

PROSPERITAS

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The Hong Kong Tax System - Key features and lessons for Policy Makers -

Hong Kong has been one the world's fastest-growing jurisdictions, rising from poverty at the end of World War II to a beacon of prosperity in the 21st century. Formerly a British colony and now a "Special Administrative Region" of the People's Republic of China, Hong Kong is ranked as the world's freest economy according to both Economic Freedom of the World and the Index of Economic Freedom. A key reason for Hong Kong's success is an optional flat tax system. Tax rates are low by global standards and there is very little double-taxation of income that is saved and invested. Combined with a modest burden of government, Hong Kong is well-positioned to continue its rapid growth. With globalization making it increasingly easy for jobs and investment to cross national borders, other jurisdictions would be wise to follow Hong Kong's model of limited government and non-discriminatory taxation.

by Michael Littlewood¹

THE TAX SYSTEM – AN OVERVIEW

Key Features:

- Hong Kong has a low-rate optional flat tax of 16 percent on personal income. Taxpayers can choose an alternative system with graduated rates, though the top rate in this system is only 17 percent.²
- There is no Pay-As-You-Earn (that is, no withholding of tax on income from employment) in Hong Kong, meaning that taxpayers pay their entire income tax liability themselves (usually twice a year).
- Corporate income is taxed at a flat rate of 17.5 percent.³

¹ University of Auckland Law School (formerly City University of Hong Kong Law School).

² Inland Revenue Ordinance 1947 (as amended), sections 13 and 43 and schedule 2. The top rate in the optional "progressive" system was 19 percent, but the government just proposed a 17 percent rate, a reform which is widely expected to go into effect immediately. See <http://www.budget.gov.hk/2007/eng/budget25.htm> for more information.

³ Inland Revenue Ordinance 1947 (as amended), section 14 and schedule 8.

- The tax base is narrowly defined compared to most other jurisdictions and the rules relating to expenditure are relatively generous. Consequently the burden is almost always substantially lighter than the rates of tax suggest.
- There are no payroll taxes in Hong Kong. Workers put 10 percent of their income into private retirement accounts (subject however to a relatively low maximum).
- Hong Kong generally does not double-tax dividends, interest, and capital gains.
- There is no death tax in Hong Kong.
- There is no general sales tax or value-added tax in Hong Kong, though the government has considered this option.⁴
- Hong Kong has a territorial system, so there is no additional layer of tax on income earned in other jurisdictions (even if it is not taxed in those other jurisdictions).
- Even after 60 years, the entire tax code is only about 200 pages.⁵
- Hong Kong's budget usually has a budget surplus and there is very little government debt. Indeed, the government generally has surplus reserves.⁶

Key Observations:

- Hong Kong has been one of the world's fastest growing economies. Per capita income today is about \$30,000, up from less than \$2,000 after World War II.⁷
- Hong Kong has a very low burden of government of government spending, at least by modern standards.⁸ The budget consumes about 20 percent of GDP.
- Hong Kong's tax system comes closer than any other existing tax system to the flat tax proposed by Robert Hall and Alvin Rabushka.⁹

⁴ Hong Kong government, "Broadening the Tax Base, Ensuring our Future Prosperity: What's the Best Option for Hong Kong," July 18, 2006. Available at <http://www.taxreform.gov.hk/eng/document.htm>.

⁵ On the simplicity of Hong Kong's tax system, see Michael Littlewood, *How Simple Can Tax Law Be? The Instructive Case of Hong Kong*, TAX NOTES INT'L, 23 May 2005, 689.

⁶ Hong Kong Financial Secretary, Budget Speech 2005/2006, available at <http://www.budget.gov.hk/2005/eng/speech.htm2005/2006>, paragraph 108. In Hong Kong the position of Financial Secretary is analogous to that of Secretary of the Treasury in the US.

⁷ World Bank, "GDP per capita 2005, Atlas method and PPP." Available at <http://siteresources.worldbank.org/DATASTATISTICS/Resources/GNIPC.pdf>. Angus Maddison, "Historical Statistics for the World Economy, 1-2003 AD," Available at http://www.ggdc.net/maddison/Historical_Statistics/horizontal-file_10-2006.xls.

⁸ The best general works on Hong Kong's public finances are perhaps still ALVIN RABUSHKA, *VALUE FOR MONEY: THE HONG KONG BUDGETARY PROCESS* (1976) And A J YOUNGSON, *HONG KONG ECONOMIC GROWTH AND POLICY* (1982). See also MINERS, note 13 supra.

⁹ ROBERT E HALL & ALVIN RABUSKA, *THE FLAT TAX*, 2nd ed (1995).

- The wealthy pay most of the tax in Hong Kong. The bottom 60 percent pay no income tax while the richest 100,000 taxpayers (the top 8 percent) pay 57 percent of the total tax burden.¹⁰
- Hong Kong may be at a crossroads. Even though there is virtually no public debt and surplus revenues, some policy makers have expressed interest in a value-added tax. If Europe's experience is any indication, this could lead to an expansion of government and signal the beginning of an unfortunate decline in Hong Kong's competitive position.

I. INTRODUCTION

Hong Kong's tax system is remarkable in several important respects.¹¹ First, the independence of Hong Kong's tax system and public finances survived the return of the territory to Chinese rule in 1997. Since then, Hong Kong's constitution has been set out in an instrument called the Basic Law,¹² which is itself subordinate to the Chinese constitution.¹³ The Basic Law provides for (among many other matters) what is colloquially called the "fiscal firewall" – that is, the complete separation of Hong Kong's tax system and public finances from those of the Central People's Government ("CPG") in Beijing.¹⁴ In particular, the Basic Law provides that the CPG will not levy taxes in Hong Kong and that the revenues raised by the Hong Kong government will not be handed over to the CPG.¹⁵ Thus Hong Kong, which is by far the richest part of China, is also the only part to make no direct contribution to the CPG's finances.

Second, Hong Kong has a remarkably modest burden of government, at least compared to other wealthy jurisdictions. That a government that levies only exceptionally light taxes has been able to operate at a surplus is of course largely due to the fact that its spending has been relatively very low. As shown in Figure 1, total government spending has remained below 20 percent of gross domestic product, far lower than the 30 percent-plus levels of government spending in the United States, Switzerland, Ireland, and other nations with supposedly

¹⁰ See text below at notes 41 to 50.

¹¹ Hong Kong's system of income tax is provided for, still, by the Inland Revenue Ordinance 1947. Pieces of primary legislation in colonial Hong Kong were called ordinances, not acts. This appears to have been the practice in British colonies not possessing responsible government. The practice has survived the return of the territory to Chinese rule in 1997. The best commentary on Hong Kong's tax system is PETER WILLOUGHBY & ANDREW HALKYARD, *ENCYCLOPAEDIA OF HONG KONG TAXATION* (1993, loose-leaf).

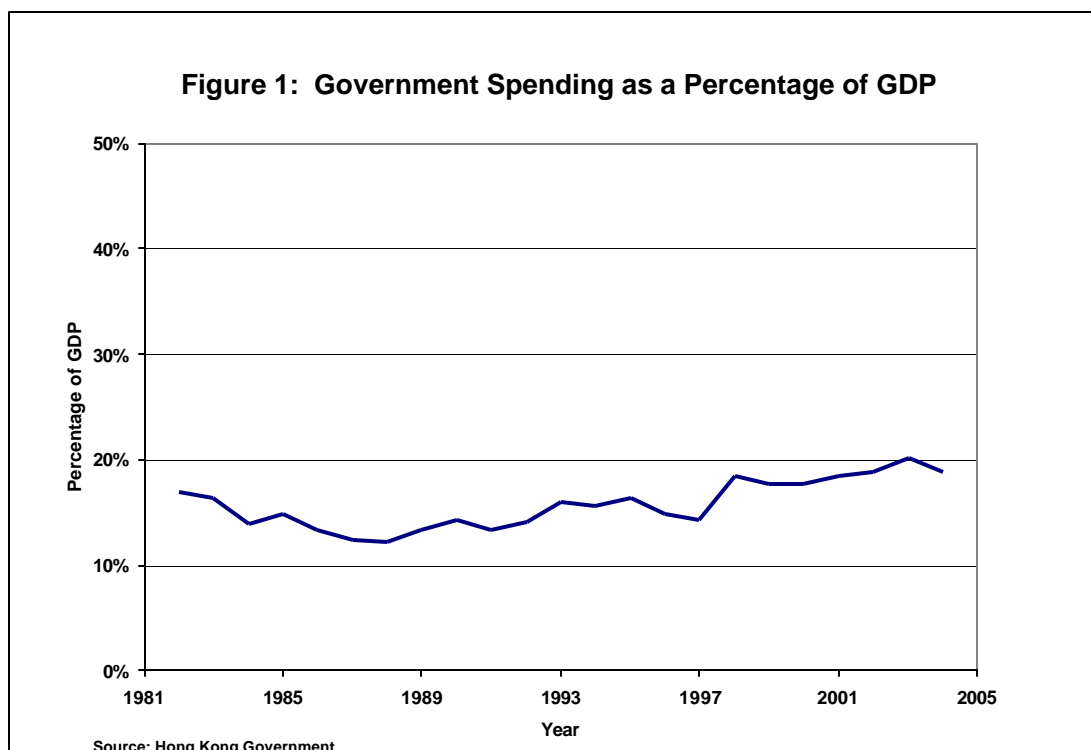
¹² The Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China (hereafter Basic Law).

¹³ See generally YASH GHAI, *HONG KONG'S NEW CONSTITUTIONAL ORDER: THE RESUMPTION OF CHINESE SOVEREIGNTY AND THE BASIC LAW*, 2nd ed, 1999; PETER WESLEY-SMITH, *CONSTITUTIONAL AND ADMINISTRATIVE LAW IN HONG KONG*, 2nd ed, 1994; and NORMAN MINERS, *THE GOVERNMENT AND POLITICS OF HONG KONG*, 1998.

¹⁴ See Michael Littlewood, *The Taxing and Spending Powers, in Hong Kong* (Anton Cooray ed), in *INTERNATIONAL ENCYCLOPAEDIA OF LAWS: CONSTITUTIONAL LAW* (R Blanpain ed, 2003) 248.

¹⁵ Basic Law, article 106.

modest burdens of government. Yet the Hong Kong people seem more content than other peoples not only with the burden of taxation (as one would expect) but also (more intriguingly) with the balance of taxation and public spending.



Indeed, there has been no basic tax reform in Hong Kong since peacetime income taxes were first established there in 1947.¹⁶ But, given the remarkable successes of Hong Kong's tax system, the lack of reform is not necessarily a bad thing. Indeed, the stability of the territory's tax system must be counted among its virtues.

Hong Kong features prominently in the economic miracle which has transformed Asia since 1946.¹⁷ The territory thus provides valuable evidence in support of the hypothesis that relatively light taxes (and light regulation generally) tend to promote economic growth.¹⁸

¹⁶ On the history of Hong Kong's tax system, see the Appendix to this paper and also Michael Littlewood, *Taxation without Representation: The History of Hong Kong's Troublingly Successful Tax System* [2002] BRITISH TAX REVIEW 212.

¹⁷ Current per capita GDP in Hong Kong is about US\$24,000. See the 2005/2006 Budget Speech, note 6 supra, supplement (Economic Prospects for 2005).

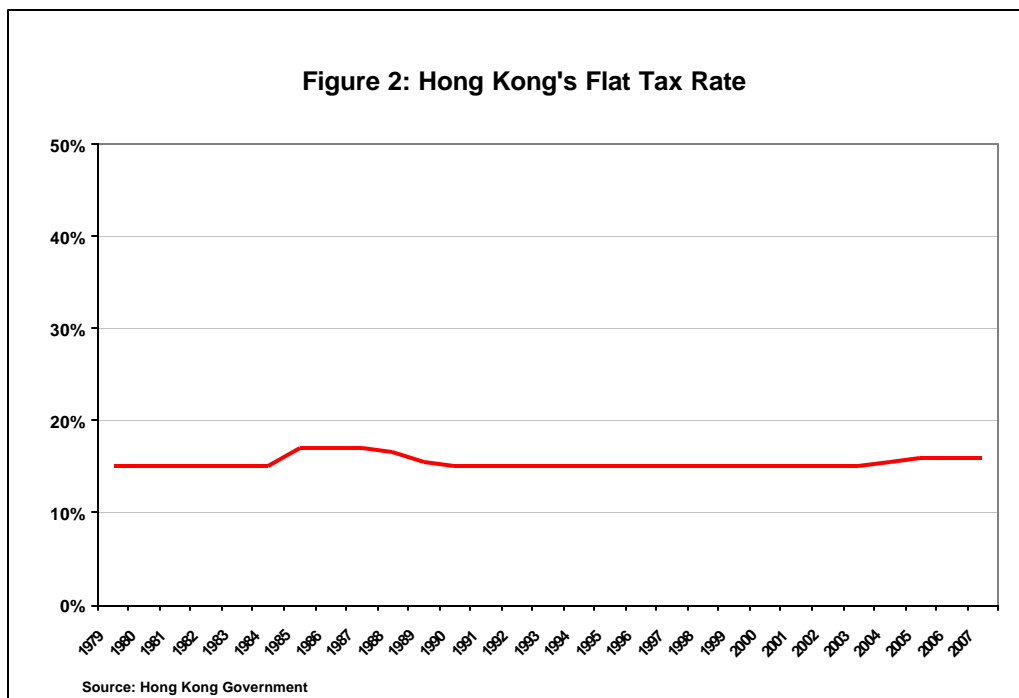
¹⁸ Against this, most of the rest of east Asia (in particular, Japan, South Korea, and Taiwan; and, to a lesser extent, Singapore) seems to support the contrary hypothesis – that higher rates of taxation and government interventionism do not necessarily obstruct growth.

II. DESCRIPTION OF HONG KONG'S TAX SYSTEM

The Structure of Hong Kong's Tax System

The Inland Revenue Ordinance 1947 provides for a schedular system of three separate taxes. Property tax is charged on rents derived from land and buildings; salaries tax on income from employment (and on analogous income such as directors' fees); and profits tax is charged on the profits of business (whether incorporated or unincorporated).¹⁹ Other forms of income (such as most importantly interest and dividends) are generally not taxable.²⁰

There is also a mechanism called personal assessment. This is like a "normal" income tax, except that it is optional. That is, instead of paying the schedular taxes on the several components of their income, taxpayers who elect personal assessment add together those components of income and pay tax on the total. In various circumstances, personal assessment produces a lower liability than would the schedular taxes. For example, it is only by electing personal assessment that a taxpayer can set business losses off against other taxable income.²¹



The Allowances and the Rates of Tax

Hong Kong's flat tax is an optional system. Taxpayers can choose to pay the flat tax, but they can use the regular tax system if that results in a lower tax liability (this is the opposite of the alternative minimum tax in the United States, which requires taxpayers to calculate their

¹⁹ Inland Revenue Ordinance 1947 (as amended), parts II, III and IV, respectively.

²⁰ Dividends are not taxable in any circumstances. Interest is taxable only if produced by the carrying on of a business (such as money-lending or supplying goods or services on credit). Royalties are treated as profits and taxable accordingly.

²¹ Inland Revenue Ordinance 1947 (as amended), part VII.

taxes twice and then pay the larger amount). The maximum personal rate of tax is currently 16 percent.²² As shown in Figure 2, this maximum tax rate – or optional flat tax – has remained remarkably constant in recent decades.

Very few people, however, pay tax at the maximum personal rate of 16 percent. To begin with, there is a relatively generous system of allowances. The “basic” allowance (available to all taxpayers) is HK\$100,000 (more than \$12,800) and the “married person’s” allowance is HK\$200,000 (more than \$25,600).²³ There are also allowances for children and for various categories of dependent relatives (parents, grandparents, siblings, etc). The effect of these is to exempt the first part of the taxpayer’s income from tax – the amount exempted depending on the taxpayer’s personal circumstances (marital status, number of children, etc). There is provision also for the deduction of various categories of personal expenditure, notably (1) charitable donations; (2) expenditure on institutional care of elderly relatives; and (3) home loan interest. Again, the effect of these provisions is to exempt the relevant part of the taxpayer’s income from tax, in the circumstances in which they apply.²⁴

Once these allowances and deductions have been taken into account, personal income is taxable at the following rates:

1. upon the first HK\$35,000 at 2 percent;
2. upon the next HK\$35,000 at 8 percent;
3. upon the next HK\$35,000 at 12 percent; and
4. upon the rest at 17 percent.²⁵

These rates are however subject to a rule that a taxpayer’s liability to tax cannot exceed 16 percent of her taxable income, without the benefit on any allowances or personal deductions.²⁶

The net effects of the allowances, personal deductions, brackets and rates of tax are as follows.

1. Most people (about 60 percent of the working population) pay no tax on their incomes at all (because the allowances and deductions to which their circumstances entitle them effectively exempt them from tax altogether).
2. Of those whose incomes are taxable (that is, the other 40 percent), the great majority pay at an average rate of less than 16 percent. The reason for this is that the allowances, personal deductions and progressive rates of tax (2 percent, 8 percent, 12

²² Inland Revenue Ordinance 1947 (as amended), sections 5, 13 and 42 and schedule 1.

²³ Hong Kong operates a currency board system under which the Hong Kong dollar is pegged to the US dollar at about HK\$7.80 = US\$1.00.

²⁴ Inland Revenue Ordinance 1947 (as amended), parts IVA and V.

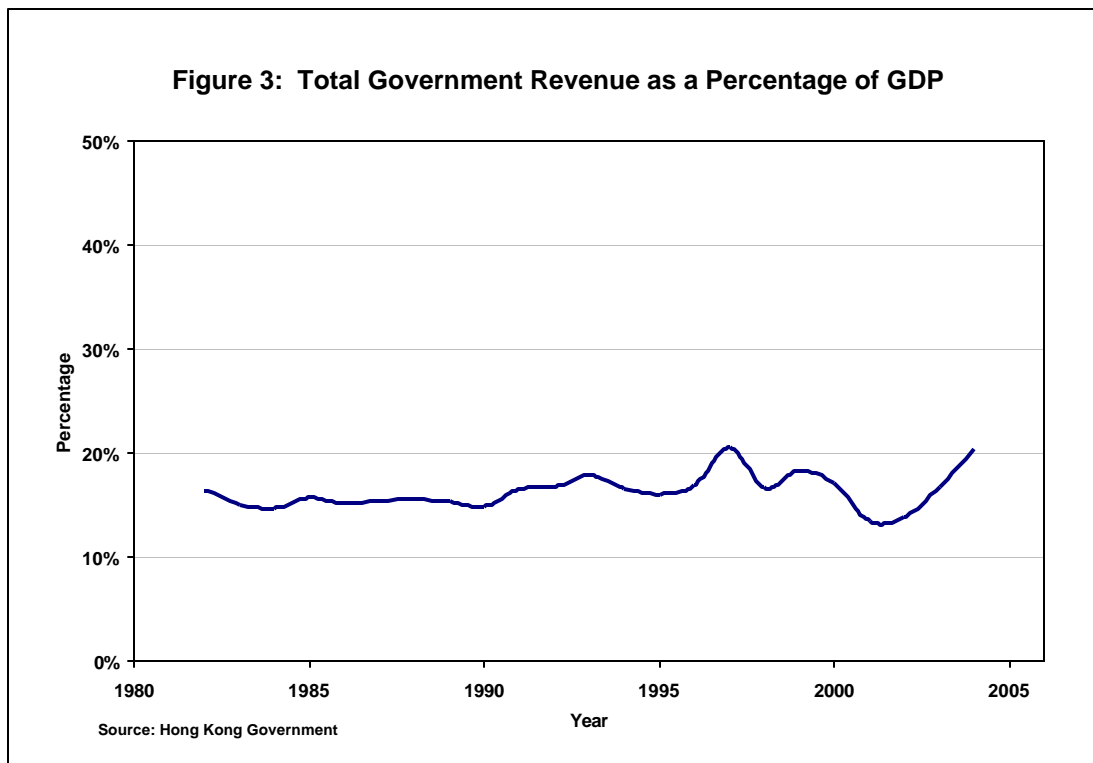
²⁵ Inland Revenue Ordinance 1947 (as amended), schedule 2. See <http://www.budget.gov.hk/2007/eng/budget25.htm> for more information.

²⁶ Inland Revenue Ordinance 1947 (as amended), section 13 and 42.

percent and 17 percent) produce a total liability of less than 16 percent.

3. A very small number pay tax at 16 percent. This rate of tax applies only where it produces a lesser total liability than would the progressive rates (2 percent, 8 percent, 12 percent and 17 percent).

The burden of taxation on individuals in Hong Kong is much *lighter* than the rates of tax suggest. The first reason for this is that important categories of income are not taxed. In particular, dividends are not taxed in any circumstances and offshore income and interest are generally not taxed.²⁷ Perks, also, are commonly not taxed.²⁸ A second reason is that the rules relating to deductibility are unusually generous.²⁹ As shown in Figure 2, the total tax burden is about 20 percent of GDP.



Corporate Profits

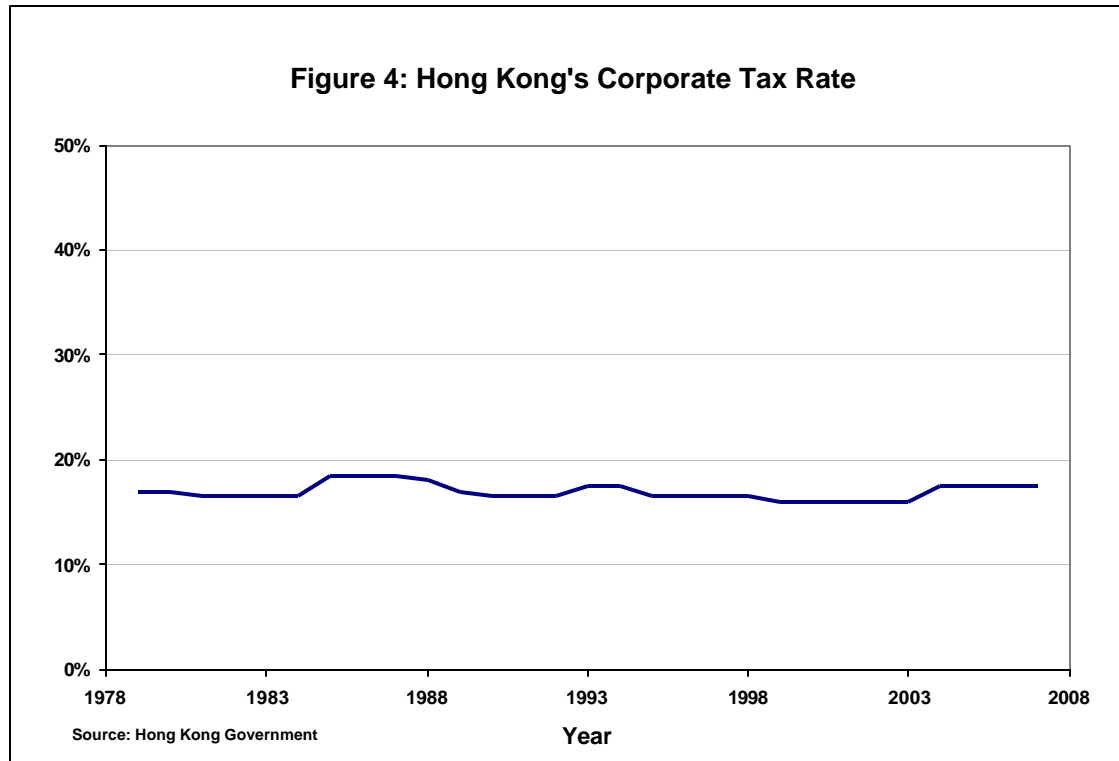
The profits of corporations are subject to profits tax at 17.5 percent.³⁰ This rate, like the flat tax on personal income, is reasonably low and has remained largely unchanged in recent decades. Figure 3 shows that the rate has never reached 20 percent.

²⁷ See Inland Revenue Ordinance 1947 (as amended), sections 14 and 26 and WILLOUGHBY & HALKYARD, note 11 supra.

²⁸ See Inland Revenue Ordinance 1947 (as amended), sections 8 and 9 and WILLOUGHBY & HALKYARD, note 11 supra.

²⁹ See Inland Revenue Ordinance 1947 (as amended), section 16 and WILLOUGHBY & HALKYARD, note 11 supra.

³⁰ Inland Revenue Ordinance 1947 (as amended), section 14(2) and Schedule 8.



The tax burden on business, relative to most other jurisdictions, is even lower than implied by the 17.5 percent tax rate. This is because there is virtually no double-taxation in Hong Kong. No further tax is imposed on dividends. In other words, dividends are treated as distributions out of a taxed fund, and accordingly exempt.³¹ Notably, though, dividends are exempt from tax even if the profits out of which they are paid have *not* been taxed.³² The profits tax on corporations is a final liability. It is not subject to adjustment, either upwards or downwards, in light of shareholders' total incomes or other circumstances. Nor is there any system of integration of corporate and shareholder liability: since dividends are simply not taxable, there is obviously neither any need nor any room for integration.

Deductibility of Business Expenses

Expenditure is generally deductible if (1) it is incurred in producing taxable profits and (2) it is of a revenue nature (rather than of a capital nature).³³ The kinds of restrictions on deductibility common elsewhere are notably absent in Hong Kong. For example, there are no limits (other than the two just referred to) on the deductibility of expenditure on entertainment, payments to associates, etc. The cost of providing perks is generally deductible, even if (as is commonly the case) the benefit is not taxable from the employee's point of view.

³¹ Inland Revenue Ordinance 1947 (as amended), section 26.

³² See WILLOUGHBY & HALKYARD, note 11 *supra*.

³³ Inland Revenue Ordinance 1947 (as amended), sections 16 and 17.

Depreciation allowances are available for capital expenditure incurred on (1) plant and machinery and (2) buildings.³⁴ In the case of plant and machinery, there is an “initial allowance” of 60 percent. In other words, the taxpayer is entitled to an immediate write-off of 60 percent. This is followed by annual allowances of 10 percent, 20 percent or 30 percent, depending on the nature of the plant or machinery in question. As the Hong Kong government has acknowledged, these provisions amount in effect to an across-the-board reduction in the rate of profits tax. More cynically, they can be seen as a surreptitious shifting of the burden from businesses (which are typically in a position to benefit from them) to people in employment (who are not). Certain types of plant qualify for an immediate 100 percent write-off – in particular, computers, software and equipment used in manufacturing.

Expenditure on buildings is depreciable at rates intended to reflect useful economic life.

There is provision for balancing charges and balancing allowances where taxpayers dispose of depreciated assets for other than book value.

Special Preferences

Hong Kong’s tax system is relatively free of provisions aimed at particular sorts of businesses or activities. There are provisions that are perceived as providing preferences, but only in comparison to the tax codes of other nations. But almost always these provisions merely reflect Hong Kong’s decision to have a territorial tax system that does not double-tax income that is saved and invested. Important instances already mentioned are (1) the general non-taxability of offshore income; (2) the general non-taxability of interest (which does not, however, extend to financial institutions or to firms supplying goods or services on credit) and (3) the immediate 100 percent write-off for equipment used in manufacturing. Also notable is that, in the case of banks and other financial institutions, there is an exception to the general non-taxability of offshore income. In other words, banks and other financial institutions, unlike other taxpayers, are generally taxed on their offshore income.³⁵

Other Taxes

There is no capital gains tax in Hong Kong. Nor are there provisions (such as are to be found in some other jurisdictions) deeming short-term capital gains to be income. Consequently, capital gains are simply not taxable. The distinction between trading profits (which are taxable) and capital gains (which are not) is left entirely to the courts.³⁶

Hong Kong has no general sales tax, no VAT and no GST.³⁷

The Hong Kong government’s main sources of revenue (in addition to the taxes provided for by the Inland Revenue Ordinance) are rates (a tax on occupiers of land and buildings); stamp duty (a tax on specified categories of documents, principally those used in connection with

³⁴ Inland Revenue Ordinance 1947 (as amended), part VI.

³⁵ Inland Revenue Ordinance 1947 (as amended), section 15.

³⁶ See WILLOUGHBY & HALKYARD, note 11 supra, commentary on section 14.

³⁷ VAT (value added tax) and GST (goods and services tax) are essentially the same, but VAT is the preferred term in Europe and GST is the preferred term elsewhere (for example, in New Zealand, Australia, Canada and Singapore).

transfers of land and transfers of shares);³⁸ land sales;³⁹ sales taxes on petroleum products and on specified categories of luxury goods; and the interest on the government's accumulated reserves (which has sometimes covered as much as 10 percent of public spending).

The Non-Taxability of Offshore Income

The three schedular taxes and personal assessment are all confined to income derived from Hong Kong.⁴⁰ In other words, persons and corporations resident in Hong Kong are generally not taxed on income derived from outside Hong Kong. Equally, income derived from Hong Kong by persons or corporations resident elsewhere is taxable. This is so of all categories of taxable income – profits, income from employment, and rents.

Distribution of the Tax Burden

Key indicators of the operation of Hong Kong's tax system and of its public spending include the following.

1. In 2004/2005, 1.27 percent of the working population paid tax at the maximum rate of 16 percent and contributed 35.8 percent of the total salaries tax receipts.⁴¹ This relatively heavy burden on large incomes seems however to inspire very little dissatisfaction. The reason for this is presumably that, although the burden is relatively heavy, it is in absolute terms very light, since liability is capped at 16 percent (and the definition of income is relatively very narrow). As Adam Smith once observed, "In a light tax a considerable degree of inequality may be supported; in a heavy one it is altogether intolerable."⁴²
2. In 2004/2005, the 100,000 most heavily burdened taxpayers (representing 8 percent of the total number of taxpayers) contributed 57 percent of the total tax yield (down from 61.1 percent in 2002/2003).⁴³ The bottom 660,000 taxpayers (representing 52 percent of the total) paid 3.2 percent of the total tax yield.⁴⁴ As indicated above, about 60 percent of the workforce were not taxed at all.⁴⁵
3. In 2002/2003, the 500 most heavily burdened corporate taxpayers (representing 0.9 percent of the total) paid 59.2 percent of the tax paid by corporations.⁴⁶

³⁸ Stamp Duty Ordinance 1981.

³⁹ Virtually all privately held land in Hong Kong is held on lease from the government. The terms of such leases are used as a means of regulating land use (as to both the nature of use and the size of building permitted). The rents payable to the government are typically low, but premiums (for new leases and variations to existing leases) are large.

⁴⁰ Inland Revenue Ordinance 1947 (as amended), sections 5, 8, 14 and 42.

⁴¹ Hong Kong Financial Secretary, The 2005-05 Budget: Information Pack for the Financial Secretary's Consultations, Chart 11, available at <http://www.budget.gov.hk/2005/eng/eng-informpack.pdf> (last visited 11 April 2006). Hereafter "Information Pack".

⁴² *Wealth of Nations*, V ii j 4.

⁴³ Information Pack, supra note 41 (Chart 11).

⁴⁴ Information Pack, supra note 41 (Chart 11).

⁴⁵ The total number of taxpayers in 2004/2005 was 1,260,000 (Information Pack, supra note 41, Chart 11) out of a total population of about 7 million.

⁴⁶ Hong Kong Financial Secretary, Top 500 Corporations Pay Most Profits Tax (in the Year of Assessment 2002-03), available at http://www.budget.gov.hk/2005/eng/chart_top500e.pdf (last visited 11 April 2006).

Aggregate Taxation and Spending

With total receipts totaling about 20 percent of GDP, the Hong Kong tax system collects more money – as a share of national output – than the federal tax system in the United States. Federal taxes currently consume about 18.4 percent of GDP in America. Yet Hong Kong collects a greater share of taxes with a tax system that has much lower rates and almost no double-taxation of income that is saved and invested.

See table below to see how the government’s 2004/2005 revenues were constituted.⁴⁷

Although it has generally operated at a surplus, the Hong Kong government does issue debt. Generally, however, this is done for the purpose of funding self-financing infrastructure projects (railways, toll-roads, etc). One of the government’s principal reasons for financing such projects in this way (rather than out of its reserves) seems to be to create a secondary market in government-issued debt instruments (important for Hong Kong in its role as a financial center).

2004/2005 Hong Kong Government Revenues	
<i>Percent of total revenues</i>	
Profits tax	23.40%
Salaries tax, property tax and personal assessment tax	17.00%
Utilities, fees and charges	6.80%
Betting duty	6.20%
Rates	6.10%
Stamp duty	5.40%
Land fund, properties and investments	8.20%
Duties	3.30%
Land premium	5.90%
Other operating revenue	5.00%
Other capital revenue	12.70%
Total	<u>100%</u>

Source: Hong Kong Financial Secretary

Public spending in Hong Kong is generally about 20 percent of GDP⁴⁸ and has been fairly constant at about that level since the 1970s. As a result of the 1997 East Asian financial crisis, spending has in recent years marginally exceeded 20 percent and the government’s explicit fiscal targets include bringing this figure back down to 20 percent “or below”.⁴⁹ Article 107 of the Hong Kong Basic Law requires the Hong Kong government to “keep the budget commensurate with the growth rate of its gross domestic product”.⁵⁰ Exactly what this means is debatable, but it is generally interpreted as meaning that public spending should remain constant as a percentage of GDP (or, at least, that this percentage should not be permitted to rise). Given that the Hong Kong government has for several decades both aimed

⁴⁷ Information Pack, supra note 41, Chart 14.

⁴⁸ See the 2005/2006 Budget Speech, note 6 supra, paragraph 85.

⁴⁹ Information Pack, supra note 41, Chart 12.

⁵⁰ See below at note 81.

at and achieved public spending of about 20 percent of GDP, article 107 has given this figure a sort of de facto constitutional status (though it seems most unlikely the courts would actually enforce this or any other figure). Although obviously attractive in some respects, the figure of 20 percent seems to be arbitrary, for no theoretical justification for it seems ever to have been given.

III. WHY THE TAX SYSTEM IS GOOD

Hong Kong's tax system seems potentially instructive in several respects.

Low Levels of Taxation and Public Spending

The levels of taxation and public spending in Hong Kong are very low compared to other developed jurisdictions; yet the Hong Kong people seem more content than other peoples with the balance of taxes and spending. It is notable, in particular, that taxation generally attracts very little public debate in Hong Kong. The reasons for this remain unclear; further research is needed. The rudimentary state of Hong Kong's system of public welfare is no doubt one reason the Hong Kong government is able to operate at such low levels of taxation. In other words, Hong Kong's systems of taxation and public spending may be less redistributive than others. A more important reason, however, may be that other governments collect more tax from middle-class taxpayers for the purpose of financing benefits for middle class taxpayers.

Simplicity

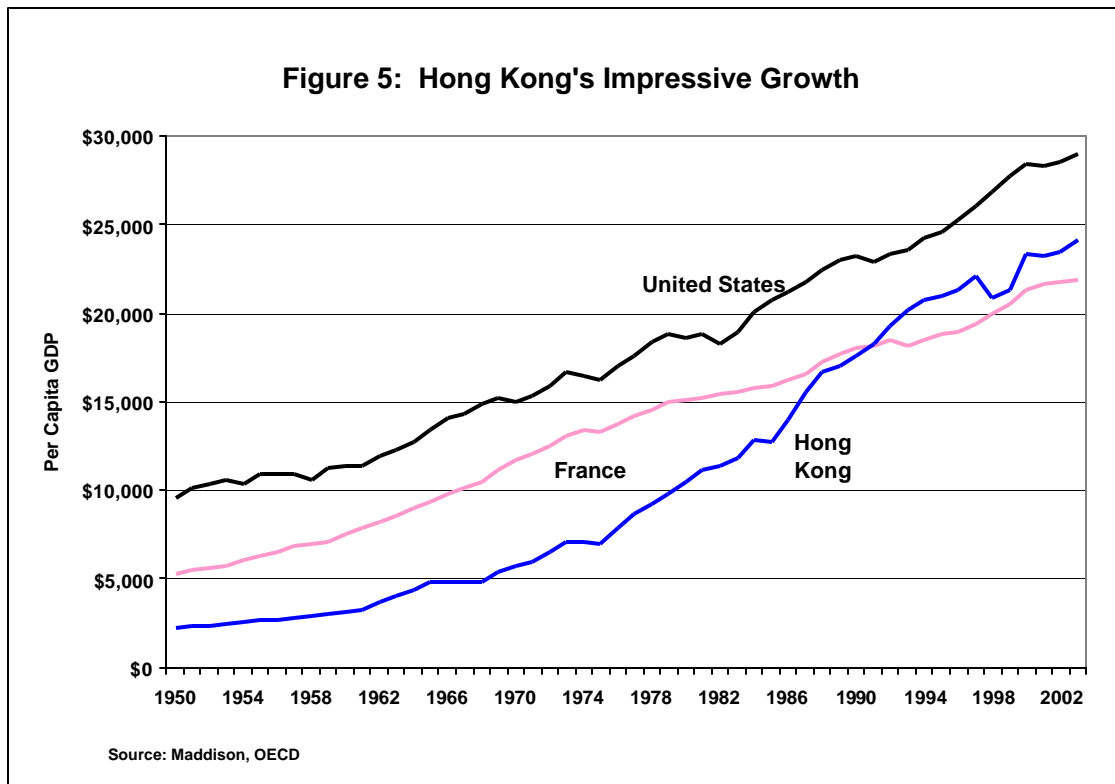
Hong Kong's tax system is exceptionally simple. The Inland Revenue Ordinance consists of only about 200 pages all up – and it contains not only the substantive law but also the machinery for its administration: taxpayer's obligations, the Commissioner's powers, appeals procedures and so on. Moreover, the Ordinance, together with the decisions of the courts as to its interpretation (themselves relatively few in number), constitutes virtually the whole of the law – provision for subsidiary regulations exists, but almost no use has been made of it. This simplicity seems in turn to be made possible by two main factors. The first of these is the very low rates of tax. Secondly, the legislature has trusted the judges (on whom falls the burden of interpreting the relatively skeletal legislation) to produce interpretations which are principled, respectful of taxpayers' rights and protective of the government's revenues – and the judges have done so.⁵¹

Economic Prosperity

Perhaps the strongest argument for Hong Kong's tax system is that the jurisdiction has enjoyed unparalleled growth. As seen in Figure 5, per capita GDP has jumped from about \$2,000 to more than \$25,000 in the six decades that the flat tax has been in place. To be sure, there are many factors that contribute to prosperity, including the rule of law, property rights, sound money, limited government, and a laissez-faire attitude to private sector activity. Indeed, Hong Kong has the top ranking in both Economic Freedom of the World and the Index of Economic Freedom.⁵²

⁵¹ For a lengthier treatment of these issues, see Littlewood, note 5 supra.

⁵² James Gwartney and Robert Lawson, with William Easterly, *Economic Freedom of the World: 2006 Annual Report*, The Fraser Institute, 2006. Available at <http://www.cato.org/pubs/efw/efw2006/efw2006-3-a-k.pdf>. Tim Kane, Kim R. Holmes, and Mary Anastasia O'Grady, *2007 Index of Economic Freedom*, The Heritage



A pro-growth tax regime is not be the only cause of Hong Kong's prosperity, but it surely is a contributing factor. Workers, investors, entrepreneurs and others are not penalized for creating wealth.

IV. HONG KONG AND HALL/RABUSHKA

Perhaps the most important lessons to be learned from Hong Kong's tax system lie in its similarity to the flat tax system proposed by Robert Hall and Alvin Rabushka.⁵³ The Hall/Rabushka system is one of the more important contributions to modern tax theory. It seems not to be generally recognized, though, that the Hall/Rabushka system is very similar to (and apparently largely based on) the system of taxation which exists in Hong Kong. Because of this similarity, the historical operation of Hong Kong's tax system affords important evidence as to the merits of the Hall/Rabushka system. Given that Hong Kong's tax system has proved remarkably successful, it tends to support the case for the Hall/Rabushka proposal.

The main points of similarity between the Hall/Rabushka proposal and the system in fact operating in Hong Kong include the following.

Foundation and Dow Jones & Company, Inc, 2007. Available at <http://www.heritage.org/research/features/index/downloads/2007PastScores.xls>.

⁵³ See HALL & RABUSHKA, note 9 supra.

Low, Flat Rates of Tax

Hong Kong's Inland Revenue Ordinance and Hall/Rabushka both provide for a low, flat rate of tax - currently 16 percent in Hong Kong⁵⁴ (and 17.5 percent for corporations)⁵⁵ and 19 percent under Hall/Rabushka.⁵⁶ Hong Kong's experience tends to support the argument that low, flat taxes can be feasible in an affluent, modern society.

It may be worth noting in this connection that the success of Hong Kong's tax system cannot be dismissed on the basis that the territory is a mere colonial trading post, for several decades ago it ceased to be such and emerged as a modern, affluent city-state. The population numbers seven million. The government, although not democratic, is mindful of public opinion. It subsidises a range of public services including a large public housing program, a comprehensive public health service and an expensive public education system. In some respects, Hong Kong's public services are not as extensive as those to be found in comparably affluent western societies. For example, by western standards Hong Kong's public housing is cramped and uncongenial and its social welfare system inadequate. In others, they are better. Examples include the public transport system, the financing of the territory's eight universities and the preservation of extensive undeveloped parkland adjacent to urban areas.⁵⁷

Generous Allowances

Hong Kong's existing tax system and Hall/Rabushka both feature generous allowances which effectively exempt small incomes from tax altogether.⁵⁸ Hong Kong's experience thus tends to support the hypothesis that the establishment of low, flat-rate taxation might be facilitated by exempting a substantial part of the population from tax altogether.⁵⁹

Schedular Structure

Hong Kong's tax system and Hall/Rabushka share similar schedular structures. In Hong Kong, as has been explained, there is no tax on income as such but, rather, three separate taxes (property tax, salaries tax and profits tax), plus personal assessment. The Hall/Rabushka system likewise does not impose a tax on income as such. Rather, there is a schedular system, similar to Hong Kong's, except that instead of three taxes (as in Hong Kong), there only two ("wage tax" and "business tax") and there is no personal assessment.

Despite these differences, the two systems are very similar. Hall/Rabushka has no separate tax on rents, because rents are covered by business tax.⁶⁰ In Hong Kong, in contrast, rents are in some circumstances chargeable to property tax (in particular, where the landlord is a natural person) and in other circumstances to profits tax (in particular, where the landlord is a

⁵⁴ Inland Revenue Ordinance 1947 (as amended), sections 13 and 42 and schedule 1.

⁵⁵ Inland Revenue Ordinance 1947 (as amended), section 14 and schedule 8.

⁵⁶ HALL & RABUSHKA, note 9 supra, Appendix: A Flat Tax Law (hereafter Hall/Rabushka Model Statute), sections 202 and 203.

⁵⁷ On the nature of Hong Kong society and the territory's system of government generally, see MINERS, note 13 supra.

⁵⁸ Inland Revenue Ordinance 1947 (as amended), parts IVA and V; Hall/Rabushka Model Statute section 201.

⁵⁹ It is perhaps worth repeating in this connection that there is no general sales tax in Hong Kong.

⁶⁰ Hall/Rabushka Model Statute section 102(3).

corporation).⁶¹ Similarly, although Hall/Rabushka has nothing quite like Hong Kong's personal assessment, wage tax is structured so as to serve very similar functions. In particular, Hall/Rabushka provides for the proprietors of a business to "employ" themselves so as to benefit from the exemptions built into wage tax (rather than to bear the flat rate of tax from the first dollar).

Hong Kong's experience seems to confirm that a tax system structured in this way can operate satisfactorily. It suggests also that such a structure might make it more difficult for a government to increase the rates of tax.⁶²

Offshore Income Is Not Taxable

Hong Kong's tax system and Hall/Rabushka are both based on the source principle. That is, offshore income is not taxable.⁶³ Hong Kong's experience confirms that this is feasible in a complex modern society.

It is notable, too, that Hong Kong's Inland Revenue Ordinance does *not* contain detailed source rules - that is, rules for distinguishing between income which is derived from Hong Kong (and is therefore taxable) and income which is derived from outside Hong Kong (and is therefore not taxable). Rather, the legislation leaves it almost entirely to the courts to draw the line; and the courts have fulfilled this function satisfactorily.⁶⁴ Hong Kong's experience thus confirms not only that it is feasible to base a modern tax system on the source principle (at least if the rates of tax are very low), but also that doing so need not entail complex source rules.

Corporate Profits and Dividends

Under both Hong Kong's existing tax system and Hall/Rabushka, corporate profits are taxable, but no further tax is imposed on dividends.⁶⁵ This approach is feasible only because the maximum personal rate of tax is about the same as, or lower than, the corporate rate (for otherwise distributed corporate profits would be taxed at a lower rate than other personal income). Under Hall/Rabushka, the corporate rate and the maximum personal rate are both 19 percent.⁶⁶ In Hong Kong, the corporate rate (17.5 percent) is marginally higher than the maximum personal rate (16 percent). Again, Hong Kong's experience confirms that this approach is viable. In other words, it seems to demonstrate that the supposed challenge of taxing corporate income only exists in jurisdictions with high rates of tax.

⁶¹ See Inland Revenue Ordinance 1947 (as amended), sections 5 and 14 and the commentary on these sections in WILLOUGHBY & HALKYARD, note 11 *supra*.

⁶² See *infra* at note 84.

⁶³ Inland Revenue Ordinance 1947 (as amended), sections 5, 8, 9 and 14 and the commentary on these sections in WILLOUGHBY & HALKYARD, note 11 *supra*; Hall/Rabushka Model Statute sections 101(c)(3) and 102.

⁶⁴ See WILLOUGHBY & HALKYARD, note 11 *supra*, for a summary and analysis of these cases.

⁶⁵ See WILLOUGHBY & HALKYARD, note 11 *supra*; HALL & RABUSHKA, note 9 *supra*, chapter 3.

⁶⁶ Hall/Rabushka Model Statute sections 202 and 203.

Simplicity

Hong Kong's Inland Revenue Ordinance (at 200 pages) is very simple, but not as simple as the Hall/Rabushka Model Tax Statute (5 pages).⁶⁷ Even so, Hong Kong's Inland Revenue Ordinance demonstrates that, at least at very low rates of tax, it is possible for tax legislation to be much simpler than the statutes to be found in other developed jurisdictions. More particularly, Hong Kong's experience seems to confirm that Hall and Rabushka may well have been right to suppose that, at least at low rates of tax, it is feasible for the taxing legislation to use only broad terms, and leave it to the courts to define them.⁶⁸

Tax Treatment of Interest

Under Hall/Rabushka, interest is neither taxable nor deductible.⁶⁹ Hong Kong's tax treatment of interest is less straightforward but nonetheless instructive. In Hong Kong, interest is in some circumstances counted as profits and therefore chargeable to profits tax. This is so if the interest is produced by the carrying on of a business, such as money-lending or selling goods on credit. Otherwise, however, interest is not taxable in Hong Kong. For example, interest paid on bank deposits is generally not taxable. Likewise, interest paid by a company to a shareholder is generally not taxable. Equally, interest is in some circumstances deductible (such as where incurred in the production of profits and paid to a bank) and in other circumstances not (such as where paid to an associate who is not obliged to pay tax on it).⁷⁰ Hall/Rabushka's approach is simple and principled. Hong Kong's is messy and unprincipled – but it works. Which is better is debatable.

Capital Expenditure and Capital Gains

Hall/Rabushka provides for the immediate 100 percent write-off of capital expenditure on equipment, structures and land.⁷¹ Hong Kong's tax system does not. Rather, as has been explained,⁷² the Inland Revenue Ordinance provides for (1) the immediate 100 percent write-off of *some* forms of capital expenditure (notably computers and manufacturing plant); (2) very generously accelerated depreciation allowances for all other plant and machinery (beginning with an immediate 60 percent write-off); (3) economically realistic depreciation rates for buildings;⁷³ and (4) no deduction for capital expenditure on land. Under Hall/Rabushka, the proceeds of sales of equipment, buildings and land held on capital account are taxable.⁷⁴ In Hong Kong, they are not (though there is depreciation recovery).

Taxing Consumption rather than Income

The Hall/Rabushka tax is said to be a tax on consumption, because of the absence of double-taxation of capital income and the expensing of investment on equipment, buildings and land. In this respect, too, Hong Kong's tax system is a messy but successful hybrid, for in Hong

⁶⁷ HALL & RABUSHKA, note 9, Appendix.

⁶⁸ See Littlewood, note 5 *supra*.

⁶⁹ Hall/Rabushka Model Statute sections 101 to 105; HALL & RABUSHKA, note 9 *supra*, chapter 3.

⁷⁰ See generally WILLOUGHBY & HALKYARD, note 11 *supra*.

⁷¹ Hall/Rabushka Model Statute section 104.

⁷² See above at note 34.

⁷³ See above at note 34.

⁷⁴ Hall/Rabushka Model Statute section 102(5).

Kong (1) dividends are not taxable, (2) capital gains are not taxable and (3) interest is taxable only if produced by the carrying on of a business.

Fiscal Constitutionalism

Hong Kong's tax system and constitution have built into them a number of features designed to make it difficult for the government (if it were ever so inclined) to effect substantial increases in the rates of tax. Some of these features are objectionable, in that they are plainly antidemocratic. On the other hand, it may be that the Leviathan hypothesis is valid - that, in other words, democracy has tended to lead to higher levels of taxation and public spending than would have accorded with the greatest possible satisfaction of voters' actual preferences.⁷⁵ If this is so, it might be desirable to restrain Leviathan - that is, to devise mechanisms tending to improve the degree to which the levels of taxation and public spending accord with voters' preferences. Hong Kong suggests how this might be done.⁷⁶

V. REFORM

In Hong Kong, as is recounted above, there has been almost no structural tax reform since taxes on income were first introduced in the 1940s. Given that the territory's tax system has been notably successful, however, the lack of reform may be a positive feature rather than a negative one.

Indeed, it is fair to say that the programs of tax reform followed by other governments over the last 25 years or so (for example, in the US and the UK) have generally consisted of modifying their tax systems so as to make them more like Hong Kong's. In particular, Hong Kong's tax system serves as an exemplar in the following respects: (1) the rates of tax are low; (2) the tax system is relatively neutral (in that there are very few provisions aimed at particular industries, etc); and (3) the law is very simple.

It is necessary to note also that to some extent Hong Kong has served as a model for tax reform in other jurisdictions. Until the 1970s, the British government and the colonial Hong Kong government regarded it as self-evident that Britain's tax system was superior to Hong Kong's; and that the colony's tax system should therefore be reformed so as to make it more like Britain's.⁷⁷ In the 1970s, however, as Hong Kong's economy continued to grow and Britain's relative economic decline became more serious and more obvious, the colonial government came to the view that it had nothing to learn from Britain as to taxation and public finance (except how not to go about it). The British government, under Margaret Thatcher, came to agree. Hong Kong's tax system has also long been regarded in the US - in particular, by Milton Friedman and Alvin Rabushka - as a potentially instructive model.

It is necessary to note that Hong Kong's tax system, despite its remarkable successes, is marred by a serious and ugly flaw: it was produced, and has since been maintained, by a system of government which is not democratic. Hong Kong thus remains open to the charge that its tax system and public finances may not be in accordance with the preferences of the

⁷⁵ See for example GEOFFREY BRENNAN & JAMES M BUCHANAN, *THE POWER TO TAX: ANALYTICAL FOUNDATIONS OF A FISCAL CONSTITUTION* (1980).

⁷⁶ See below under the heading "Obstacles to Reform".

⁷⁷ See Littlewood, note 16 supra.

people; and that, rather, they serve the interests of the Beijing-aligned business elite which controls the territory's government. Indeed, it would seem fair to say that precluding populist increases in public spending and taxation has been one of the principal factors influencing the design of the territory's system of government since Hong Kong Island was first colonized by the British in 1842. On the other hand, however, Hong Kong enjoys a semblance of democracy (though not the real thing) and political debate in the territory is vigorous. The legislature is composed of persons who are selected by a system of elections which was clearly designed not to produce a result in accordance with the preferences of the populace; but this system nonetheless features a number of political parties whose aim is to get themselves elected. These parties presumably propose whatever policies they think likely to appeal to voters – and yet they have always been very restrained in their calls for changes to the fiscal regime. In particular, there seems to be very little public demand for increased public spending and increased taxes. It seems, then, that although Hong Kong's government is undemocratic, its approach to taxation and public spending enjoy considerable public support.⁷⁸

Of course it does not necessarily follow, from the fact that Hong Kong's flat-tax system enjoys considerable popular support, that similar tax systems would enjoy similar levels of support in other parts of the world. Different peoples might simply have different preferences. Moreover, Hong Kong's populace is peculiar, in that it substantially selected itself (by immigrating from the Chinese Mainland) on the basis of an aversion to Chinese communism and a preference for economic freedom, minimal government and low taxes. On the other hand, there is considerable popular support for tax cuts in most countries.

VI. OBSTACLES TO REFORM

If it is assumed that taxation should be in accordance with voters' preferences, it follows that obstacles to the achievement of this objective are generally undesirable. It is widely thought, however, that democracy has tended to lead to policies on taxation and public spending which are systematically unsatisfactory, in the sense that they fail to satisfy voters' preferences as fully as might have been possible. In response to this perception, it has sometimes been proposed (most famously by James Buchanan) that the taxing and spending powers of the state should be constitutionally constrained so as to eliminate or at least minimize this problem.⁷⁹

In most countries, these proposals have made relatively little progress. In this respect, too, however, Hong Kong is exceptional: the system of government, the constitution, and the tax system itself were all designed with the basic objective of making it difficult for the government (1) to increase taxes; (2) to increase the tax system's progressivity; (3) to increase public spending as a percentage of GDP; or (4) to operate at a deficit. Yet the literature on fiscal constitutionalism (as this field has become known) has made little use of this potentially helpful case study; equally the literature on Hong Kong's system of government has generally downplayed this crucial aspect of it. It is worth examining the

⁷⁸ On Hong Kong's system of government and constitution, see GHAI, WESLEY SMITH and MINERS, all note 13 supra and Blanpain, ed, note 14 supra.

⁷⁹ See for example BRENNAN & BUCHANAN, note 75 supra.

several components of Hong Kong's fiscal constitution, however, with a view to determining what, if anything, the rest of the world might be able to learn from them.

There are six main constraints on the taxing and spending powers of the Hong Kong government. They are as follows.

1) The Structure of the Government

The structure of the Hong Kong government, as provided for by the Basic Law,⁸⁰ appears to have been designed with the basic objective of eliminating the possibility of populist increases in taxes or in public spending. In particular, this objective seems to have been a major factor in determining (1) the peculiar process for selecting of the head of the government (called the Chief Executive) and (2) the equally peculiar composition of the legislature (called the Legislative Council).

Hong Kong's system of government is, however, profoundly anti-democratic. This paper therefore does not consider the possibility that it might be worth emulating.

2) Legislative Procedure

The Legislative Council's rules of procedure (some of which are contained in the Basic Law, some in other instruments) appear to make it effectively impossible for its members even to *propose* legislation increasing either taxes or spending without the consent of the Chief Executive.

Again, this is profoundly anti-democratic. Again, therefore, this paper therefore does not consider the possibility that it might be worth emulating.

3) Constitutional Constraints on the Taxing and Spending Powers

The Basic Law contains – in articles 107 and 108 - provisions expressly restricting (1) increases in taxation; (2) increases in spending; and (3) deficit spending. Article 107 provides as follows:

“The Hong Kong Special Administrative Region shall follow the principle of keeping expenditure within the limits of revenues in drawing up its budget, and strive to achieve a fiscal balance, avoid deficits and keep the budget commensurate with the growth rate of its gross domestic product.”⁸¹

Article 108 provides (in part) as follows:

“The Hong Kong Special Administrative Region shall, taking the low tax policy previously pursued in Hong Kong as reference, enact laws on its own concerning

⁸⁰ See note 13 supra. Hong Kong's system of government, as provided for by the Basic Law, is still in fact in accordance with the British colonial norm prevailing in the mid-nineteenth century. The return of the colony to China in 1997 entailed very little change.

⁸¹ Basic Law article 107.

*types of taxes, tax rates, tax reductions, allowances and exemptions, and other matters of taxation.*⁸²

The meaning of these provisions is debatable and to date has not been tested in the courts. To examine the possible interpretations would be beyond the scope of this paper. But articles 107 and 108 demonstrate both the difficulty of drafting provisions of this kind and one approach to resolving the problems.⁸³

4) Inequity as a Virtue

Hong Kong's system of income tax is, and was intended to be, "inherently inequitable".⁸⁴ The businessmen who designed it appear to have thought that inequitable taxes would be tolerable at low rates, but intolerable at high rates.⁸⁵ The Hong Kong government accepts that this is so. Thus the government accepts also that it is impossible for it to substantially increase the rates of tax, unless it structurally reforms the tax system first. The reason is that taxpayers whose burden is light do not object if their neighbours' is lighter still; but if the burden were heavier, they would object to others not contributing a fair share.

It seems unlikely that any democratically elected government would wilfully reform its tax system with the objective of making it more inequitable. Most democratic governments, far from deliberately exacerbating their tax systems' inequity, go to very considerable lengths to ameliorate it. This is indeed one of the principal causes of the extreme complexity of modern tax law. One lesson which might be learned from Hong Kong is that the lengths to which most democratic governments go to minimize inequity may be (depending on their objectives) excessive and counterproductive. Thus, one strategy which a government wanting to tame Leviathan could adopt would be to pursue the goal of tax equity with less vigour than it otherwise would. The consequences might include a gradual intensification of the tax system's inequity. This in turn might make it more difficult for the government to increase the rates of tax.

5) The Visibility of Hong Kong's Taxes

Hong Kong's taxes are unusually visible. The withholding mechanisms upon which other governments rely (and which tend to blur taxpayers' awareness of how much they are paying) are conspicuously absent. In particular, Hong Kong has no withholding of tax on income from employment (Pay-As-You-Earn or PAYE). Also, there is in Hong Kong no general sales tax, no VAT and no GST.⁸⁶ That the Hong Kong government relies hardly at all

⁸² Basic Law article 108.

⁸³ See Littlewood, note 14 supra.

⁸⁴ The epithet "inherently inequitable" was first applied to Hong Kong's tax system by a British civil servant in 1940 and has been routinely reapplied since. See Littlewood, note 16 supra. The reason for the inequity is that the schedular structure of Hong Kong's tax system operates so as in various common circumstances to impose different liabilities on taxpayers whose circumstances and incomes are the same. Whether the Hall/Rabushka system shares this characteristic is debatable.

⁸⁵ Compare ADAM SMITH, note 42 supra.

⁸⁶ In most countries where there is a GST or a VAT, retail transactions are routinely carried out on the basis of tax-inclusive prices. Presumably this tends to reduce consumers' awareness of the burden of the tax.

on withholding mechanisms is routinely regarded as no more than an administrative curiosity. But most countries' income taxes are collectable *only* because of PAYE. It is reasonable to suppose, therefore, that if the Hong Kong government wished to substantially increase the rates of tax on income, it would need to introduce PAYE first. Equally, if the Hong Kong government wished to reduce the allowances so as to impose tax on the 60 percent or so of the workforce currently not paying, it would likely need to introduce PAYE first. The absence of PAYE thus seems to constitute a substantial restraint on the Hong Kong government's capacity to increase the burden of taxation.

It would obviously not be desirable for governments currently relying on PAYE simply to abolish it, because the probable immediate consequence would be chaos. But it would be possible, and it might be desirable, for democratic governments to restructure their systems of PAYE so as gradually to wean themselves off it. This would tend to increase voters' awareness of the tax system. This, in turn, might lead to a balance of taxes and spending more in accordance with their actual preferences.⁸⁷

6) Hong Kong's Implicit Social Contract

The rates of tax in Hong Kong are very low and the burden is generally substantially lighter than the rates of tax suggest. Moreover, there is no general sales tax, no VAT and no GST. Consequently, most people pay very little tax indeed. Hong Kong is thus governed on the basis of an implicit social contract to this effect: that most people pay very little tax and, in return, they do not complain too loudly about the relatively low level of public spending. Presumably there is less demand for public spending than there would be if poor people were more heavily taxed; equally, for so long as this implicit social contract remains in place, it would be harder than would otherwise be the case for the government to increase the progressivity of the tax system.

VII. REMAINING CHALLENGES

Hong Kong's tax system functioned very satisfactorily - and almost always produced greater revenues than the government wished to spend - from 1947 (when peacetime income taxes were first introduced) until 1997 (when the territory was returned to Chinese rule). Unfortunately, the handover was almost immediately followed by a financial crisis affecting most of East Asia. The Hong Kong government thus found itself operating at a deficit. Dealing with this deficit has been the principal economic challenge facing the Hong Kong government from 1997 until now.⁸⁸

Although the immediate cause of the Hong Kong government's recent deficits was the 1997 Asian financial crisis, another important factor was that in the run-up to the handover (from about 1990 until 1997), the colonial government increased its spending dramatically. In particular, it greatly increased the number of civil servants and greatly increased also the

⁸⁷ Prominent among those recently making the case for tax visibility is Milton Friedman. See Joseph Thorndike, Historical Perspective: What You Don't Know Can Hurt You, <http://www.taxhistory.org/thp/readings.nsf/cf7e9c870b600b9585256df80075b9dd/60cca25aae80903885256ff6006ea59d?OpenDocument>, 27 July 2005.

⁸⁸ See the 2005/2006 Budget Speech, note 6 *supra*, paragraphs 78-90.

level of their salaries. The principal reason for this increased spending was that it was thought to be desirable as a means of minimizing the political uncertainty arising from the planned return to Chinese rule – an event unique in the history of the world, entailing the handing over of one of the world’s most vibrant centers of capitalism to an avowedly communist superpower.

Hiring more civil servants and dramatically increasing their salaries might have been appropriate in the very peculiar circumstances facing Hong Kong in the 1990s. The result however has been that the territory now has a civil service which is perhaps larger and more expensive than the territory’s tax system seems capable of financing. The government (which is dominated by Beijing-aligned business interests) has sought to address this problem by not increasing civil servants’ salaries and letting inflation effectively reduce them. It is also however seriously examining the possibility of introducing a VAT.⁸⁹

This would appear to present a number of problems. The most important of them is that it would constitute the renegeing, by the government and the more affluent members of Hong Kong society, of the implicit social contract referred to above. The likely consequence would be that Hong Kong’s poorer residents – who currently pay almost no tax and whose demands on the government are correspondingly restrained – might raise their demands in accordance with their increased liability to tax.

VIII. CONCLUSION

Hong Kong’s tax system is exemplary in the several respects which this paper has reviewed. In particular, it is the closest the world has yet come to producing a system of taxation in accordance with the ideas advanced by the advocates of flat taxes, from Walter Blum and Harry Kalven⁹⁰ to Robert Hall and Alvin Rabushka.⁹¹

It is possible to suggest refinements which might bring Hong Kong’s tax system closer to the flat tax ideal – but, given how close it is already, it seems almost churlish to do so. Indeed, it may be that the various flat-tax models which have been proposed (such as Hall/Rabushka) could be improved by bringing them into closer alignment with Hong Kong’s existing tax system.

A more serious problem facing Hong Kong might be that any major change in the territory’s tax system is likely to be away from the flat tax ideal, rather than towards it. If Hong Kong were to abandon or compromise the approach to taxation and public spending which it has traditionally followed, the world as a whole would be the poorer, in that something of very considerable theoretical interest would have been lost. It would of course be ridiculous to suggest that the Hong Kong government should refrain from modifying its tax system, so that the rest of the world can continue to study it. It is to be hoped, though, that the Hong Kong government does not effect substantial changes to its tax system, unless with the clear support of the territory’s people. The proposed introduction of VAT – which would presumably be regressive and a breach of the territory’s implicit social contract – seems not to satisfy this criterion.

⁸⁹ See the 2005/2006 Budget Speech, note 6 supra, paragraphs 102-104.

⁹⁰ WALTER BLUM & HARRY KALVEN, *THE UNEASY CASE FOR PROGRESSIVE TAXATION* (1953).

⁹¹ HALL & RABUSHKA, note 9 supra.

APPENDIX: THE HISTORY OF HONG KONG'S TAX SYSTEM

Hong Kong Island was colonized by the British in 1842.⁹² The objective was to establish a base from which British traders could conduct their affairs (notably selling opium to the Chinese) without being under the control of the Chinese government. The colony fulfilled this objective very satisfactorily. In 1860, the colony was extended to include the adjacent part of the mainland (the Kowloon Peninsula); in 1898, it was extended again to include another 1,000 square kilometers or so of the hinterland and some nearby islands (collectively called the New Territories). Hong Kong remained a British colony until 1997, when it became a Special Administrative Region of the People's Republic of China. The Chinese government promised that Hong Kong would enjoy "a high degree of autonomy"⁹³ and that its "capitalist system and lifestyle"⁹⁴ would "remain unchanged for 50 years".⁹⁵ To date the Chinese Government has by and large honored this promise.

The British objective, in 1842, was to establish only a trading post, not a settler colony. The British therefore equipped the colony with a skeletal system of government intended to provide what was necessary to service business, and no more.⁹⁶ Taxes were accordingly very light. The government financed itself by various means including land sales, stamp duty and estate duty.

There were no taxes on income in Hong Kong until the second world war. In 1939, the colonial Hong Kong government proposed to establish an income tax for the purpose of financing a contribution to the British war effort.⁹⁷ The proposal was for what the British and Hong Kong governments regarded as a "normal" income tax – that is, a tax on income as such, covering both (1) the worldwide incomes of persons resident in Hong Kong and also (2) income derived from Hong Kong by persons resident elsewhere.⁹⁸ But the business community, in whose interests the colony was governed, objected. The expatriate businessmen would reluctantly have accepted an income tax, so long as the rates of tax were very low. The Chinese were more vehemently opposed. This was hardly surprising, given that they were unused to taxes on income; that the revenues were to be spent for the benefit of Britain rather than Hong Kong; that at this time China itself was suffering from both civil war and occupation by the Japanese; and that the Chinese population of Hong Kong had mostly selected itself (by immigrating from the mainland) on the basis of an enthusiasm for unrestrained capitalism. The Chinese businessmen would reluctantly have gone along with taxes on income from employment and rents, but a tax on profits they regarded as beyond the

⁹² The best general history of Hong Kong is FRANK WELSH, *A HISTORY OF HONG KONG* (1997).

⁹³ Joint Declaration of the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the People's Republic of China on the Question of Hong Kong, 1984 (hereafter "Joint Declaration"), article 3(2).

⁹⁴ Joint Declaration, Annex 1, article 1.

⁹⁵ Joint Declaration, Annex 1, article 1.

⁹⁶ See GHAI, note 13 *supra* and WESLEY SMITH, note 13 *supra*.

⁹⁷ See Littlewood, note 16 *supra*.

⁹⁸ To suggest that there is such a thing as a "normal" income tax is inevitably to invite argument. But the word was routinely used in this sense at the time by both the Hong Kong government and the Colonial Office in London. See Littlewood, note 16.

pale. The colonial government could have gone ahead and established an income tax regardless (for the colony's system of government was not democratic),⁹⁹ but deemed it impolitic to do so. The impasse was resolved on the basis that the representatives of business would support the establishment of a system of income tax; and the government would abdicate the design of it to them.

The result was the War Revenue Ordinance 1940. This established a peculiar system of taxation which differed from the government's original proposal in two basic respects. First, there was no tax on income, as such, at all. Instead, there was a schedular system of three separate taxes on three different kinds of income: profits tax was charged on the profits of business;¹⁰⁰ salaries tax was charged on income from employment (and on analogous income, such as directors' fees);¹⁰¹ and property tax was charged on the rental value of land and buildings.¹⁰² Secondly, the system was said to be "based on the source principle", meaning that only income derived from Hong Kong was taxable. Offshore income, in other words, was simply not taxable.¹⁰³ The maximum rate of tax was 10 percent.¹⁰⁴ But the allowances were set so high, and the average income in Hong Kong at that time was so low, that less than 1 percent of the populace were liable to pay any tax at all.

A year later, the War Revenue Ordinance 1940 was repealed and replaced by the War Revenue Ordinance 1941. This left the original system basically intact, but to the original three taxes added a fourth, on interest. It was called, of course, interest tax.¹⁰⁵ The War Revenue Ordinance 1941 also increased the rates of tax, the new maximum being 14 percent.¹⁰⁶ But on 7 December 1941 the Japanese attacked Pearl Harbour and, more or less simultaneously, Hong Kong. On 25 December 1941 the British colonial government surrendered and so its administration of the colony's tax system was temporarily suspended.

In 1945, British rule was restored. In 1946, the Hong Kong government again proposed the establishment of a "normal" income tax, this time as a permanent measure (rather than a temporary wartime one). The business community, of course, was opposed. As a compromise, the peculiar system of taxation devised during the war was resurrected. This was achieved by the Inland Revenue Ordinance 1947, which remains in force today. The Inland Revenue Ordinance 1947 was closely based on the War Revenue Ordinance 1941 and preserved its basic structure. Thus, as before, there was no tax on income as such; instead, there were separate taxes on profits, salaries, rents and interest;¹⁰⁷ and, as before, income derived from outside Hong Kong went untaxed.¹⁰⁸ The maximum rate of tax was 10

⁹⁹ See GHAI, note 13 supra and WESLEY SMITH, note 13 supra.

¹⁰⁰ War Revenue Ordinance 1940, sections 13-26.

¹⁰¹ War Revenue Ordinance 1940, sections 8-12.

¹⁰² War Revenue Ordinance 1940, sections 5-7.

¹⁰³ War Revenue Ordinance 1940, sections 5, 8, 13 and 14.

¹⁰⁴ War Revenue Ordinance 1940, sections 5, 8, 13 and 14.

¹⁰⁵ War Revenue Ordinance 1941, sections 30-35.

¹⁰⁶ War Revenue Ordinance 1941, sections 5, 14, 15, 16 and 30.

¹⁰⁷ Inland Revenue Ordinance 1947, Chapters II, III, IV and V.

¹⁰⁸ Inland Revenue Ordinance 1947, sections 6, 9, 15, 16 and 29.

percent.¹⁰⁹ As before, the allowances were set at levels that entirely exempted 99 percent of the population from tax.¹¹⁰

The only noteworthy change effected by the 1947 Ordinance was that “personal assessment” was added to the four wartime taxes (property tax, salaries tax, profits tax and interest tax).¹¹¹

Since 1947, the Inland Revenue Ordinance has been repeatedly amended, but much less often and much less extensively than tax legislation has been amended in other developed jurisdictions. Virtually all the amendments have been trivial. Consequently, the Ordinance’s basic structure remains almost entirely intact. The only change worth mentioning is that in 1989 interest tax was abolished. This, however, was a less important change than it might at first appear, because (1) throughout the period during which interest tax was imposed (1941 and 1947 to 1989), its scope was curiously narrow (that is, interest was commonly not taxed); (2) the scope of profits tax was widened so as to catch interest in some circumstances; and (3) the rules relating to deductibility were amended so as in various common circumstances to preclude the deduction of interest unless the recipient was obliged to pay profits tax on it.

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¹⁰⁹ Inland Revenue Ordinance 1947, section 5.

¹¹⁰ Inland Revenue Ordinance 1947, sections 13 and 43.

¹¹¹ See above at note 21 and Inland Revenue Ordinance 1947, sections 42-44.

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