# Hong Kong

## Hong Kong, the Pearl of the Orient, continues to shine bright

**by Elizabeth L. Thomson**

Despite the onslaughts this year by the Financial Action Task Force and the Organization for Economic Cooperation and Development, Hong Kong managed to keep its position as the Pearl of the Orient, and indeed of the whole offshore world.

Foreign companies continue to flock to Hong Kong in record numbers to establish their regional headquarters and to tap into China's immense economic potential. Hong Kong's top-notch banking system, excellent infrastructure, rule of law and simple and favorable tax environment make it an ideal spot for basing international business activities.

Across the border, China has effectively become the world's manufacturing center, with its economy continuing to grow at a rate of almost 8% a year. With its strong cultural affinity with China, Hong Kong remains the ideal launching pad for China business.

The year 2002 was marked by many positive developments in Hong Kong's economy, including international recognition of its strengths, important government initiatives in the financial sector and a welcome return to positive gross domestic product growth, after an unexpectedly long bout with the Asian flu after Hong Kong was handed back to China in 1997.

After three quarters of decline heading into last year, Hong Kong's economy emerged from recession in the second quarter of 2002, thanks largely to a strong external sector. Exports of goods and services, for example, rose by 5.9% and 8.6% respectively over the previous year.

Despite a slow economic recovery in the United States, export demand within Asia has been buoyant. And with the Hong Kong dollar pegged to the US dollar, Hong Kong's exports also became more competitive, as the dollar depreciated against other major currencies. This was good news for importers in many countries, including Canada, who could source Asian goods more cheaply.

And for the sixth consecutive year, Hong Kong was identified as the world's freest economy in the US-based Cato Institute's *Economic Freedom of the World Report*. With an overall score of 8.8 out of a maximum of 10 points, Hong Kong ranked first among the 123 economies in the study. By comparison, China placed 101st, with a score of 5.3.

The United Nations also acknowledged the strengths of Hong Kong's economy last year. The UN Conference on Trade and Development's *World Investment Report 2002* named Hong Kong as the best-performing host for inward foreign direct investment in all of Asia, second in the world behind Belgium and Luxembourg. This was particularly notable because, despite worldwide press about businesses moving in droves to Singapore and Shanghai, Singapore ranked only 13th and China was not even in the Top 30.

In addition, the Hong Kong Legislative Council finally passed the *Securities and Futures Bill* in March. The bill, 10 years in the making, consolidates and modernizes a set of 10 existing laws. Though market participants have criticized some aspects of the new law, the government's effort to simplify the legal framework for Hong Kong's finance sector was welcome. Despite these positive developments, equity prices in Hong Kong, as in most parts of the world, fell through most of 2002, before rebounding sharply in October. Market sentiment was volatile, reacting strongly to comments by Finance Secretary Anthony Leung Kam-chung about delisting penny stocks and reconsidering the currency peg.

The Achilles heel of Hong Kong's economy continues to be its domestic sector, weighed down by consumer and asset price deflation and high unemployment, which is good news for businesses because they can find high-quality, experienced employees at reasonable wages. But even with Hong Kong's strong export performance, the government is forecasting GDP growth of only 1.5% for 2002.

### FUTURE PROSPECTS

Analysts have been predicting Hong Kong's decline ever since Britain began negotiating its return to Chinese rule almost 20 years ago.

In the past five years alone, Hong Kong has weathered a transfer of sovereignty, a financial crisis, two recessions and the fallout of the September 11, 2001 terror attacks against the US, giving pessimists ample opportunity to be proven right. This gloomy view of Hong Kong's fate, however, contrasts sharply with the actual data for new business activity.

Even though Hong Kong's economy was in recession in 2001, the number of foreign-owned regional headquarters, 944, and regional offices, 2,293, here reached all-time highs. And although figures are not yet available for 2002, surveys suggest the combined total is expanding at a rate of more than 100 offices per year. Most of the bad news coming out of Hong Kong in recent years has focused on local asset prices and domestic consumer sentiment. But these are misleading indicators of Hong Kong's health as a regional trading and investment hub. In fact, as the numbers above show, never before has Hong Kong been a more attractive place to establish a regional headquarters.

A large part of this allure undoubtedly originates across the border in China, which has established itself as a recession-proof juggernaut, posting almost 8% GDP growth each year, regardless of external conditions. Almost every day, we meet global entrepreneurs sourcing products in China who want to use Hong Kong as their base for exporting to North America or Europe, or who want to establish a headquarters in Hong Kong as a base for their China operations.

Often, these people are looking for products such as Direct Import Programs that allow them to sell directly to large retailers on an FOB basis through a Hong Kong company, without any of the overhead costs associated with setting up a branch office. Their choice of Hong Kong is hardly surprising, given its well-developed infrastructure. Hong Kong's privately owned port, the world's busiest container port, has long been the major *entrepôt* for southern China's trade with the world. Hong Kong's decision in late September to join the *US Container Security Initiative* should ensure goods shipped from Hong Kong will continue to enjoy efficient and timely access to the US market.

More importantly, however, is Hong Kong's unique relationship with China, being part of China and separate at the same time under the "one country, two systems" policy. About 48% of external investment in China comes from Hong Kong, according to Hong Kong Government statistics.

At the same time, Hong Kong businesses, including many foreign-owned, Hong Kong-registered businesses, employ more than five million workers in neighboring Guangdong province. As a result of close business and cultural ties, Hong Kong offers an unmatched pool of knowledge on how to do business in Chinese markets, a crucial factor, since we have found many ventures in China fail due to insufficient understanding of local business cultures and complex government regulations, and often inappropriate or poorly thought-out corporate structures.

Equally significant, however, are those elements that set Hong Kong apart from China. First, Hong Kong's legal system, based on British common law, is familiar to most international businesspeople. This system is guaranteed to remain separate until 2047, and gives Hong Kong a predictable legal framework based on a respect for the rule of law.

Secondly, the banking system is separate from China's state banking system. Hong Kong is one of the world's leading financial centers, with some 79 of the world's top 100 banks represented, and it remains "offshore" in relation to business activity in China, or anywhere else in the world, for that matter.

Finally, Hong Kong's simple, predictable, low-tax regime gives it a source of ongoing competitive advantage over every other Asian jurisdiction when it comes to locating regional headquarters. Hong Kong imposes a 16%-flat tax on corporate profits, but the tax system is based on source, not on residency, so transactions related to business in China, or anywhere else in the world, may be totally tax-free in Hong Kong.

The situation in China, on the other hand, is quite different. A handful of well-publicized cases this year regarding the Chinese Government's pursuit of superrich individuals for tax evasion have highlighted the convoluted and sometimes arbitrary nature of that country's tax system. Corporate tax rates run as high as 33%, but vary depending on industry, entity structure, location and special terms negotiated with local and national governments.

As a result, any enterprise setting up headquarters in China has to contend not only with inconsistent infrastructure and a weak banking system, but also with high and unpredictable taxes. And since the Chinese tax system is based on residency, they might also find their profits in other countries were subject to tax in China.

Because of its favorable tax system, we have first-hand experience with global entrepreneurs and multinationals using Hong Kong not only as a headquarters for trading in China and the rest of Asia, but also as a base for holding companies, trusts and investment companies. Hong Kong is a low-tax regime, not a no-tax regime. Due to its simple and universally applicable tax laws, higher due diligence standards and annual audit requirements, local companies and trusts are seen as excellent low-tax vehicles, without any of the stigma attached to entities domiciled in "offshore" jurisdictions.

**The World's Freest Economies**

1. Hong Kong
2. Singapore
3. The United States
4. The United Kingdom
5. New Zealand
6. Switzerland
7. Ireland
8. Australia
9. Canada
10. The Netherlands

Source: The Cato Institute's *Economic Freedom of the World 2002 Annual Report*

### Conclusions

Hong Kong's domestic sector continued to struggle through a painful recovery in 2002, but it had little effect on its short- and medium-term prospects. As China develops, and more and more foreign firms attempt to do business there, companies are becoming increasingly innovative in sourcing their products and identifying market niches. Competition has given rise to more complicated operational structures, as firms try to squeeze costs out of their supply chains. As a result, these firms have become more reliant on the kind of specialized expertise, advice and services more readily available in Hong Kong.

To paraphrase Mark Twain, the rumors of Hong Kong's death have been greatly exaggerated. With its distinctive legal, banking and tax systems, and a growing economic powerhouse across the border, Hong Kong remains a vital investment hub not only for China, but also for the whole of Asia. And Canadian and US businesspeople seem to agree, because they continue to make Hong Kong their first stop whenever they come to Asia looking for business opportunities. ■

*Elizabeth L. Thomson, a Canadian and Hong Kong lawyer, is the president of ICS TRUST (Asia) Ltd. (www.icstrust.com), a leader in Asian tax, trusts, trade and direct import programs. She may be reached by e-mail at ics@icstrust.com*