degree of uncertainty as previously. Some would-be buyers may consequently not take the trouble to enter the competition which, ultimately, is likely to dampen market dynamism/efficiency. Government gains little as a result as it is evident that not proceeding to sell a parcel of land is not contingent on shrouding seller intentions in a veil of secrecy (a site can be withdrawn even in circumstances where the base price or equivalent is disclosed).

The asymmetry is stretched further by camouflage employed in relation to the named price. This procedural tactic apparently serves the purpose of preventing market players from inferring that a bid by a developer which fails to meet minimum official targets, and hence is insufficient to trigger an auction, is indicative of the low value he/she may place on the site made available and may thus have “unhealthy” ramifications. This logic is neither compelling nor grounded in empirical insights. By the same token, there is no reason to assume that the named price is cast in stone and constitutes a final offer by a potential buyer. Again, by manipulating information in a manner that is seemingly to the advantage of the seller, the government is inflating transaction costs experienced by developers and providing concrete disincentives to would-be participants in the competitive process. As stated earlier, this may undermine market dynamism/efficiency.

It should be noted that this is not just a matter of dynamism/efficiency in the strict sense of the term. The land market in Hong Kong is heavily concentrated. The government is the sole seller and the number of active buyers is distinctly modest. The absence of genuine competition, attributable to this monopolistic/monopsonistic structure, is of course not conducive to dynamism/efficiency. In the final analysis, the consumer bears the brunt of the distortions caused as evidenced by the lofty price levels, uninspiring quality of product, and limited choice available. Issues of equity also arise on both the supply and consumer sides. Small and medium-size operators

face significant barriers in seeking entry into the industry, “abnormal” profits accrue to a handful of developers, and the low and middle strata of the middle class (the so-called “sandwich class”; but not necessarily the working class beneficiaries of public housing) struggle to maintain a rewarding lifestyle (Poon and Chan 1998; Wong 1998; Tse, Hui, and Chan 2001; Li 2006).

A credible case can arguably be made for dismantling the application list mechanism (and, by extension, the Land Sale Program) altogether and reverting to a traditional-style auction format (i.e., the pre-1999 status quo). The English model, which confers a modest advantage on the buyer, is satisfactory in most respects, but the Dutch one, which marginally favors the seller, constitutes a viable alternative. There is reason to believe that, given the peculiar features of the Hong Kong institutional environment, a model blending the characteristics of the two (e.g., it might be possible to start the exercise along English lines, pause, and conclude in a Dutch fashion) could be the “optimal” configuration. The sealed-bid option, whether of the first-price or second-price variety, might prove more appealing to the government, whose desire for openness is not invariably strong, and would be acceptable, in our view. However, the more transparent variants might be preferable during this phase of Hong Kong’s political development.

Even if abandoning the application list formula turns out to be an unrealistic prospect in light of prevailing bureaucratic constraints, incorporating adequate disclosure into the process would qualify as a progressive policy initiative. It is difficult to justify the secrecy surrounding seller and buyer intentions regarding the financial side of the transaction. All the relevant parties should enjoy unencumbered access to both the base price and its named counterpart and should incur low transactions costs in pursuing their quest for land acquisition. Government failure, attributable to information asymmetries reflecting flawed allocative mechanism design, is apparently a source of structural imbalances which have adverse implications for the welfare of the community as whole and key segments thereof.

Conclusion

Hong Kong has a highly open and flexible economy by international standards. Nevertheless, it does not lack institutional rigidities and does not always operate in a liberal textbook fashion. The government which literally presides over this unique economic structure cannot be portrayed as peripheral and passive. Indeed, it is capable of activism of both the constructive

and unhealthy type. The latter has grown increasingly common during the post-1997 era because of the uneven performance of the economy in the face of exogenous shocks and endogenous adjustments, nervousness occasioned by China's constant shadow, intensifying pressures from the grass roots, and deterioration in the quality of political and bureaucratic leadership.

In this inherently fragile institutional setting, the analytical focus has shifted to some extent from the phenomenon of market failure to that of government malfunctioning. This is arguably a welcome development as Hong Kong needs to seek creative ways (beyond capitalizing on the China connection) to sustain its dynamism ("prosperity" rather than merely "stability") well into the future. Much is to be gained by applying the tools of microeconomic policy analysis in an effort to identify problems meriting careful attention and means to address them effectively. The dissection of the land auction process illustrates that this is a potentially fertile research strategy. The allocation of an ultra scarce societal resource leaves much to be desired and could apparently be undertaken in a more efficient and equitable manner.

This particular example serves a number of analytical purposes. First, it illustrates that government failure is not necessarily attributable to a flawed overall policy design, although this possibility should by no means be ruled out. It has not been unequivocally demonstrated that private ownership of land is preferable to the present configuration in Hong Kong. Indeed, such an option may not be politically feasible in the current circumstances. Given the prevailing uncertainties, it might be desirable to focus methodically on symptoms of malfunctioning which are rooted in an inadequate process architecture/unsatisfactory procedural model. This may have the added benefit of providing an impetus to the study of institutional economics and law & economics, both of which are in their infancy in the territory.

Another inference that may be drawn in light of the survey undertaken here is that microeconomic policy analysis is a versatile tool whose application in Hong Kong need not be confined to a handful of negative externalities and excessive market power. Concepts such as "asymmetric information," "principal and agent," "property rights," "regulatory capture," and "utility maximization" (other than merely by private agents) may be employed productively in dissecting issues that loom large on the public agenda. Last but not least, policy problems do not have to be examined exclusively from a "top-down" perspective, as is common in the territory. They may be decomposed effectively and explored meaningfully from a "bottom-up" standpoint, generating useful insights that could pave the way for action geared toward strategic and operational improvement.

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