TAXATION AND DEMOCRACY IN HONG KONG

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\textsuperscript{1} This report draws on and also repeats some arguments from previous work.
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EXECUTIVE SUMMARY

Introduction
Tax reform is coming in Hong Kong – the question is “when” rather than “if”. The most likely major reform being canvassed is the introduction of Hong Kong’s first ever consumption tax, in the form of a Goods and Services Tax (GST). When a GST is finally introduced (perhaps in 2009) it will represent the most radical taxation reform in Hong Kong since 1947. That was the year when the Inland Revenue Ordinance (IRO) put the territory’s first ever, effective, income tax system into place.

Hong Kong’s revenue law system is widely seen as being out-dated. The Hong Kong Special Administrative Region (HKSAR) is also notable for retaining a comparatively outmoded political system? Given that Hong Kong is plainly, by most measures, a first-world, city-state and has been so for some time, this conjunction of attenuated development in two fundamental public policy, regimes raises several questions:

• First, how has this come to pass?
• Second, what relationship, if any, lies behind the development and maintenance of these two regimes?
• Third, if major tax reform is coming is this bound to add significant impetus to the calls for increased democracy in Hong Kong?

The perhaps surprising answer to the third question is a qualified, “no”. This review explains why. It also provides some answers to the first two questions.

The Political Structure in Hong Kong
The Hong Kong Special Administrative Region (HKSAR) commenced political life, on July 1, 1997, with a deliberately maintained, colonial-style, governance system, following the change of sovereignty from the UK to the People’s Republic of China (PRC). The mini-constitution passed by the PRC Parliament for the HKSAR, the Basic Law enabled Hong Kong’s previous colonial “executive-led” system to continue essentially unchanged.

Nowhere else in the developed world can one find a political structure, in 2005, which retains so many aspects of the late 18th century model on which it is based including, an entirely non-elected Government; a fairly weak, only partly democratic Legislative Council (LegCo); and a comparatively independent judiciary. Like Hong Kong, other developed jurisdictions maintain significant respect for the Rule of Law but, in addition, they have, over time, built democratic, multi-party, representative, systems of government. Hong Kong has what one commentator characterises as a “thin” Rule of Law regime – in contrast to the “thick” Rule of Law regimes applying in almost all other advanced States.

The Revenue Regime in Hong Kong
Hong Kong first introduced an income tax in the War Revenue Ordinance (WRO) in 1940, ostensibly in order to contribute to the financing of Britain’s war effort. Its (short-lived) operation was ended when the Japanese Imperial Army swiftly overran Hong Kong in late 1941, very soon after the bombing of Pearl Harbour. The WRO created a system of schedules, establishing three separate taxes on different categories of income - a property
tax with a flat rate, a salaries tax with progressive rates and a profits tax with a flat rate for corporations and progressive rates for unincorporated firms. The ordinance exempted all offshore income from taxation.

In 1945 British rule resumed and in 1947 a new income tax regime (the IRO) was enacted. The IRO copied all the essential features of the WRO and retains them to this day.

The Hong Kong income taxation system, both in its 1940 and 1947 incarnations, is peculiar in its use of operationally separate schedules. Different taxes are levied on different categories of income rather than a single income tax being levied on a taxpayer's total income. It is also unusual in using a territorial or source-based system where profits or income arising outside of Hong Kong are not subject to taxation.

The Hong Kong revenue regime today encompasses the following key features:

- A narrow taxation base which still relies on operationally separate tax schedules for different types of income – no general income tax;
- Low taxation rates;
- No taxation of income derived from outside of Hong Kong regardless of the residence status of the taxpayer (source-based taxation);
- Simple and relatively stable taxation laws;
- Retention of stamp duties in the system;
- Almost no use (until recently) of Double Taxation Treaties;
- Comparatively constrained government spending;
- Very little government borrowing;
- Infrequent (until recently) deficit budgeting; and
- Massive accumulated fiscal reserves.

Despite its low tax regime, Hong Kong has still managed to provide public housing on a massive scale and to finance excellent transport and communications systems and comparatively sound, education and health systems. At the same time, it has managed to amass public, foreign currency reserves of over $US120 billion.

The explanation for this apparent fiscal miracle has a number of facets. One important explanatory factor has been the fact that successive Hong Kong Governments have had access to a revenue source rarely available in the modern age to most Governments: land. Government land policy has fostered one of the highest densities of any major city in the world. The Government, historically, could – as a monopoly “commodity” supplier - rely on accessing additional revenue by leasing land long-term into a market characterised by ever rising demand. The Government also has taken a large fiscal bite from many secondary market transactions. Ultimately, market forces set limits on the upper level of prices which might be obtained but within these constraints, the Government remained well-placed to
benefit significantly from its continuing, primary role in the real estate market. It is now well recognised, though, that Hong Kong’s narrow (land revenue related) tax base is a serious, systemic, fiscal flaw which needs to be fixed.

**Does Increased Taxation Drive Increased Democratisation**

Numbers of scholars have taken a range of perspectives on the interaction of taxation and political systems. It appears that one of the rallying cries of the American Revolution in the late 18th century, “no taxation without representation” was genuinely galvanising at that time. The better view today, however, is that citizens of the modern world do not, as Ross puts it, “generally rebel against taxation without representation; rather, they appear to rebel against taxation without commensurate government services.” Ross looks at the historical commentary as well as data from 113 countries over more than 25 years before coming down firmly in favour of the “cost-benefit” view of the linkage between revenue systems and political development. A number of other studies have come to similar or supporting conclusions.

In the modern world, in both rich and poor jurisdictions, citizens are concerned about their political rights. But when it comes to taxation, what they apparently seek, when they turn their minds specifically to this issue, is value for the money they pay to government.

Another way of putting this is to presume that the process of linking taxation to political structure development typically goes through two phases. Phase one (as noted by Ross) sees citizens applying a cost-benefit analysis. If they feel broadly satisfied that their form of government delivers fairly effective “goods” (in a mainly corruption free manner) in return for taxes paid, then an increase in taxation may well be deemed acceptable once it is appropriately explained. The process enter phase two where citizens, having completed the phase one reckoning, find that, instead of being broadly satisfied, they collectively and markedly lack fiscal confidence in their particular form of government. In this case, any move to increase taxes may very well result in firm demands for serious political structure reform.

**Conclusion**

We can now address the three questions set out in the Introduction.

*The first question asked how the HKSAR has come to retain both an outmoded political system and an out-dated tax system?* The fundamental, historical drivers of these two public policy “museum pieces” include:

- A powerful, conservative alliance over the last 150 plus years between successive Hong Kong Governments and a range of British and Chinese business and professional elites. (Over the last 25 years, Beijing has increasingly become a key player within this policy-shaping cluster.)

- A reliance by Government on the use of land as a revenue raising, oil-like commodity, to an extent not seen elsewhere in the modern developed world (particularly since World War II).

- The *realpolitik*, which, from 1949, governed Britain’s working relationship with the People’s Republic of China.
• Stunning (“Mini-Dragon”) economic growth rates post World War II (until 1998), which: (a) took Hong Kong’s per capita GDP from below that of India in 1946 to higher than that of Australia with 50 years; and (b) produced full employment and rising wages for an exceptionally adaptable and hardworking, mainly immigrant population.

• A “sojourner” population which tended to see Hong Kong for many years as, most of all, an excellent but still somewhat uncertain, staging post.

• A Government placed under (and which placed itself under) significantly less pressure to develop a “welfare state” of the complexity typically encountered in most other developed economies. (What evolved is system which has been described as the “residual welfare state”.)

The second question asked what relationship, if any, lies behind the development and maintenance of these two regimes? Our answer is that Hong Kong’s under-developed tax system is not primarily a product of the lack of democracy which has been a hallmark of Hong Kong’s colonial-style political system. The research suggests that Hong Kong’s comparatively outmoded taxation and political systems have developed largely in parallel. The explanatory underpinnings of the outcomes we see today are quite similar, however. In particular, elite business groups in Hong Kong have, virtually from the inception of British rule, had an inordinate, self-focussed influence on much public policy development. There is no question that this influence has been particularly important in the mix of factors which has left Hong Kong with such a conspicuous democratic deficit in its system of government. These business-related groups have generally worked in harmony with other key shapers of that system including successive Hong Kong and UK Governments – and Beijing. The influence of these groups on the development of tax policy in Hong Kong has been even more notable.

The third question asked, if major tax reform is coming is this bound to add significant impetus to the calls for increased democracy in Hong Kong? Even though it is now widely recognised that significant reform of both these systems is needed, the answer here, as we noted at the outset, is a qualified, “no”.

The HKSAR Government accepts that reform of both systems is on the agenda, though it takes a different view on the degree of reform required, especially in the case of political reform, than do many commentators. The debate over reforming Hong Kong’s awkward political system has been running with some intensity for well over a decade. The HKSAR Government is, effectively, entirely appointed by Beijing. And LegCo remains seriously flawed as a law making body, most of all because of its system of Functional Constituencies. Hong Kong people know they are ready for full democratisation and they see this as the best long term solution to Hong Kong’s governance shortfalls. What is perhaps most disturbing about the current position is that it prevents Hong Kong from using a “free political market” to choose the best leaders available. It also leaves Hong Kong without a modern, transparent system for replacing an under-performing Government.

The discourse on reforming Hong Kong’s revenue system is of a somewhat different nature to the political reform debate. The discussion about tax reform does not deal with issues as fundamental as how Hong Kong should choose its Government - and elect its Legislature. It remains contentious, of course, but the argument is primarily about the political-economy consequences of different tax policy options and about the legislative and administrative arrangements needed to implement change.
The fundamental issues which need to be addressed as Hong Kong prepares for tax reform include:

1. How can the Government best be “weaned” from its continuing, excessive dependency on revenues derived from land-related transactions?

2. Would Hong Kong benefit from the introduction of a new, general Goods and Services Tax?

3. Is it time to reconsider Hong Kong’s reliance on sourced-based or territorial taxation?

4. Is it time to consider replacing the schedular system in the IRO with a single, general income tax?

5. Should other reforms be considered in order to widen the tax base?

6. How can the tax burden be shared most fairly under any reformed system?

Item one is perhaps most important of all. The “transformation” of land into an oil-like, government monopolised commodity in Hong Kong was not without its benefits in times past. But these benefits have come at an increasing cost. The “use by” date for this genuinely extraordinary system has passed.

Our research suggests that, prima facie, the HKSAR Government is well placed, based on Hong Kong’s sound, historical fiscal record, to proceed with taxation reform as a project largely separated from the process of political reform. The erosion of the credibility of government in Hong Kong, post-1997, raises doubts about whether this conclusion holds so well today, however. The HKSAR Government knows, too, that its unelected status fundamentally undercuts its legitimacy. All of which has tended to make the Government, overall, rather timid when it comes to much major policy development and implementation. The irony is perhaps, that although the historical track record suggests strongly that the Hong Kong Government enjoys a comparatively sound record fiscally, the Government’s own behaviour, post-1997, betrays a recurring lack of fundamental confidence. In other words, although the literature - and history - indicate the Hong Kong Government is comparatively well placed to initiate major tax reform as a stand alone project, the Government, itself, does not feel as if this is the case.

Given this political reality, the most sensible way forward would be to mesh serious tax reform in Hong Kong with meaningful political reform. This would assist the implementation of tax reform and boost Government credibility. More importantly, it would be in the best interests of Hong Kong.
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GLOSSARY OF ABBREVIATIONS USED

NOTE: All web-based sources cited were available at the time of writing. Hard copies of web-based source materials have been retained by Richard Cullen.
1.0 INTRODUCTION
Why does Hong Kong retain, in 2005, both a surprisingly dated taxation system and a comparatively outmoded political system? This question is all the more pertinent given that Hong Kong is clearly, by most measures, a first-world city-state and has been so for some time. A natural follow up query is, what relationship, if any, lies behind the creation and maintenance of these two fundamental, public policy, regimes? This report provides some answers to these two questions.

In the next Part we provide an overview of Hong Kong’s political structure and its taxation system. We explain how these two regimes have developed and how they compare with comparable systems elsewhere in the developed world. In Part 3, we provide a review and analysis of the literature on the interaction between revenue regimes and general governance systems across a significant range of jurisdictions. This segment of the report provides the means to appraise the rather special Hong Kong experience – in Part 4 of the report. Part 5 is the conclusion where we summarise the findings of the report and document a number of comments, questions and recommendations.

2.0 KEEPING IT SIMPLE
2.1 The Political Structure in Hong Kong
Prior to the arrival of the British in 1841, Hong Kong was home to a series of scattered Chinese fishing and farming communities. For over 150 years, the British maintained Hong Kong as an enclave, plainly separated from Mainland China. In July, 1997, sovereignty over Hong Kong reverted from the UK to the People’s Republic of China (PRC). We are now approaching the 10th anniversary of Beijing’s resumption of dominion over what is, today, the Hong Kong Special Administrative Region (HKSAR) of the PRC.

By 1841, something of a peaceful political revolution had been achieved in the UK. Momentum for reform built after the loss of the American colonies under George III in 1783 and his death in 1820. The Reform Act (1832) introduced major parliamentary changes. Parliamentary government – where Parliament became the supreme repository of power and the Monarch was reduced to a largely figurehead role - was established at this time.

2 The key documents governing the reversion of sovereignty over Hong Kong from the UK to the PRC are: The 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, signed 19 December 1984 (Joint Declaration); and the Basic Law of the Hong Kong Special Administrative Region of the People’s Republic of China (Basic Law). The Basic Law was adopted by China’s Parliament, the National People’s Congress, and promulgated on 4 April 1990. The primary commentary on the Basic Law is Ghai, Yash, Hong Kong’s New Constitutional Order (2nd ed.) (Hong Kong University Press, Hong Kong, 1999).

3 The political entity we know today as the United Kingdom was established as a result of the Act of Union (1800) which created the United Kingdom of Great Britain and Ireland (and terminated the Parliament of Ireland and gave Ireland representation in the new Parliament of the United Kingdom (see, Walker, David, The Oxford Companion to Law (Clarendon Press, Oxford, 1980) 1250-1251)). Great Britain was the political entity formed by the Acts of Union (1706 and 1707) which joined England and Wales with Scotland (ibid., 536).

4 When the Treaty of Paris recognised the US as a nation.

5 Walker, op. cit. note 3, 927. It is interesting to note the comparative responses to the outcome of the American Revolution (1775 – 1783). The victorious US and defeated Great Britain both recognised the flaws in the political structure prevailing during the reign of George III. A still powerful Monarch participated (disastrously as it transpired) in major political decision-making and he was able to pass on his significant political powers to his offspring. The US answer, minted by 1788, was, at a fundamental level, to create a still very powerful President – an “elected Monarch”, almost – but one who, though independent, was answerable in certain circumstances to the US Congress under the Constitution of the United States (1788) and who was also subject to the operation of the Bill of Rights (1791), as interpreted by the constitutionally independent US Supreme Court (see, Constitution of the United States, The Penguin Concise Columbia Encyclopedia (Penguin, Harmondsworth, 1987) 194). The UK answer came some decades later, as noted in the text. Essentially the UK approach stripped virtually all political power from the Monarch and transferred it to a Government within Parliament. This left the Monarchy formally intact – but as a figurehead. The Government, meanwhile, was to be constrained by
When British rule in Hong Kong commenced it was never envisaged that decision-makers would have to be held accountable to colonial subjects in any significant political sense. By the 1850s, the UK had begun to introduce forms of parliamentary government into some, mainly “white” colonies within the British Empire.6 “Non-white” colonial possessions, including Hong Kong, normally did not qualify for this form of representative government, however.7 The applicable colonial governance system in these cases might be termed the “George III model”: a powerful executive Governor was teamed with a relatively weak, usually appointed, legislature and a comparatively independent judiciary.8

Right through until the handover in 1997, Hong Kong retained a colonial-style system of government where the Governor and his senior bureaucrats acted as combined ministers and administrators. They were accountable in an administrative sense to their superiors and the bureaucrats had to abide by civil service regulations, but neither the Governor nor his senior officers were accountable politically.9 They were answerable in the sense that they provided answers to the public directly and via the legislature.

Hong Kong’s first ever Legislative Council (LegCo) was established by 1843. It comprised four members, one of whom was the Governor, who was also the President of LegCo.10 Legco was expanded steadily over the following 140 years but all LegCo members remained appointed until 1985 when the first ever, limited, non-direct election of members occurred.11 By this time LegCo had increased to a total of 57 “Official Members” and “Unofficial Members”.12

In 1991, the first 18 directly elected members joined LegCo in accordance with the agreement reached between the UK and the PRC on the limited political development allowed in Hong Kong prior to the 1997 handover.13 The 1995 LegCo was, effectively, fully elected, under the reforms introduced by the last British Governor of Hong Kong, Chris
Patten. These reforms were bitterly opposed by Beijing which replaced the 1995 LegCo with a Provisional Legislative Council (PLC) for approximately one year from July 1, 1997. In 1998, a two year, partly, directly elected LegCo replaced the PLC. At the most recent LegCo elections in 2004, 30 of the total of 60 LegCo members were returned by direct elections and the remaining 30 members were returned under the (British introduced) Functional Constituency (FC) system.14

From the outset, Legco’s powers were limited and to this day, they remain curtailed. In particular, LegCo members have only very restricted rights to introduce new legislation (most legislation must be introduced by the HKSAR Government) and the voting rules for LegCo provide that whenever legislators propose motion debates, new laws or amendments to government legislation, these can only be passed if separate majorities of FC members and directly elected members are achieved.15 Hong Kong laws are, thus, not made by a fully representative, primary law making body. Moreover, LegCo has inadequate powers to hold the still, effectively, entirely Beijing-appointed HKSAR Government properly to account.16

The governance system that ultimately evolved in Hong Kong under British rule was something of a hybrid – part presidential, part parliamentary - but embedded in an enduring colonial tradition. Like the US, Hong Kong placed a great deal of power outside the legislature. In Hong Kong, power used to rest in the hands of the Governor, and now the Chief Executive. That said, the dominant influence has been the UK parliamentary tradition. This explains why LegCo has been able, over time, to build a de facto capacity to hold the Government to account, to a degree, in a quasi-parliamentary manner.

The HKSAR thus commenced political life with a deliberately maintained, colonial-style governance system. The Basic Law enabled the colonial “executive-led” (that is, civil service-led) system to continue essentially unchanged. The Basic Law envisaged that, together with the Chief Executive, civil servants would continue to play the most important political role in post-1997 Hong Kong. Article 48(5) refers to a number of senior official posts, most of which were filled by civil servants, as “Principal Officials.”17 The administrative apparatus and the Chief Executive together make up the “Executive Authorities,” which is the HKSAR Government.18 While the Basic Law provides that the HKSAR Government is “accountable” to the legislature, it does not incorporate the notion of political accountability.19 Article 99 also makes it clear that “public servants” (a category that includes civil servants) are responsible to the HKSAR Government and not to the legislature.20

14 History of the Legislature, at: http://www.legco.gov.hk/general/english/intro/hist_lc.htm. For a detailed review of Hong Kong’s democratic development and especially the development of LegCo since World War II, see, generally, Sing, ibid. For a comprehensive review of the background to and operational drawbacks of Hong Kong’s Functional Constituency system see: www.civic-exchange.org under “publications”. Note, in particular (at this website): Young, Simon N. M., Hong Kong’s Functional Constituencies: Legislators and Elections; Sing, Ming, To What Extent have the Members of the Functional Constituencies Performed the Balancing Role; Young, Simon, N. M. and Law, Anthony, A Critical Introduction to Hong Kong’s Functional Constituencies; and Li, Gladys and Kat, Nigel, Functional Constituencies: The Legal Perspective. Civic Exchange also has a comprehensive book on FCs due for publication in 2005 (Loh, Christine (ed.) Functional Constituencies (Hong Kong University Press, Hong Kong, 2005). This book includes updated versions of the above articles, together with a range of other chapters.
15 See, Article 74 and Part 2, Annex 2, Basic Law.
16 Loh, Christine and Cullen, Richard, Political Reform in Hong Kong (2005) Journal of Contemporary China, 147.
17 The majority of the principal officials were previously civil servants. In almost all cases, they had to resign from their civil servant positions in order to be appointed as Principal Officials. The Director of the Independent Commission Against Corruption and the Director of Audit were not historically employed as civil servants but on contract terms.
18 Basic Law, Articles 59 to 60.
19 Basic Law, Article 64.
20 “Public servants” is a wider term than civil servants and covers legislators, principal officials, appointees to public bodies who are not employed on civil service terms, and mainstream civil servants. LegCo Paper CB(2)1809/01-02(03) provides the official definitions for “civil servants” and “public servants.”
Nowhere else in the developed world can one find a political structure, in 2005, which clearly retains so many aspects of the late 18th century model on which it is based. Like Hong Kong, other developed jurisdictions maintain significant respect for the Rule of Law, but in addition, they have over time built democratic, multi-party, representative systems of government. Hong Kong has what one commentator characterises as a “thin” Rule of Law regime – in contrast to the “thick” Rule of Law regimes applying in almost all other advanced States.

2.2 The Revenue Regime in Hong Kong

2.2.1 Introduction

Hong Kong’s taxation system has remained essentially unchanged in its fundamentals for around 60 years. The primary tax-imposing components in this system have been:

- The Inland Revenue Ordinance (Cap. 112) (IRO)
- The Stamp Duty Ordinance (Cap. 117) (SDO); and
- The Estate Duty Ordinance (Cap. 111) (EDO).

The SDO was originally introduced in 1866 and is the oldest of Hong Kong’s taxation ordinances. The SDO remains an important revenue raising instrument. The EDO dates back to 1932. It was recently decided that estate duty should be abolished in Hong Kong. The SDO and the EDO are discussed further, briefly, below, as are other important sources of government revenue in Hong Kong, including land-transaction revenues. It is the IRO which is the centre-piece of the Hong Kong tax regime, however, so it is the IRO which we need to consider in the greatest detail at this point.

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21 There is considerable debate about the exact meaning of the Rule of Law. Peerenboom deals with these concerns well when he argues that: “Debates about the meaning of the Rule of Law should not blind us … to a broad consensus as to its core meaning and essential elements. At its most basic, Rule of Law refers to a system in which law imposes meaningful limits on the State and individual members of the ruling elite, as captured in a notion of a government of laws, supremacy of law and equality of all before the law.” (Peerenboom, Randall, A Government of Laws, Democracy, Rule of Law and Administrative Law Reform in the PRC (2003) 12 Journal of Contemporary China, 45 (at page 51).) It is difficult, too, to argue with the British (left-wing) historian E.P. Thompson who wrote that the Rule of Law is a “cultural achievement of universal significance” (Thompson, E.P. Whigs and Hunters: The Origin of the Black Act (Pantheon Books, New York, 1975))

22 See: Peerenboom, ibid.; and Peerenboom, Randall, China’s Long March Toward Rule of Law (Cambridge University Press, Cambridge, 2002). Peerenboom draws a useful distinction between “thin” and “thick” versions of the Rule of Law. His arguments in this regard are most completely set out in Peerenboom-2002. See also the following review of this book: Fu, Hua Ling, Review: China’s Long March Toward Rule of Law (2004) 34 Hong Kong Law Journal, 205. Briefly, a thin Rule of Law regime is characterised by: clear procedural rules for law making; publicly promulgated laws; no retrospective laws; laws made by a duly authorised law-making entity; relatively clear, consistent and stable laws; and fairly enforced laws. A thick Rule of Law regime enjoys important additional (political morality) features, typically including: democratic government; advanced protection for human rights and certain stipulations about property and economic system rights. See also, Goodstadt, Leo F., Uneasy Partners (Hong Kong University Press, Hong Kong, 2005) 12-13, where the author notes that that the colonial administration created a unifying ideology based on two principles, the Rule of Law and the economic doctrine of laissez-faire. See, too, Cullen, Richard, The Rule of Law in Hong Kong, at: http://www.civic-exchange.org/publications/2005/rolawe.pdf. Another advanced polity which has a limited system of democracy is Singapore. The People’s Action Party (PAP) has dominated politics in Singapore since self government was achieved in 1959 (full independence – from the Malaysian Federation – came in 1965). It has never been out of power and has never faced other than a very small number of opposition members in Parliament (see, Political Forces, at: http://www.economist.com/countries/Singapore/profile.cfm?folder=Profile%2DPolitical%20Forces).

23 Enactments in Hong Kong have always been (and are still called) “Ordinances”, rather than “Acts”. The term ordinance signifies (amongst other things) in Anglo Common Law, a form of delegated legislation, such as the laws passed by an inferior, colonial legislature (Walker, op. cit. note 3, 906).

2.2.2 Origins of the Inland Revenue Ordinance

Hong Kong first introduced an income tax in 1940, ostensibly in order to contribute to the financing of Britain’s war effort. This original taxation system lasted only briefly until Japanese occupation in 1941. In 1945 British rule resumed and in 1947 a new income tax regime, along the lines of its war-time predecessor, was instituted. This taxation system has remained in place and essentially intact up to the present day.

The Hong Kong income taxation system, both in its 1940 and 1947 incarnations, is peculiar in its use of operationally separated “schedules”. Different taxes are levied on different categories of income (with a separate schedule for each category of income) rather than a single income tax being levied on a taxpayer’s total income. In 2005, this is unusual – but it was also becoming atypical much earlier than this. By the mid-20th century the trend towards levying income tax as a single tax on all forms of income was well established across many jurisdictions. It remained common, even when all income was subject to tax under a general income tax, that different taxation rates might apply to different types of income (for example income from property and income earned by incorporated taxpayers (companies) was often taxed at different rates from income derived from personal exertion (salaries and wages). The use of differential rates could, to a degree, replicate the impact of different schedules. A key difference, however, is that under a schedular system such as that adopted and still used in Hong Kong, not only may rates differ according to which schedule applies, but if you have income which does not fit within any schedule (for example, income from interest on deposits or dividend income) then such income remains entirely outside the income tax net.


26 The nature of schedular systems of taxing income (compared to systems imposing a general income tax) is discussed in, Holmes, Kevin, The Concept of Income – A Multi-Disciplinary Analysis (IBFD, Amsterdam, 2001) 28-33. Littlewood-2002 (ibid.) argues that a schedular system such as that operating in Hong Kong can work successfully “so long as rates of tax are low, but it will not support higher rates of tax on higher incomes.” With high rates, the system becomes inequitable. When multiple classes of income are taxed independently at progressive rates, an individual whose income consists entirely of, for instance, profits will pay more tax than an individual whose income consists of both profits and, for instance, property rents. He continues “If the rates of tax are low, the inequities will be small and so may be tolerable. But the higher the rates of tax, the greater will be both the injustice and, consequently, the political cost of administering the system.” This argument can be questioned, however. Australia, for example, has long relied on a tax applied to total income (rather than separate schedules of income). Within that system, though, it has been normal that the tax rates applicable to income from exertion have had far higher top rates than the tax rates paid by incorporated taxpayers (including essentially individual “incorporated” taxpayers). In 1936, Australia’s Federal Government introduced new tax legislation. (It was meant to usher in a uniform tax system with State cooperation. It failed to do so. Later, during World War II, the Federal Government effectively imposed uniform income tax laws on the States.) This legislation (the Income Tax Assessment Act (1936)) makes a useful point of comparison as it provided the framework for income taxation for decades after in Australia and it is still an important component in Australia’s current income tax regime (see: http://scaleplus.law.gov.au/html/pasteact/2/3036/pdf/ITA1936Vol01.pdf.) Under the 1936 tax legislation, the flat tax rate imposed on incorporated taxpayers was 5%, the top tax rate imposed on personal exertion income was almost 29% (for incomes over 6,900 pounds) and the top tax rate imposed on income from real property (typically, rents) was just under 34% (for taxable income over 3,700 pounds). Thus high wealth individuals were expected to pay tax at almost six times the rate applying to companies on the upper portion of their incomes and individual property owners were taxed at a rate almost seven times that applying to companies on high end property income (arg, Baldwin, A.J., and Gunn, J.A.L., The Income Tax Laws of Australia (Butterworth & Co., Sydney, 1937) 1076-1079). The actual tax rate discrepancies applying under the Australian system have varied over time (and the separate tax rates applying to property income have gone) but significant discrepancies in applicable tax rates have characterised Australia’s uniform tax system for almost 70 years now. This level of discrepancy has produced strains and continues to attract criticism: “A large gap between the top personal income tax rate and the company tax rate creates an incentive to redefine personal income as company income” (Shorten, Bill, An Alternative Vision for Australia – Building our Nation, at: http://www.fabian.org.au/library/event_papers_2005/1118116108_23303.html). Despite this long history of significant tax rate divergence, the Australian tax system has remained politically workable over many decades,
It has been strongly argued that the central explanation for the adoption and retention of this unusual, indeed archaic, system for taxing income is the role played by Hong Kong's business elites in influencing and constraining the development and reform of the taxation system.\textsuperscript{27}

The first moves to introduce an income tax in Hong Kong came in December 1938 when Governor Northcote established the Taxation Committee to look at the possible adoption of income taxation in the jurisdiction. The committee was constituted largely by representatives of the colonial business and banking elites. The one Chinese member of the committee, Lo Man-kam, an anglophile solicitor, enjoyed a close relationship with the colonial authorities. The "prevailing British wisdom" held that an income tax in the mould of those found in Britain and other developed jurisdictions was the only "sensible recommendation the committee could make." Indeed, Northcote's creation of the committee was ultimately motivated by a need to "oblige the leaders of the business community to share the responsibility for this unpalatable truth." As expected, the committee recommended that an income tax be introduced.\textsuperscript{28}

In September 1939, when the UK declared war on Germany, the Governor pushed ahead with his plans to introduce an income tax in order to contribute to Britain's war effort. An Income Tax Bill designed to establish a single tax on all income was prepared. The Chinese business community was "vehemently opposed in principal to any form of tax on income. In particular, they were opposed to any tax at all on business profits." Their stance quickly attracted the support of the expatriate business community.\textsuperscript{29}

The Hong Kong business elite, both expatriate and Chinese, had enjoyed influence in the colonial administration for some time. In the mid-19th century, expatriate merchants had pressured the Colonial Government into allowing the hongs, large trading houses, to nominate representatives to the LegCo. This practice continued into the 20th century when the Unofficial Members of LegCo typically represented Hong Kong's wealthy manufacturers, banking families and the British professional class.\textsuperscript{30}

While the Governor could constitutionally override dissent amongst the Unofficial Members, he chose, instead, to convene a War Revenue Committee in order, "to cement the private sector's position that it was only because of the war that extra revenue was required."\textsuperscript{31} It was also argued that British sensitivity was heightened by the fact that the revenues "were intended not to be spent for the colony's own direct benefit, but to be transferred to Britain."\textsuperscript{32} This committee proposed only a "partial income tax" and while the colonial authorities "regarded the committee's proposal as barely adequate, even as a temporary wartime measure," they nonetheless adopted the proposal.\textsuperscript{33}

The War Revenue Ordinance (1940) created a system of schedules, establishing three separate taxes on different categories of income - a property tax with a flat rate, a salaries
tax with progressive rates and a profits tax with a flat rate for corporations and progressive rates for unincorporated firms. The ordinance exempted all offshore income from taxation.\textsuperscript{34}

In drafting the ordinance, the War Revenue Committee copied, it is said, the schedular British income tax system introduced by Prime Minister Addington in 1803, despite the fact that the British system itself had been reformed in 1910 to base tax liability on a taxpayer’s total income. In Littlewood’s view, the committee chose to copy a system which Britain, “had effectively discarded thirty years earlier” because the representatives of business believed the separated schedular structure would reduce the possibility of future increases in tax rates.\textsuperscript{35}

The newly established tax system met significant criticism from the authorities in Britain and the War Revenue Committee was reconvened the following year. The War Revenue Ordinance (1941) replaced its predecessor and introduced small changes, including the introduction of an additional interest tax and an increase in the maximum rate of taxation.\textsuperscript{36} The new ordinance, however, was short-lived. In December 1941, six months after its adoption, Hong Kong was occupied by the Japanese.

Following the war and a return to British rule, the Hong Kong Government again sought to implement a general income tax. It was said that the Government “regarded it as obvious: (1) that the colony required a peacetime income tax; (2) that the schedular system devised during the war would not suffice; and (3) that the rates of tax should be comparable to those in Britain.” The jurisdiction’s business interests once more, however, opposed any such tax during peacetime. Again, rather than impose an income tax system in the face of such opposition, the colonial authorities established a new committee with business community representation. The new committee recommended, as a temporary measure, the adoption of the wartime tax system.\textsuperscript{37}

The new 1947 tax legislation, the Inland Revenue Ordinance (IRO) “retained the basic schedular structure and the restricted territorial ambit of the War Revenue Ordinance” of 1941. Again, there were separate schedules for salaries, profits and interest originating in Hong Kong. The effective maximum rate of tax was set at 10%, far below the Government’s hoped for maximum rate. The new ordinance differed in one important sense from its predecessor in that it introduced a system of “Personal Assessment” whereby an individual could choose to pay tax (at progressive rates) on his or her total income, rather than use the strict schedular system.\textsuperscript{38}

The Colonial and British Governments regarded the IRO as “profoundly flawed.” They intended: “to scrap the schedular taxes and establish a normal income tax (that is, a single tax on income as such)”; “to withdraw the exemption from tax of offshore income”; and “to raise the rates of tax to levels comparable to those in Britain.” These proposed reforms were, however, abandoned in the coming years. Again, Littlewood puts this down to business opposition. At the same time, British concerns about the system gradually faded as Hong Kong began to raise sufficient revenues to make it no longer reliant on the British treasury.\textsuperscript{39}

\textsuperscript{34} Ibid., 221. This approach was entirely consistent with the 19\textsuperscript{th} century tax policy – favouring sourced-based taxation in the colonies – adopted by the British as their Empire developed (see, Barker, William B., Expanding the Study of Comparative Tax Law to Promote Democratic Policy: The Example of the Move to Capital Gains Taxation in Post-Apartheid South Africa (2005) 109 Pennsylvania State Law Review, 101, at 111.

\textsuperscript{35} Littlewood-2002, op. cit. note 25, 221-222. The perception amongst the business elites that the reliance on separate schedules would help forestall future tax increases may not have been well founded, however – see discussion at note 26.

\textsuperscript{36} Ibid., 222-223.

\textsuperscript{37} Littlewood-2004, op. cit. note 25, 387.

\textsuperscript{38} Ibid., 388.

\textsuperscript{39} Littlewood-2002, op. cite note 25, 227-228.
Since 1947, the IRO has been formally re-examined on three occasions, in 1954, 1968, and 1976, by Review Committees. Yet, no major alterations have been made to the taxation system. One observer has noted that the tax law in Hong Kong has relied for its development, over many years, on a sequence of ad hoc amendments.40 The failure of the Review Committees to foster substantial changes seems to be explained by a combination of business influence (the committees were “dominated by representatives of the colony’s business interest”) and government reticence.41 All of the committees recommended amendments which would have “expanded the scope of the charge to profits tax” to include some level of offshore income.42 The 1954 committee, for instance, recommended that the “scope of the charge [be] widened to include all profits derived from a trade or business carried on in Hong Kong except for foreign taxed profits.” The recommendation and resulting legislation were “effectively nullified from the start by assurances given by the Government to the business community that profits arising outside Hong Kong would continue to be free of tax.” In 1968, an extension of taxation to profits arising outside Hong Kong was again rejected on the grounds that the business community would oppose such a move.43 In 1984, an amendment was finally introduced whereby “interest income of all types of taxpayers ‘arising through or from the carrying on’ of the taxpayer’s business in Hong Kong was deemed to arise in Hong Kong” The amendment received a hostile reception from the business community, however, and was quickly repealed in 1986.44

The 1976 review committee made perhaps the most significant recommendation for reform when it suggested that income tax should be assessed on total income, eliminating the separated schedular system of assessment. In 1978, the Government was still considering this recommendation but, by the following year, the authorities had decided not to pursue such a reform. The Government’s decision was again, it would seem, influenced by the business community’s “firm and vociferous opposition to tax reform.”45

2.2.3 Overview of the Current Revenue Regime

The British established Hong Kong as a “free port” which meant that goods could enter and leave free of any customs or similar duties.46 This continues to be the case today. Indeed, Hong Kong has long prided itself on its low and simple, general tax regime.47 Direct taxes applied to business profits and earned income still remain amongst the lowest in the developed world.48

The regime outlined in Section 2.2.2, as it applies today, encompasses the following key features:49

- A narrow taxation base;
- Low taxation rates;

43 Ibid., 5-6.
44 Ibid., 7.
46 See definition of “free port” at: http://www.answers.com/topic/free-port
49 This outline of the current Hong Kong revenue system summarises and updates a more comprehensive review of the taxes applying in the HKSAR, which can be found in Cullen, Richard, Revenue Law in Hong Kong: The Future in Wacks, Raymond (ed.) The New Legal Order in Hong Kong (Hong Kong University Press, Hong Kong, 1999) Chapter 12.
Separate schedules applying separately identified taxes to different classes of income – no general income tax;

- No taxation of income derived from outside of Hong Kong regardless of the residence status of the taxpayer (source-based taxation);
- Simple and relatively stable taxation laws;
- Retention of stamp duties in the system;
- Almost no use of Double Taxation Treaties (DTTs);\(^\text{50}\)
- Comparatively constrained government spending;
- Very little government borrowing;
- Infrequent (until recently) deficit budgeting; and
- Massive accumulated fiscal reserves.

The main taxes are:

- Profits tax;
- Salaries tax; and
- Property tax.

All of these taxes are imposed, still using separate schedules, by the IRO.

Profits tax, the most important tax, is imposed by Part IV of the IRO. It currently applies at a flat rate of 17.5% to corporations and (usually) at progressive rates (with a maximum rate cap of 16%) to individual taxpayers.\(^\text{51}\) The crucial practical and legal issue is source: only profits which can be shown to have (or which, in a few limited cases, are deemed to have) a source in Hong Kong are subject to profits tax. As the discussion above demonstrates, the adherence to this source rule has been driven, to a large extent, by the desire of businesses, at all levels, to use Hong Kong as a base from which to operate without incurring tax on any offshore operations.\(^\text{52}\) The operation of the source principle in Hong Kong has been the subject of much litigation. Overall, its application has, historically, worked fairly well, however.\(^\text{53}\)

Today, though, the source rule as applied in Hong Kong is coming under renewed stress due to the ease with which increasing numbers of business transactions – especially

\(^{50}\) Hong Kong’s approach to DTTs has been changing since 1997, however. Up until the handover it had entered into virtually no DTTs – apart from a handful of specialised agreements dealing with certain income arising from international transport operations. Today it has a Double Tax Arrangement with the Mainland PRC and another on the way with the Macau Special Administrative Region of the PRC (separate jurisdictions subject to a single sovereign do not enter into “treaties” with one another, hence the “arrangement” nomenclature). It also has DTTs with Belgium and Thailand and is negotiating DTTs with several other EU countries and Vietnam (see, Deloitte Asia Specific: Hong Kong – September, 2005, at: http://www.deloitte.com/dtt/newsletter/0,1012,sid%253D253D2935%2526cid%253D93241,00.html; and, What’s New, at: http://www.ird.gov.hk/eng/new/).


\(^{52}\) The motivation for retaining a source-based taxation system dates back to Hong Kong’s original status as a “free port”. This status meant that Hong Kong was a place where trading business could be done, in the 19th century, without need to be concerned about taxation, either through customs duties or income tax. As the need for some sort of income tax was grudgingly conceded just prior to and after World War II (see discussion above) the impact of the new tax regime was restricted from the outset by the incorporation of a source rule restricting profits tax to profits arising within Hong Kong. This source-based taxation regime has remained highly attractive to business as Hong Kong has, since the 19th century, made the transition from trading port, to manufacturing centre to, nowadays, a sophisticated, mostly service-based economy.

\(^{53}\) Halkyard, Andrew, The Hong Kong Tax Paradox (1998) 8 Revenue Law Journal 1, 20. This article contains a useful summary of the key cases on source.
service-related transactions – can be completed relying primarily on the Internet. The Inland Revenue Department (IRD), which administers the IRO (and the SDO) regularly issues Departmental Interpretation and Practice Notes (DIPNs). One of the most recent DIPNs attempts to address the challenge to the source rule in Hong Kong posed by electronic commerce.  

One commentator recently noted that:

_Ecommerce poses a source based jurisdiction such as Hong Kong with considerable threats. HK has a largely service based economy (80% or more of GDP is from services)._ 

Apart from this new challenge to the source rule, Hong Kong remains, in practice, the last remaining first-world jurisdiction to rely so heavily on a rule which excludes from the tax-net all profits which can be shown to have arisen outside of the jurisdiction. Profits tax remains the most important tax imposed by the IRO, accounting for around 24% of total revenue in 2004.

Salaries Tax, which is imposed by Part III of the IRO, is also an important funding source providing about 13% of total revenue in 2004. Salaries tax applies at progressive rates (2%, 8%, 14% and 20%) but it is subject to a “maximum” or “standard” rate of 16% flat on total taxable income. The salaries tax system, unlike the profits tax regime, allows almost no scope for deductions – but it does provide a series of generous allowances, as a result of which, over 50% of wage and salary earners in Hong Kong are typically exempt from paying any salaries tax. The salaries tax system is also source-based but the specified source

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56 Wong, Antonietta, Unpublished Thesis Manuscript (2005) (on file with Richard Cullen): "Jurisdictions using the territorial system to varying degrees include Bolivia, Costa Rica, El Salvador, Guatemala, Kenya, Malaysia, Nicaragua, Panama, Paraguay, Singapore and Uruguay [see Thuronyi, Victor, _Comparative Tax Law_ (Kluwer Law International, The Hague, 2003) 287]. Singapore uses a form of source-based taxation whereby a resident company is subject to tax on all domestic and foreign source income received or deemed to be received in Singapore. If business operations are conducted in Singapore, then income from those operations is domestic source income. Resident individuals are taxed on their domestic source income and foreign source income received in Singapore. A non-resident individual is not taxed on foreign source income received in Singapore. Malaysia uses another version of territorial or domestic source-based taxation. Resident and non-resident companies do not pay tax on foreign source income, irrespective of whether it is received in Malaysia, except in the case of banking, insurance, shipping and air transport companies which are taxed on their worldwide income. Resident individuals are taxed on their domestic source income and foreign source income received in Malaysia. See: Prabhu, Ajit and Chua Eng Khong, _Operations Test Defines Income_ (2000) 11 International Tax Review 29.
South Africa only replaced its (UK-colonial) sourced-based tax system with a world-wide, residence based tax system following the collapse of the Apartheid system and the swearing in of South Africa’s first non-racial Government in 1994 (see Barker, op. cit. note 34, 111).
58 Ibid.
59 2005/2006 Hong Kong Budget – Tax Rates Card, at: http://www.pwchk.com/home/eng/hktax_rates_card_2005.html. It is often said that Hong Kong applies a “flat tax” to salaries and wages. A true flat tax applies a fixed (flat) rate of tax typically on all income from zero-plus-one-dollar of income to infinite-dollars of income. The Hong Kong salaries tax regime clearly (based on the description above) does not apply a flat tax in this way. The term “flat tax” is, however, often used as a (rather inaccurate) short-hand term in place of the more correct “maximum” or “standard” tax rate.
60 See, Hong Kong Yearbook 2004- The Economy at, http://www.info.gov.hk/yearbook/2004/en/03_05.htm. The most significant single group paying salaries tax is civil servants. Indeed, one could be forgiven for thinking the salaries tax system is Hong Kong was designed, more than anything else, by civil servants for civil servants. The salaries tax system has long either not taxed or taxed very lightly a range of benefits commonly enjoyed by more senior civil servants, such as housing, travel, education and health benefits. In addition, the rates of salaries tax payable have been kept low. See, further, Cullen, op. cit. note 49, 378-379.
rules in Part III, backed up by DIPNs and case law have meant that source is less of an issue than with profits tax.\textsuperscript{61}

The final schedular tax imposed by the IRO is property tax, which applies at a flat rate of 16\% of actual rent received, less a statutory allowance of 20\% for repairs and maintenance. Corporations owning property are exempt from property tax – they pay profits tax on rents received instead. Receipts from property tax accounted for about 0.5\% of total revenues in 2004.\textsuperscript{62}

Stamp duties imposed by the SDO raise between 4-10\% of revenue depending very much on activity in the real estate and share markets.\textsuperscript{63} Betting Duty (on horserace, lottery and football betting) imposed by the Betting Duty Ordinance\textsuperscript{64}, raised some 6\% of total revenue in 2004. Estate and gift duties used, until recently, to be imposed by the EDO but these duties have recently been abolished.\textsuperscript{65} The yield from these duties has been quite low for some time.\textsuperscript{66} Other comparatively minor sources of revenue include: property rates, various fees and duties (such as excise duties on tobacco, alcohol and petroleum products) utility charges and vehicle-related imposts.\textsuperscript{67} More significant, non-taxation sources of revenue include: investment and interest income (on fiscal reserves – see below), and direct land-transaction revenues, which are discussed in some detail below.\textsuperscript{68}

Despite this low tax regime, Hong Kong has still managed to provide public housing on a massive scale, to finance excellent transport and communications systems and comparatively sound education and health systems.\textsuperscript{69} At the same time, it has managed to amass public foreign currency reserves of over $US120 billion.\textsuperscript{70}

\textsuperscript{64} Cap. 108.
\textsuperscript{65} See, Hong Kong – Abolition of Estate Duty, at: http://www.bakernet.com/NR/rdonlyres/3834909F-DAF6-403E-B6E9-ED3DC84F088A/38378/HKAbolitionofEstateDuty.pdf. The argument is that, by becoming one of the first jurisdictions in East Asia to remove death/estate/gift duties, Hong Kong will: help small Hong Kong businesses with cash flow problems; encourage increased location of assets in Hong Kong; and strengthen the HKSAR’s position as a regional funds manager (see, Abolition of estate duty helps promote HK’s asset management business, at: http://www.fstb.gov.hk/eng/sfst/fsst19.html.)
\textsuperscript{66} The Hong Kong Institute of Certified Public Accountants estimated that the EDO typically generated less than 1\% of total government revenues (see, Estate Duty Review Consultation Document, at: http://www.hkicpa.org.hk/professionaltechnical/taxation/submissions/submission_201004.pdf.)
\textsuperscript{68} Ibid.
\textsuperscript{69} Cullen, op. cit. note 49, 386.
\textsuperscript{70} Economy, The Economist, 27 August 2005, 90. These fiscal reserves are known, officially, as the Exchange Fund. The Exchange Fund, today, essentially comprises: (A) the fiscal reserves (money saved from revenues raised but not spent over previous decades) of the Government’s General Revenue Account (roughly 40\% of the Exchange Fund); and (B) the balance of government foreign currency reserves which back the Hong Kong Dollar (HKD) (roughly 60\% of the Exchange Fund). The Exchange Fund is managed by the Hong Kong Monetary Authority (HKMA). The HKMA also manage the quasi-currency board pegging of the HKD to the US Dollar (USD). That part of the Exchange Fund backing the HKD covers about 240\% of all HKD notes and coins in circulation plus certain other securities. It only covers about 30\% of all HKD deposits, however. A Currency Board fixes the exchange rate of Currency A (the HKD in this case) to an “anchor”, much stronger Currency B (the USD in this case) at a fixed rate and promises to convert cash and equivalent holdings of Currency A to Currency B at any time at the fixed rate (see, http://users.erols.com/kurrency/intro.htm). It is argued that Hong Kong does not have a real Currency Board system because, amongst other things: (a) the HKMA manages the HKD other than in accord with strict Currency Board principles; and (b) the HKMA (unlike a true Currency Board) also operates like a Central Bank, in certain respects – by regulating the banking and financial systems. See, further, An Introduction to the Hong Kong Monetary Authority, at: http://www.info.gov.hk/hkma/ar2004/english/summary/summary_eng.htm; Hong Kong Yearbook 2004 – The Exchange Fund, at: http://www.info.gov.hk/yearbook/2004/en/04_12.htm and Lo, Chi, The Demise of the Hong Kong Dollar, at: http://www.chinabusinessreview.com/public/0303/commentary.html. The recent, unprecedented
The explanation for this apparent fiscal miracle has a number of facets. First, the Hong Kong Government has had access to a revenue source rarely available in the modern age to most Governments: land. Hong Kong is not large at around 1,000 square kilometres. And, until relatively recently, one had to live and work within this small area if one wished to make a life based in Hong Kong.\textsuperscript{71} From its inception, British Hong Kong did not allow (virtually) any sale of freehold land.\textsuperscript{72} All land was made available as leasehold land. Moreover, the practice grew of restricting the availability of land for development. This tended to drive up the price of land (towards the upper limits of what the market would accept) and revenue receipts.\textsuperscript{73} 

The reliance on land-related revenues in Hong Kong follows a pattern established by the British by the early 19\textsuperscript{th} century – arguably in response to the unhappy experience of attempting to impose long-distance, London-devised taxes in the British–American colonies in the second half of the 18\textsuperscript{th} century. This tax approach culminated in the loss of those colonies and the establishment of the United States of America.\textsuperscript{74} In essence, this new system sought to fund the establishment of new British Empire colonies by relying, primarily or significantly, on the disposal of (appropriated or discount-purchased) Crown land by Colonial Governments.\textsuperscript{75} 

The entire land management system has become self-reinforcing and, arguably, financially addictive (for the Government).\textsuperscript{76} Government land policy has fostered one of the highest population densities of any major city in the world. Hong Kong has more skyscrapers, at over 7,400, than any other city on the planet, including New York.\textsuperscript{77} The majority of these are residential. This density has allowed the provision of first rate transport and communications.

The heavy reliance of the HKSAR Government on deficit financing (discussed in the text shortly) has been paid for out of the Government’s fiscal reserves in the Exchange Fund. Unlike in the case of accessing additional revenues through extra taxation, where the approval of LegCo is mandatory, the HKSAR Government can access the fiscal reserves without need to seek LegCo approval.\textsuperscript{77} Since the 1980s, Hong Kong entrepreneurs have been transferring their manufacturing and other businesses to the Mainland (and especially to the adjacent Province of Guangdong). Since the 1990s, numbers of individuals have begun to commute to Hong Kong from the now vast city of Shenzhen directly across the border. Shenzhen has seen its population grow from under 100,000 to over 7 million plus in less than three decades. See, http://pdf.sznews.com/szdaily/2001/0418/1.htm. 

\textsuperscript{72} The Hong Kong Anglican Cathedral occupies freehold land. Landholders in the New Territories have also historically been allowed, by the Government, to enjoy certain special rights to land based on ancestral rights which derive from membership of long established communities in the New Territories. 

\textsuperscript{73} In 1995/96, as the last “bubble” real estate market was approaching its peak during the last years of British rule, the Hong Kong Government derived some 32\% of total revenues from land-related transactions (including sales, lease modification premiums and stamp duties – but not including profits tax and salaries tax arising directly from the real estate sector) see, Loh, Christine, \textit{The Government’s High-Land-Price Policy: Can Hong Kong People Afford it?} at: http://www.citizensparty.org/housing/landpric.html. See, too, Bell, Daniel A, \textit{Hong Kong’s Transition to Capitalism} at: http://www.findarticles.com/p/articles/mi_qa3745/is_199801/ai_n8787332. This heavy reliance on land transaction revenues in Hong Kong has, it would seem, been developed and introduced as a matter of practice. It has been found to work, so the practice has developed further. It has not been developed in accordance with some theoretical, tax policy plan. The practice, nevertheless, bears some resemblance to the theories propagated by Henry George, the 19\textsuperscript{th} century American economist and social reformer who long advocated the introduction of a single tax on the unimproved value of all land to replace all other taxes. See, http://www.answers.com/topic/henry-george. See also, Smith, Julie P., \textit{Taxing Popularity: The Story of Taxation in Australia} (Federalism Research Centre, Canberra, 1993) 18-24. A Henry George follower, Lizzie Magie, created the board game Monopoly in 1904 to demonstrate his theories (http://www.answers.com/topic/henry-george).

\textsuperscript{74} See discussion in Section 2.1, above and Section 3.2.2 below. 


\textsuperscript{77} \textit{Tall Buildings}, The Economist, 9 April 2005, 90.
systems with greater speed and lower cost than would otherwise have been the case. It has also, originally incidentally and now as a matter of policy, left the greater part of Hong Kong’s total area either subject to low density use or zoned as public (mostly park) areas.78

Government policy has, predictably, had a significant upward impact on the price of land. The Government, historically, could always, it seemed, rely on accessing additional revenue by leasing land long-term (as the sole supplier) into a market with ever rising prices. The Government also takes a large fiscal bite from many secondary market transactions. Strict usage conditions are stipulated in each government lease. If a developer purchases an old building wishing to rebuild at say five times the height of the building to be replaced, the developer needs to obtain a variation to the purchased lease. To get this, the developer has to pay a substantial “land premium” to the Government. When one adds in the profits tax paid by developers and all the others involved in construction, transaction based stamp duties and salaries tax paid by those working in the sector, the HKSAR Government has continued to rely, in recent years, on land transaction related revenues for around 50% of its income.79

There are, of course, market limitations on just how high land prices may be influenced by government – even within a comparatively closed system such as that which has operated in Hong Kong. That is, government cannot simply set any price for land it chooses. If a price is too high, then buyers in the market simply will not respond. Thus the Hong Kong Government has had experience with trying to sell commercial land, for example, where there were simply no takers.80 More recently, following the onset of the Asian Financial Crisis (AFC) in mid-1997 the Government found it difficult to sell plots for residential development. Subject to these fundamental constraints, successive Hong Kong Governments have played a significant role – over several decades – in creating conditions which have typically put upward pressure on land values.

An immediate problem thrown up by this system was how to house ordinary people affordably if residential flats are priced, per square foot, at New York or Tokyo levels. The Government’s answer to this dilemma has been to build (generally well located but very basic and cramped) public housing on a massive scale. The land comes at zero nominal cost, as the Government owns all land. Healthy revenues (including from land-related transactions) have, historically, readily funded public housing expenditure. The completed flats have then been let at, normally, no more than 10% of a tenant’s (usually untaxed) income.81 Around 50% of Hong Kong people reside in public housing.82

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78 This does not mean that the Government has especially good “green” credentials. On the contrary, successive Hong Kong Governments have displayed almost a mania for land reclamation from Victoria Harbour and beyond and for massive road and bridge building projects, for example. See, further, Loh, Christine, *Alternative Policy Address 2005-2006*, at, http://www.civic-exchange.org/publications/2004/apa05e.pdf. The fact that Hong Kong has taken a very high density approach to building (thus maximising government land-related revenues) has, by accident more than design, left much of its land area comparatively under-developed or undeveloped.


80 The Hong Kong Government experienced serious difficulties in selling (leasing) land for commercial / industrial use in East Kowloon in the past, for example (discussion with Leo Goodstadt, 30 September 2005). A question arises as to whether this high land price practice arose, primarily, from a carefully considered and implemented policy or whether it is the product of government mostly “learning from doing”. It looks that both factors have played a role. Although it is hard to find evidence of a carefully considered, long-term strategy behind this practice in Hong Kong, it is clear that: (a) this approach was consistent with long-time practice within the colonial British Empire; and (b) the dominant government-business alliance in Hong Kong favoured this approach. See, further, Goodstadt, op. cit. note 22, Chapter VI.

On the day after the handover, on 2 July 1997, the AFC began, when the Thai currency, the Baht, collapsed. The AFC, combined with a range of other factors, triggered a huge collapse in asset values in Hong Kong. These other factors included: (a) competency problems within the new HKSAR Government; (b) a currency, the Hong Kong Dollar, pegged to the United States Dollar via an adapted Currency Board system, and (c) “bubble-economy” property values established during the final years of British rule.

Property prices began to collapse by 1998, shortly after the AFC hit. By 2003, at the height of the Severe Acute Respiratory Syndrome (SARS) crisis, residential property prices had fallen by about 70% from their bubble-market peak. This, in turn, had a devastating impact on the revenue flow to the HKSAR Government. The Government came to rely, over a period of years (and for the first time in living memory) on substantial deficit financing to meet recurrent expenditure. Mass market residential property prices have recovered significantly since the low point in 2003 (up by some 30-40%). Nevertheless, it is well recognised today that Hong Kong’s narrow (land revenue related) tax base is a serious systemic fiscal flaw which needs to be fixed.

The Hong Kong Government has also historically been able to control expenditure quite effectively. Cultural-economic reasons provide an important part of the explanation for this. Briefly, Hong Kong people have long relied heavily on family and related networks to cope with a multitude of life’s exigencies. Moreover, from the 1960s until the 1990s, Hong Kong maintained high economic growth rates sustaining full employment. Also important was the long established reluctance of the Government to introduce more comprehensive programmes to tackle endemic social justice deficiencies within Hong Kong.

This combination of factors meant that the Government was put under (and placed itself under) significantly less pressure to develop a “welfare state” of the complexity typically encountered in most other developed economies. What evolved is a system which has been...
described as the “residual welfare state”. The rate of public welfare spending has been increasing, however. Hong Kong’s ageing population and rising social welfare expectations help explain a significant part of this growth. It is in the area of transfer payments (direct payments by government to individual citizens) that welfare budgets in other developed countries have seen the greatest growth and where they typically exceed direct public welfare spending (typically on public welfare infrastructure, like housing, schools and hospitals) significantly. Until the 1990s, Hong Kong was notable for its comparatively low level of transfer payments. From the mid-1990s, welfare spending of all kinds (including transfer payments) began to rise in Hong Kong. More recently, welfare spending has been cut back in Hong Kong as part of the efforts by the Government to curb its reliance on deficit financing of current expenditure. Goodstadt argues that Hong Kong’s social spending policies have long been and remain deeply flawed – a position made all the more indefensible given the HKSAR’s massive fiscal reserves and familiarity with world-wide best practice.

Another factor of some importance is the Hong Kong Jockey Club (HKJC) (formerly the Royal Hong Kong Jockey Club). The HKJC is a not-for-profit organisation which has long held a monopoly granted by the Government to run all legal gambling activities in Hong Kong. In 2003 the HKJC had a turnover of around US$9 billion. The HKJC typically contributes over 10% of HKSAR Government revenues in the form of betting duties and other taxes. Also significant is the major public spending programme of the HKJC based on its operating surpluses. Hong Kong is dotted with hospitals, educational establishments and a substantial number of other public facilities all funded in full or in part by the HKJC.

What this review demonstrates is that Hong Kong has, for decades, maintained a remarkable reliance on a distinct schedular taxation derived, originally, from the early 1800s UK income tax system. Moreover, profits or income arising outside of Hong Kong are not subject to tax within the HKSAR. In relying so heavily on the use of both separately operating schedules and source-based taxation as fundamental principles, Hong Kong is in company, in 2005, with a small minority of other jurisdictions. Countries such as Belgium, Colombia, Croatia, and Mexico have now moved from a schedular system to widen the tax
base in each case. Furthermore, unlike most other developed jurisdictions, Hong Kong imposes: no tax on capital gains, only very limited taxes on fringe benefits and; no general tax on the provision of goods and services. A key reason Hong Kong has been able not only to fund public spending, but to put away substantial fiscal reserves, whilst relying on such a taxation system, has been the major revenue streams from land-related transactions, where the Government deliberately positioned itself as a monopoly supplier of this vital “commodity”. Moreover, in difficult years, such as those after 1997, when revenues have fallen short of spending, the Government has been readily able to cover shortfalls by accessing accumulated reserves – a process which has not required LegCo spending approval.

In summary, Hong Kong has survived and, indeed, thrived, into the 21st century whilst relying on a revenue regime which would not have been out of place in the 19th century.

### 3.0 THE RELATIONSHIP BETWEEN TAXATION AND DEMOCRACY

#### 3.1 Introduction

In this Part, we review, in some detail, the understanding which has developed about the relationship between government revenue collection and the development of systems of government. Much of what has been written concentrates on the historical development of taxation regimes and political structures within the “European World”, including Europe itself and numbers of its “outposts”, including the US and Australia.

A wide range of perspectives has been taken and there is no firm and final view on how taxation systems have shaped political structures and vice versa. Some fairly clear trends are evident, however. First, both taxation systems and political systems have become far more complex over time. Next, an early emergent trend was a realisation amongst even autocratic rulers (normally Monarchs) that that there were limits to how much tax could be extracted by the imposition of the Royal will (backed up by force) – Kings discovered, centuries ago, that they had to negotiate to some degree with their taxpayers. As the feudal era passed in Europe and the modern industrial-capitalist era commenced, this trend grew

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101 Section 14 of the IRO, which imposes profits tax, specifically excludes capital profits from assessment of profits tax. Section 14 does tax “trade”, however, and the case law – and the IRO definitions section (Section 2) – stipulate that this term includes “an adventure in the nature of trade”. Thus one-off transactions can still be regarded as “trading” in certain circumstances (normally fairly rapid re-selling of real estate) and taxed accordingly. See, further, Cullen, op. cit. note 49, 376-377.

102 Reduced taxes apply to the provision of employee housing and certain education and share benefits. Otherwise, the “cash-convertibility” rule applies. This rule, which is based on old English case law, provides that provided an employee fringe benefit is not paid in cash and cannot be converted to cash by the employee, then it will not be considered a perquisite which can be taxed as part of salary (see, further, Cullen, ibid., 378-379).

103 It is arguable that the Hong Kong Government’s long established, high land price policy has imposed a “de facto” GST (Goods and Services Tax) on all consumers in Hong Kong. Inflated land prices (which have benefited the Government most of all) have driven up the costs of doing almost every sort of business in Hong Kong because of high rents or high initial land-purchase costs. These input costs have then been passed on to all consumers as prices for goods and services have been set. The introduction of a GST in Hong Kong is now a widely discussed new tax option (see, for example: The HKSAR Government may beat its target by balancing the books before 2008/2009, PricewaterhouseCoopers predicts, at: [http://www.pwchk.com/home/eng/pr_170105.html](http://www.pwchk.com/home/eng/pr_170105.html); and Ching, Stephen, GST and Government Bond, at: [http://www.tdctrade.com/econforum/hkcer/hkcer040601.htm](http://www.tdctrade.com/econforum/hkcer/hkcer040601.htm)).

104 See discussion at footnotes 70 and 86.
significantly. Finally, as we entered what might be termed the late-modern era, a “value for money” test of tax-acceptability appears to have taken hold. Citizens are more concerned than ever about their political rights, world wide – but they are apt to apply separate, tax-specific, assessments as the primary method of rating the acceptability of the tax system they live under.

This Part focuses, initially, on the development of taxation and governance systems in Britain over the last several hundred years and reviews the growing need Governments have faced to obtain “consent” to taxation. We then consider later political influences on the development of tax policies across a range of developed jurisdictions. Finally, we analyse the nature of the relationship between taxation and democracy today; and provide a practical, comparative review of how the challenge of funding government interacts with political development.

3.2 The Development of Taxation and Representative Institutions

3.2.1 Taxing Monarchs – An Historical Overview

A number of writers have argued that the development of representative institutions is closely tied to issues of taxation. Bates and Lien consider the development of early taxation in Western Europe where Monarchs sought increased revenues in order to wage wars. Bates and Lien cite Prestwich’s work on Edward I’s reign in England which was, according to Prestwich, characterised by a search for new taxes. Traditional sources of revenue were inadequate to fund new wars and pay the Monarch’s soldiers. Edward therefore introduced new taxes on trade and “moveables.” These new taxes provided large revenues, far greater than those from traditional taxes. However, as Bates and Lien note, because the taxed goods were moveable, the new taxes could be avoided (assets such as cows, oxen, grain, household goods, and other possessions could be transferred from place to place and hidden). Thus, Bates and Lien suggest, Monarchs such as Edward had to bargain with those who possessed property rights over the moveable tax base. In exchange for increased taxes, Monarchs agreed to share control of public policy. As Bates writes elsewhere, “The owners of taxable assets exchanged tax payments for public policies; and the forum for these trades became Parliaments. The taxation of moveable assets thus led to the surrender of executive control over the public domain.”

Bates and Lien also cite Quesnay and Mirabeau who reached similar conclusions during the 18th century when they wrote on the taxation of commerce:

“In whatever place he may live, he will always enjoy the immunity which is inherent in the scattered and unknown character of his property…It would be useless for the authorities to try to force him to fulfil the duties of a subject: they are obliged, in order to induce him to fit in with their plans, to treat him as master, and to make it worth his while to contribute to the public revenue”


Bates and Lien, ibid., 57.


Two important observations arise from Bates and Lien’s model of bargaining over tax rates and control of public policy. First, their model suggests that those sectors of the economy that are more elastic or mobile will have greater bargaining power vis-à-vis the Monarch. “Those sectors that possess more mobile factors will have greater control over public policy.”

A corollary of this is that the Monarch is likely to impose higher taxes on those citizens who possess less mobile assets and factors. Second, this model assumes that citizens have preferences not only about rates of tax, but also about government policies. Citizens’ efforts to satisfy both preferences have, thus, lead them to bargain with Monarchs.

Hughes and Oates suggest that bargaining over political representation and taxation occurred even before Edward’s reign, under John I. The first taxes on moveable property, they write, were introduced by John in 1166, a “tax of six pence in every pound’s worth (approximately one fortieth) of annual income and of chattels was taken from all laymen and clergy for the relief of the Holy Land.” In 1188, an additional tax of one tenth of “annual income and moveable property (except arms, horses, dress and precious stones) was demanded by the King from all laymen and clergy.” Several further, similar once-off taxes were levied throughout the remaining years of the century and first decade of the next century.

It was the thirteenth such tax on revenues and moveables, levied in 1207, that was of particular consequence. The King, Hughes and Oates argue, “had no immediate need of this, and it seems to have been collected against a perceived future need to recover lands lost to Philip Augustus in France…John persuaded a council of his Barons to agree to this charge on them, though not without protest: prelates in a first council had refused this as a levy on beneficed clergy, though both laity and clergy did later pay it”. This tax, they suggest, was “an important step away from feudal taxation towards national taxation” and was levied against “an unspecified future need, on property not land, and most classes of society paid it.” This new tax “was legitimised because agreed with a body which represented the community in general who would suffer it”.

Hughes and Oates, through their review of the secondary literature, show that King John attempted to increase royal revenues using a number of means, most importantly through a change in the nature of taxation “from feudal dues to taxes that had a national character, in that they were levied across all classes of society…This change in nature was accompanied by a growing recognition that taxation could not be imposed merely by the will of the King; it needed the consent of those taxed”. The Magna Carta, they argue, has “explicit references to the need for consent and regulation in financial matters.”

North and Weingast also describe the development of taxation and representative institutions as a bargain between Monarch and citizenry. They look at the development of constitutional arrangements in 17th century England following the Glorious Revolution of 1688. The State, they argue, has a “comparative advantage in coercion” and there is thus little to prevent it using its monopoly on violence to “extract all the surplus.” The Monarch, however, may be able to increase revenues by “striking a bargain with constituents that provides them some security” rather than using power “arbitrarily and indiscriminately.”

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111 Bates and Lien, op. cit. note 105, 59.
113 Ibid., 223.
114 Ibid., 224.
Even then, however, there is no guarantee of compliance - “compliance is always a potential problem.” Thus, when the Monarch is all powerful, few citizens are willing to bargain or provide loans to the State as the Monarch may break his word with impunity.  

There is a high likelihood, they say, that “the sovereign will alter property rights for his or her own benefit” and thus “lower the expected returns from investment and...lower in turn the incentive to invest.” The creation of representative institutions endowed with real power, however, can create a constraint against the Monarch: “When the institutions are carefully chosen...parties are more likely to enter into and maintain complex bargains that prevent abuse of political control by the State”. To this end, constitutions must be “self-enforcing in the sense that the major parties to the bargain must have an incentive to abide by the bargain after it is made.”

North and Weingast believe their general observations are supported by political developments in 17th century England. In the early 17th century, “fiscal needs led to increased levels of ‘arbitrary’ government, that is, to expropriation of wealth through redefinition of rights in the sovereign’s favour. This led, ultimately, to civil war”. The post civil war political institutions, they argue, failed and it was not until after the Glorious Revolution of 1688 that there was a “fundamental redesign of the fiscal and governmental institutions.” Under William and Mary, the Monarchy tied its hands and gave power to its creditors. The new institutional developments – namely a more powerful role for the Parliament – gave credibility to the Monarch’s commitments to uphold property rights and gave Parliament control over the confiscatory power of the Monarch. Under William and Mary, an era of “parliamentary supremacy” began whereby sovereignty rested in the hands of not the King alone, but the “King in Parliament.”

The institutional reforms established a “permanent role for Parliament in the on-going management of the Government and hence placed a direct check on the Crown. The Crown no longer called or disbanded Parliament at its discretion alone.” Moreover, “Parliament also gained a central role in financial matters.” It became the exclusive authority to raise new taxes and also gained a veto over Crown expenditures. “For the Crown to achieve its own goals this meant it had to establish successful relations with Parliament.”

These institutional reforms (and the resulting decreased likelihood of the Monarch reneging on agreements and increased protection of property rights), it is argued, quickly increased the willingness of the owners of wealth to provide credit to the Crown. “After the first few years of the Stuart’s reign, the Crown was not able systematically to raise funds. By the second decade of the 17th century, under mounting fiscal pressure, the Crown resorted to a series of ‘forced loans,’ indicating that it could not raise funds at rates it was willing to pay. Following the Glorious Revolution, however, not only did the Government become financially solvent, but it gained access to an unprecedented level of funds”. North and Weingast conclude that “This sharp change in the willingness of lenders to supply funds must reflect a substantial increase in the perceived commitment by the Government to honour its agreements”.

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116 Ibid., 806.
117 Ibid., 803.
118 Ibid., 806.
119 Ibid., 804.
120 Ibid., 816.
121 Ibid., 804-805.
122 Ibid.
The connection between representative institutions and taxation in Britain is fairly well established in the above literature. The arguments set out above are supported, also, by Daunton.\footnote{Daunton, Martin, Trusting Leviathan: The Politics of Taxation in Britain, 1799–1914 (Cambridge University Press, Cambridge, 2001).} He considers the politics of taxation in Britain from 1799 to 1914 and observes that “The ability of any [early European] State to extract taxation depended on the power of the Monarchy over groups and interests beyond its own immediate feudal tenants and estates. A demand for taxes by the Crown collided with the demand of landlords for rent, and these conflicting claims on the surplus of the peasantry could provoke riot and disorder”. In order to resolve these competing demands, assemblies representing the respective interests (landlords, towns, church) were convened in order to secure consent for Crown taxes. Any agreement reached was typically at the expense of one particular group, for instance the church or the landlords.\footnote{Ibid., 3.}

In England, “the creation of a parliamentary and administrative system which allowed the negotiation of taxes between different interests and the Crown” established “a high degree of consent” on the part of the citizenry whose wealth was taxed. Taxpayers were “incorporated into the fiscal regime through…participation in the negotiating of duties in Parliament. The scope of excise duties was limited by the vigilance of Parliament, anxious to prevent the executive from securing an independent source of revenue which would increase its power.”\footnote{Ibid., 5-7.}

3.2.2 Consent to Taxation and Tax Revolts
The studies just reviewed suggest an increasing importance of consent on the part of the citizenry who are subject to taxes. Some scholars have studied what occurs when such consent is absent. Adams surveys the role played by taxation in political and social change throughout history from Antiquity through the Middle Ages to the present day.\footnote{Adams, Charles, For Good and Evil: The Impact of Taxes on the Course of Civilization (Madison Books, London, 1993).} He suggests that history has been characterised by tax revolts. He paints an altogether negative picture of taxation, suggesting that, throughout history, Governments have visited “grossly inequitable tax laws and despotic enforcement practices on their people.”\footnote{Ibid., 451-452.} Taxes are necessary, he acknowledges – “it is the duty of every person to pay a fair share of the costs of maintaining the Government that serves and protects them” – but “consent is required for all lawful taxation, either by long-standing custom or by the common consent of the taxpayer. When a State taxes without bona fide consent, regardless of the equities or reasonableness of the tax, rebellion and civil disobedience are justified.”\footnote{Ibid., 452.}

Burg similarly observes that “taxation has often been onerous, and in many cases excessive and cruel.” Consequently, “reaction to its enforcement has been consistent, heated, and even violent.”\footnote{Burg, David F., A World History of Tax Revolts (Routledge, New York, 2004) ix.} One example offered is that of the imposition, by Great Britain, of the Stamp Act (1765) on the American Colonies, an event which contributed to the American Revolution. The Stamp Act was introduced in order to raise revenue to pay for the cost of maintaining an army in the colonies (as well as to recover some of the cost of the recently concluded Seven Years’ War, where, inter alia, Britain defeated France in North America).\footnote{As a result of the war, France lost most of its overseas possessions, Britain became the world’s leading colonial power and Prussia emerged as a major European power (see Levey, Judith S. and Greenhall, Agnes (eds.) The Penguin Concise Columbia Encyclopedia (Penguin, Harmondsworth, 1987) 764).}
The **Stamp Act** was approved by the British Parliament and George III in March 1765 and was to take effect in November, imposing a direct, internal tax on the colonies. The Virginia House of Burgesses soon after passed a resolution stating that it was the only assembly that had the “executive Right and Power to lay taxes and impositions upon the Inhabitants of this Colony”. The Stamp Act Congress, with representatives from nine colonies, met in New York in October 1765 and drafted a Declaration of Rights. The delegates argued that they were British subjects but could not be taxed without representation in the British Parliament. The Declaration stated: “That it is inseparably essential to the Freedom of a People, and the Undoubted Right of Englishmen, that no Taxes be imposed on them, but with their own Consent, given personally or by their Representatives...That the People of these Colonies are not and from their local Circumstances cannot be Represented in the House of Commons in Great Britain...That the only Representatives of the People of these Colonies are persons chosen therein, by themselves & that no Taxes ever have been or can be constitutionally imposed on them but by their respective Legislatures”

Disputation related to consent has, Kemp argues, also had an important impact on Australian political institutions. He cites, among other tax revolts, “the licence fee so resented by the miners at Eureka which contributed to the establishment of representative government in Australia.” Kemp argues that “The development [of the Australian] political system is, in fact, to a very marked degree the result of a search for procedures which would enable taxes to be levied without provoking civil disorder or revolt.” For the tax system to function effectively, he suggests, public consent to and support for the system is necessary. One of the principal objectives of a politically-rational tax policy must be to pursue tax policy in such a way that support for the tax system is maintained. Public hostility to the tax system may well have implications for public attitudes towards government authority more generally.

The importance of consent has not gone unrecognised in China, either. Chinese peasants, Bernstein and Lü write, have long been subjected to the imposition of “unreasonable’ ad hoc fees, fines, local taxes, assessments on peasant households, or apportionment of governmental expenses among them.” These fees and taxes were imposed, for the most part, by local governments and “had at best a dubious basis in law and official regulations”. Moreover, they were “bitterly resented” by the peasants, largely because of their “unpredictability and open-endedness and the coercive manner in which they were collected.”

Beijing recognised the growing resentment among the peasantry and sought to improve local government behaviour. In 1985, the Central Committee of the Chinese Communist Party cautioned that “excessive burdens were damaging the authority of the regime and were causing rural unrest and instability.”

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131 Quoted in Burg, op. cit. note 129, 261.
132 Quoted, ibid., 264.
135 Kemp, ibid., 277.
137 Kemp, ibid.
The taxing of Chinese peasants, Bernstein and Lü argue, is closely tied to “demands for accountability, participation, and democracy.” They quote the agricultural economist W. Arthur Lewis who wrote: “Farmers resent paying taxes for which they may get no return. However, if the services are provided by local authorities under their control, to whom the taxes are paid, the farmers can see what they are getting for their money, and are more willing to give voluntary labour as well as pay more taxes to meet their own needs.” Bernstein and Lü quote a Shandong farmer, as well, who said in 1988: “We farmers also want to talk about democracy. We can’t bend with the wind anymore. When the higher levels demand this amount of money, they must explain what the reasons are, clearly list the items, and make them known to all. It is both reasonable and lawful to pay grain [taxes]. We farmers are not confused about this. But they just take money from us in some muddled way.”

The Chinese Government’s recognition of the growing discontent and potential for conflict led them to introduce local village elections, a move, Bernstein and Lü argue, that “was significantly motivated by the hope that elections would stabilise the rural areas, enlisting peasant cooperation in governance and making village leaders accountable.”

3.3 Political Influences on Taxation Policy in Democracies

A large body of political economy literature seeks to explain the differences in public policy, and fiscal policy in particular, found amongst democracies. Peters provides a brief overview of some of the literature and the different approaches to understanding the political influences on tax policy and the resulting variation between countries. Different political cultures, he suggests, may be one explanation for different tax policies and compositions of the tax base. “The political culture of a country tends to drive government toward formulating one type of solution rather than another for its tax problems.” This view finds some support in the writing of Haycraft who suggests anti-statist values found in France and Italy have resulted in tax systems characterised by indirect taxation.

Peters, looking at 22 OECD countries from 1965 to 1990, finds “stable clusterings of taxation patterns among groups of industrialised democracies that persisted even with economic and political change.” For instance, what he loosely terms the Anglo-American democracies (US, UK, Canada, Australia, New Zealand, Japan and Switzerland) are “characterised by much higher than average reliance on the property tax, as well as on corporation taxes, and a somewhat higher than average reliance on personal income taxes.” Another cluster, the Scandinavian countries (Sweden, Norway, Denmark and Finland) has “a heavy reliance on the personal income tax but relatively low corporate income taxes.” The countries of a third cluster (Austria, Belgium, Luxembourg, Netherlands, Spain and pre-unification West Germany) “tend to use all tax instruments at their disposal, but to do so in moderation” which Peters suggests “tends to reduce the visibility of the tax system to citizens.” A final “Latin” cluster (France, Greece, Italy, Portugal and the Republic of Ireland)

138 Ibid., 13.
139 Ibid.
140 Ibid., 14.
144 The OECD – Organisation for Economic Cooperation and Development – is an international organisation which was formed in 1961. Its members, both older and more recently developed nations, work together to foster economic growth, provide aid to developing nations and expand world trade (see, Levey and Greenhall, op. cit. note 130, 628).
“rely heavily on indirect taxation, including customs duties, employers’ social security contributions, and consumption taxes...to meet their revenue needs.” Peters further observes that approaches to tax reform have also differed between these political systems - “the major action has been in the Anglo-American democracies rather than in the continental systems.” He nonetheless concludes that while culture exerts some influence over tax-related political choices, other factors may be more influential.

Some quantitative analyses have suggested that political parties and ideology may play a role in shaping tax policy choices. Left-leaning parties are said to be more likely to pursue progressive rates of taxation (imposing higher percentage tax burdens on wealthier taxpayers) and right-of-centre parties more regressive taxes (imposing a greater collective tax burden on lower income groups). Peters also cites some qualitative work which he says supports the argument that the general stance of political parties affects tax policy developments. Peters suggests, however, that “Neither the quantitative or qualitative evidence...is overwhelming in its support for the point that parties have a major influence over tax policies.”

Other scholars focus on the role of pressure or special interest groups. A number of scholars have found that interest groups have significant influence on tax policy development. Peters questions the true influence of pressure groups on “broad issues of tax policy” and suggests that one should expect more influence in the formation of smaller details of policy such as exemptions or loopholes which may be of benefit to the special interests, rather than on broad issues such as the level of tax revenues or distribution of the tax burden. Moreover, the idea that special interests are able to influence tax policy significantly is countered, Peters suggests, by the way that sweeping tax reforms were introduced across a range of jurisdictions commencing in the 1980s. These reforms tended to “eliminate many of the special privileges granted to special interests through the tax law” and have “broadened the tax base and permitted decreased average and marginal tax rates for many taxpayers,” he notes. Peters argues that it “has been ... impossible to organise taxpayers qua taxpayers effectively. Their interests in any one tax are too diffuse, and their individual tax situations sufficiently different, that they will not organise in the same way as will more specific interests to gain special treatment.”

Another argument, put forward by Steinmo, holds that tax policies (and public policies more generally) differ between advanced democracies because of differences in institutional structure. He observes that democracies “attempt in some way to link the wishes, desires, or preferences of the public with the actual policy decisions of the political elite”. Governing elites, however, “must have some degree of autonomy from the public that they represent. They must be able to act when public preferences are confused or split, when citizens are apathetic or ignorant, and even when the public is outright opposed to what the Government

146 Ibid., 61-63.
147 Ibid., 6-7.
154 Ibid., 14.
must do.” Democratic States have addressed this dilemma in different ways which, in turn, Steinmo suggests, have affected the development of tax systems in the 20th century. He looks at the development of taxation in the US, Britain and Sweden, and observes that as political rights were extended to more and more citizens, each country “developed different institutional mechanisms to accommodate this change.”

In the US, “constitution makers, fearing both an autonomous and overly responsive elite, constructed a system of multiple checks and balances and intentionally fragmented political authority. The peculiar character of the American tax system – its complexity, its inefficiency, and its low revenue yield – is a product of this institutional structure.” Steinmo says.

Sweden, by way of contrast, adopted proportional representation for its Lower Chamber but “a complicated and conservative electoral system for the Upper Chamber.” This provided the “conservative bureaucratic oligarchy that dominated the political system at the turn of the century,” Steinmo argues, with a “guarantee against a Government that would be too responsive to the will of the masses.” On this base, Swedish elites developed “corporatist institutions” in the mid-20th century which “ultimately tipped the scales in favour of a Government that could dominate, but not predominate, the political agenda.” The characteristic features of the Swedish tax system – “its stability, efficiency, high revenue yield, and surprisingly generous treatment of capital compared to the heavy burden borne by the working class,” Steinmo suggests, is a product of this institutional structure.

Lawmakers in the UK faced few constitutional restraints of the sort seen in the US and Sweden. The lack of “checks on the autonomy of the Government” seen in America and Sweden allowed “strong parties” to become “strong Governments” and “seize the reins of government.” “Strong British party Governments do not have to make the kinds of partisan compromises and build the kinds of long-term coalitions simply to pass legislation that both the Swedish and American Governments do. The British tax system – its instability, its inefficiencies, and its ever-changing distribution of tax burdens – is a product of these party-government institutions,” Steinmo argues.

Steinmo recognises that constitutional structure does not alone shape tax policy. However, he contends that the “tax decision-making institutions” and systems in these countries “are rational adaptations of their basic constitutional foundations.”

3.4 Does Increased Taxation Drive Increased Democratisation?

Ross recently considered (and statistically tested) the relationship between taxation and representation and, in particular, the claim that authoritarian Governments are forced to democratis by the need to raise taxes. In this work, Ross surveys the literature on the linkage between taxation and the development of political representation. Various scholars have noted such a linkage in English history with the earliest forms of representative...
government tied to each English King’s need for revenues. Similarly, Ross notes, in France, the influence of the provincial estates between the 14th and 18th centuries depended largely on the Crown’s need for taxes.162

These studies which look at European history, Ross argues, have influenced and shaped how contemporary scholars look at the political institutions of, and development in, non-Western countries. He points to Samuel Huntington who has written that “the lower the level of taxation, the less reason for the public to demand representation”163. Ross also cites the work of various scholars writing about the Middle East who argue that the region’s autocratic rulers are able to rely on substantial non-tax (oil) revenues and thus avoid the pressures to democratise which would likely accompany taxation.164

The argument that taxation promotes representative democracy is certainly prominent in the literature. Ross, however, notes two possible objections. First, illustrative examples are limited to the early development of a few European countries and the United States. Second, even if these cases are illustrative of “the prevailing pattern in early modern Europe and colonial America,” they may differ from today’s autocracies.165

Ross tests the hypothesised linkage between taxation and development statistically using cross-national data from 113 countries between 1971 and 1997. He tests two possible models or explanations. In one model, “democracy is linked to a higher absolute tax burden,” while in the other, democracy is linked to “a higher tax burden relative to the services the Government provides.” In the first “anti-tax” model, citizens are assumed to be interested only in minimising their taxes – “democracy is simply a way for society to curb the predatory appetites of the State”. Such a model, Ross suggests, informs the theorising of scholars such as Huntington. In the second “cost-benefit” model, citizens are assumed to consider both the cost of taxes and the benefits of government services. A rise in taxes, if offset by an increase in government services, would not necessarily promote democratisation.166 This model is similar to that outlined by Bates and Lien (discussed above) which assumes individuals have preferences about both the level of taxation – and government policies.

In Ross’s statistical analysis, the dependent variable is regime type, measured on a 0 to 10 scale from undemocratic to democratic. To test the anti-tax model, Ross uses an independent variable which measures tax revenues as a fraction of Gross Domestic Product (GDP). To test the cost-benefit model, Ross uses a variable which measures tax revenues as a percentage of government expenditures as well as an additional variable measuring the quality of government (as high government spending does not necessarily mean a high quality of government services). Controlling for a number of other variables, Ross finds “no support for the pure anti-tax hypothesis, but strong support for the cost-benefit hypothesis.”167 Ross tests the significance of tax revenues as a fraction of GDP on a country’s level of democracy using a variety of different time lags but in no case is the independent variable statistically significant. By way of contrast, Ross finds that tax revenues as a percentage of government expenditures is positively and significantly correlated with the level of democracy. Ross thus finds that “a rise in taxes per se does not appear to lead to democratisation…However, a rise in the price of government services is

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162 Ross, ibid., 231.
164 Ross, ibid., 232.
165 Ibid., 234.
166 Ibid.
167 Ibid., 243.
associated with subsequent democratisation." Citizens, Ross concludes, “do not generally rebel against taxation without representation; rather, they appear to rebel against taxation without commensurate government services.”

Another way of putting this is to presume that the process of linking taxation to political structure development typically goes through two phases. Phase one (as noted by Ross) sees citizens applying a cost-benefit analysis. If they feel broadly satisfied that their form of government delivers fairly effective “goods” (in a mainly corruption free manner) in return for taxes paid, then an increase in taxation may well be deemed acceptable once it is appropriately explained. The process enters phase two when citizens, having completed the phase one reckoning, find that, instead of being broadly satisfied, they collectively and markedly lack fiscal confidence in their particular form of government. In this case, any move to increase taxes may very well result in firm demands for serious political structure reform.

3.5 A Comparative Review

Another (Hong Kong based) scholar, Sing, has discussed certain anomalies in the application of modernisation theory in a recent book. Sing contends that, “According to modernisation theory, countries with a high level of socio-economic development are likely to see the emergence and consolidation of a democratic system.” He goes on to note that, even though the World Bank categorised Hong Kong as a first-world (high income) economy by 1987 it still remains, almost twenty years later, an undemocratic city-state. Hong Kong thus poses “an anomaly to modernisation theory.”

Sing analyses data from Freedom House from 2001 and the World Bank from 2000 to produce an informative table which contrasts jurisdiction income levels (Gross National Product (GNP)) with regime types ranging from State Hegemonic, Closed (for example, Saudi Arabia, China, North Korea, Syria) to Liberal Democracy (for example, US, UK, Australia, Canada and numbers of EU countries). The World Bank’s list of prosperous, higher-income countries all have the most democratic regimes – with the exception of Hong Kong, Singapore and Middle Eastern oil-exporting jurisdictions like Brunei, Kuwait, Qatar, and the United Arab Emirates (UAE). Brunei, Qatar and the UAE all have regime types described as State Hegemonic, Partially Open. Other (less wealthy) jurisdictions in this regime category include Algeria, Belarus, Cambodia and Pakistan. Singapore is placed in the category Non-competitive, Partially Pluralist, along with Malaysia and Uganda. Hong Kong is categorised as Semi-competitive, Partially Pluralist, alongside Brazil, Mexico and Jordan.
Sing also contrasts Hong Kong with Taiwan and South Korea. Both have been and remain notably poorer than Hong Kong (in GNP per capita terms). Yet both have progressively democratised their respective political structures to an advanced level – well beyond that achieved in Hong Kong – over the last two decades.\footnote{Ibid., 9-10.}

Sing offers a range of possible explanations for Hong Kong’s exceptional status. He notes that the Middle East States mentioned above have been able to supply first-world level public goods by accessing oil revenues. They have not had to rely heavily on conventional taxation, thus potentially lessening demand for greater citizen political rights.\footnote{Sing also argues that, given the absence of similar natural resources to oil – and no significant Islamic influence – in Hong Kong, the explanatory factors applicable in the Middle East cannot apply to Hong Kong (ibid., 10). This overlooks the way in which land has been used as a monopolist “commodity” sold and dealt with (subject to what the market would bear) by the Government in Hong Kong to create significant revenue streams (see discussion in Part 2). This matter is also discussed further below.} Sing comments, too, on the possible influence of Islam – with its stress on politics being a part of overall religious understanding.\footnote{Ibid., 10-13.} Other possible explanations include: Hong Kong’s Confucian cultural heritage; Hong Kong’s long-term, post-war, high economic growth rates; the city-state’s colonial heritage; and powerful pressures from Beijing to eschew democratic reform. Sing does not dismiss all of these explanatory factors but he feels that, at best, some may offer no more than a part of the explanation for Hong Kong’s anomalous status.\footnote{Ibid., 17-18.} Ultimately he argues that Hong Kong’s attenuated political system is the product of a fairly complex, long-term process of (ongoing) bargaining between multiple State and societal actors.\footnote{Ibid., 17-18.}

Peerenboom is another scholar who has recently completed a comparative study looking at linkages between economic development and political development.\footnote{Peerenboom, Randall. \textit{Show Me the Money: The Dominance of Wealth in Determining Rights Performance in Asia} (2004) 15 Duke Journal of Comparative and International Law, 75.} Unlike Sing’s work, this study does not pivot around a single jurisdiction (such as Hong Kong) but focuses on Asia generally – with the greatest emphasis on North East Asia. Peerenboom employs comparisons, too, from the US and France. In Part 1 of his article, he provides “an empirical overview of twelve Asian countries” looking at “physical integrity rights, civil and political rights, economic and social rights” and a range of other indicators of quality of life including, good governance, crime rates, divorce rates and Rule of Law and regulatory effectiveness.\footnote{Ibid., 77-78.}

He claims two main findings arise from this work. First, in doing any such comparisons (looking at levels of broad political development), like should be compared with like: “comparing a low-middle income country such as China with the US makes about as much sense as comparing a piano to a duck.”\footnote{Ibid., 81.} (Peerenboom argues elsewhere that this sort of inappropriate comparison has contributed to China being subjected to a double standard in the assessment of its human rights performance.\footnote{See, Peerenboom, Randall, \textit{Assessing Human Rights in China: Why the Double Standard?} (2005) 38 Cornell International Law Journal, 101.}) His second major finding is that “in the subtle and complex interplay of economics, politics, culture, law and institutions in determining rights performance, what matters most is wealth.”\footnote{Peerenboom, op. cit. note 181, 80.} He also points out that, “Asian Governments generally have taken seriously their obligations to provide the
necessary minimal conditions for human flourishing, subject to resource constraints generally in line with GDP levels….The conceptualisation however is not so much in terms of rights as traditional paternalistic beliefs that rulers are obligated to ensure the material and spiritual well being of the people.\textsuperscript{186}

4.0 TAXATION AND DEMOCRACY IN HONG KONG

This review has examined two key public policy regimes in Hong Kong in some detail: the revenue system and the political system. It argues that they are both curious in the way that they each look, in 2005 (in a first-world polity such as Hong Kong) almost like museum exhibits from another era.

We have also reviewed the literature on the general interaction of taxation (or revenue systems) with political systems in some depth. A wide range of scholars have taken a number of perspectives on this interaction. It appears that one of the rallying cries of the American Revolution in the late 18\textsuperscript{th} century – “no taxation without representation” – was genuinely galvanising at that time. It was not just a compelling political slogan – it also captured the substantive feelings on this issue shared by many citizens of the then British-American colonies. The better view today, however, seems to be that citizens of the modern world do not, as Ross puts it, “generally rebel against taxation without representation – they appear to rebel against taxation without commensurate government services.”\textsuperscript{187} Ross looks at the historical commentary as well as data from a wide range of 113 countries over more than 25 years before coming down firmly in favour of the “cost-benefit” view of the linkage between revenue systems and political development. Other studies discussed above have come to similar or supporting conclusions approaching the same basic issue from differing perspectives. Bates and Lien, for example, looking at earlier, non-democratic times, note the way bargains were struck (often in early parliamentary institutions) between Monarchs and those they taxed so that the executive would pursue public policies desired by taxpayers.\textsuperscript{188} Sing explains how anomalous (according to modernisation theory) Hong Kong’s situation is when one compares regime types with economic development levels. He argues that “[Modernisation] theory implicitly but unjustifiably assumes that undemocratic places are repressive, corrupt and lacking legitimacy and thus under enormous internal pressure to democratis[e] especially in places with a moderate [to] high level of socio-economic development.” Hong Kong, he notes, has not just enjoyed economic success but also - despite its lack of democratisation - high levels of civil liberties and certain political rights and low levels of corruption.\textsuperscript{189}

Peerenboom, meanwhile, claims that numbers of non-democratic, Asian Governments have genuinely attempted to meet the needs of their citizens driven by traditional, paternalistic norms rather than concerns about individual rights. Indeed, their lack of any need to resort to a rights-based paradigm to provide a rationale for positive social policy helps explain why such Governments can display forthright concern for the broad welfare of citizens whilst habitually clamping down on virtually all significant political dissent.

\textsuperscript{186} Ibid., 118. Although these traditions are non-liberal, Peerenboom argues that they still provide a “normative basis for social, economic, cultural and collective rights claims today” (ibid.).

\textsuperscript{187} Ross, op. cit. note 161, 247. It is also possible to look at the process which Ross discusses as being two-phased. First citizens consider tax reform from a cost-benefit perspective and, if they are seriously unconvinced of the wisdom of any proposed change, they may be energised to demand political structure reforms – see footnote 169 and accompanying text.

\textsuperscript{188} The increasing need for Governments to seek consent from their citizens to taxation is explained in Section 3.2. Barker also puts it well when he notes that, “for income tax to be successful it must popularly imposed and accepted” (Barker, op. cit. note, 34, 115).

\textsuperscript{189} Sing, op. cit. note, 171, 219-220.
In the modern world, in both rich and poor jurisdictions, all citizens are concerned about their political rights. But when it comes to taxation, what they seek, it seems, is value for the money they pay to government, above all. So how does this help explain how Hong Kong has retained for so long both its surprisingly dated taxation system and its comparatively outmoded political system? And what relationship, if any, exists between the two? The short answer to the second question, based on this study, is that there does not appear to be any direct or intimate relationship between these two regimes. The explanation of why this is so also provides a key part of the answer to the first question.

We have seen how Hong Kong has, virtually since its inception, been a city-state dominated by its business elites and related professions. These elites have changed in nature over time; once trading houses dominated, later manufacturers did, today all manner of service industries form the core of business in Hong Kong. Throughout Hong Kong’s modern history, banks, lawyers, accountants and other business service sectors have flourished. Prior to World War II, the Colonial Government ran Hong Kong as a “democracy-free zone” in conjunction with the business elites. After the last war, decolonisation (and a wave of democratisation) swept the world but left Hong Kong largely untouched. The UK had, it was said, an unwritten agreement with the new PRC to retain a colonial, non-democratic regime in Hong Kong. This suited the business elites, the UK appointed HK Government and the UK itself – they all saw their interests would be best served by maintaining a strong “executive-led”, colonial-style political system. After the UK agreed, in 1984, on the broad terms for the reversion of sovereignty over Hong Kong to the PRC on July 1, 1997, it quickly became apparent that Hong Kong’s system of government (with its still clear 18th century roots) was about to be both snap frozen and re-energised. Beijing, especially, saw this as a key to allowing the world’s largest one party state to manage this hugely prosperous British-affected enclave. Once again the business elites, who have long enjoyed a remarkable capacity to influence government policy deeply, generally found this outcome to their liking.

Especially from the 1970s onwards, Hong Kong combined competent, paternalistically responsive and largely corruption free government with decade after decade of remarkable economic growth. Hong Kong was also, above all, a city of recent migrants, many of whom (for a long time) saw themselves stopping over on the way to somewhere else – usually to some place in the Anglo, developed world.

A range of external and internal reasons – including social, economic, political, diplomatic and cultural factors – thus explain why Hong Kong’s political development remains so attenuated for such a highly developed jurisdiction.

When we consider the development and maintenance of Hong Kong’s revenue regime, similar – and certain additional – factors are evident. The influence of Hong Kong’s business elites is perhaps even more apparent. And the model for Hong Kong’s tax system, like its political system, has been borrowed from the UK. Again, it shows the hallmarks of being taken from another era. One key distinguishing factor, however, is that the maintenance of Hong Kong’s archaic revenue system has depended, especially since World War II, on the exploitation by successive Hong Kong Governments of a novel (for the modern era) revenue source: land. Although there is a lack of evidence to show that this reliance on land-related

191 Clearly, to an extent, this is a contradiction in terms. Yet this seemed to be just what Beijing wanted. The inherent contradiction in the notion of retaining a dynamic and responsive colonial-style system of governance helps explain many of the political stresses seen in HKSAR since July 1997.
192 Goodstadt, op. cit. note 22, Chapter VI and Conclusions.
revenues arose from a carefully thought through, long-term government-business strategy, it is clear that the dominant business and professional elites in conjunction with the Hong Kong Government supported this approach with conviction once they had established how well it generally suited them all. The forceful use of this revenue source has also, very likely, indirectly reduced the pressure for political reform – by reducing the need to apply conventional taxation measures more widely and at higher rates.\footnote{Regardless of any reputation which a government may have for fiscal probity and competence, tax reform is always going to be politically sensitive, especially where effective tax increases of some sort are being introduced. Note also the way that the revenue derived from land-related income has tended to shore up the notably undemocratic FC system in LegCo (described above). Funds generated have been used to support government expenditures beneficial within various FC areas – and beneficial to FC members. (We are grateful to Stephen Brown for pointing out this political impact.)} With respect to the revenue regime, however, the impact has been powerfully direct. Without this revenue source Hong Kong would have long ago felt much greater pressure to develop a more up to date, higher yielding, conventional tax system.

What this research paper says, in brief, is that these two comparatively outmoded systems have developed largely in parallel. The explanatory underpinnings of the outcomes we see in 2005 are quite similar. But Hong Kong’s under-developed tax system is not, primarily, a product of the lack of democracy which has been a hallmark, since British rule commenced, of Hong Kong’s colonial-style political system.

Hong Kong rates relatively well according to the “cost-benefit” test of taxation explained (particularly by Ross) in Section 3.4. Hong Kong has never had democratic government. But it has, by many measures, enjoyed relatively corruption free, paternalistically successful government for several decades on end – at least up until the time of the handover. Hong Kong residents have never shown any serious sign, to use Ross’s formulation, of wanting to rebel against taxation because it was not commensurate with the provision of government services.\footnote{Hong Kong has, historically, ranked well in the Heritage Foundation’s Economic Freedom Index, and has typically ranked well in the Global Competitiveness Report published by the World Economic Forum. On the United Nations Human Development Index Hong Kong does less well but still not too badly. See, Loh, Christine and Foong, Kee, Hong Kong as a World City, at: http://www.civic-exchange.org/publications/2005/pop-lohkee.pdf.} The fact is that: (a) the significant reliance on land-related revenues helped underpin low (or zero) formal tax rates within the recognised tax regime for all Hong Kong residents; and (b) successive Governments were, overall, seen to be providing a tolerable level of services given the tax-take.\footnote{The resort to land-related revenues, insofar as they tended to look like the sale of a government controlled resource rather than any sort of tax, tended to strengthen this latter perception, of course.}

It follows from this comparatively positive historical record on the operation of the revenue system, that the HKSAR Government may be well placed to take a “two track” approach on taxation reform and political reform. That is, the Government may be able to proceed with serious tax reform without having to weave that reform within a significant political reform package.

A cautionary note needs to be sounded here, however. Since Hong Kong became the HKSAR it has lived through eight comparatively difficult years. As well as having to struggle with the impact of the AFC, the HKSAR Government has had to try and manage serious outbreaks of Bird Flu and SARS\footnote{For a good review of the SARS crisis in Hong Kong, see, Loh, Christine and Civic Exchange (eds.) At the Epicentre: Hong Kong and the SARS Outbreak (Hong Kong University Press, Hong Kong, 2003). See also, Srivastava, D.K. and Cullen, Richard, SARS in the HKSAR: Some Important Legal Issues (2003) (July) Hong Kong Lawyer, 71.} a major debacle over proposed new anti-subversion
laws, and a range of other crises. The HKSAR Government has struggled to cope with these challenges. It has, since 1997, frequently had to operate in emergency management mode, so that longer term policy development and implementation have both suffered.

The HKSAR Government is comprised entirely of Hong Kong people but it remains, according to Beijing’s preference and under the terms of the Joint Declaration and the Basic Law, an entirely appointed (by Beijing) Government. Many commentators feel that a significant factor underpinning this sub-optimal governance outcome has been the steadfast opposition amongst Hong Kong’s wealthy elites and in Beijing to moving beyond the HKSAR’s currently highly limited form of democratic participation to a system of full democracy. The Basic Law clearly allows for full democratic government in the HKSAR – especially from 2007 onwards – but it does not mandate such change.

The perceived competency problems of post-1997 Hong Kong Governments – combined with some of their citizen-provoking policy initiatives – have served to make Hong Kong a far more “political city” than it was in decades past. The Ross cost-benefit test of a Government’s capacity to develop and reform its tax system thus may not apply in an entirely straightforward way in post-1997 Hong Kong because of the erosion of faith in the Government and the growth in awareness of the potential benefits of political reform since the handover.

5.0 CONCLUSION

The creation and maintenance of both Hong Kong’s revenue system and its political system present several public policy questions worthy of investigation. Detailed research suggests that these two systems have been formed by often similar influences but they have largely been shaped in parallel with one another. Hong Kong’s curiously antiquated (and successful in many ways) revenue system is not, primarily, the direct progeny of the remarkably durable, colonial-style political system.

197 Article 23 of the HKSAR’s mini-Constitution, the Basic Law requires the HKSAR to enact laws on subversion and a range of other national security matters. Full coverage of Hong Kong’s seminal “Article 23 crisis” may be found at: http://www.article23.org.hk/english/main.htm.

198 See further, Loh, Christine and Cullen, Richard, Political Reform in Hong Kong (2005) 14, Journal of Contemporary China, 147.

199 For a detailed analysis and discussion of the factors which held back the growth of democracy in Hong Kong under British rule and which continue to inhibit democratisation in the HKSAR, see, Sing, op. cit. note, 171. Some of these factors have clearly been negative – including the opposition of Beijing and many members of the Hong Kong business elite to increased democracy. Some factors, though have been more “positive”; not least the remarkable economic success story overseen by the non-democratic but comparatively effective and accountable, British, colonial-style, civil-service-based government. See also, Goodstadt, op. cit. note 22.


201 In March, 2005, the unpopular first Chief Executive (CE) of the HKSAR, Tung Chi-hwa, stepped down when almost three years into his second five year term as CE.. Shortly after, Donald Tsang (Tung’s Chief Secretary – and de facto “number two”) was appointed by Beijing as a replacement CE for the two year balance of Tung’s term, until mid-2007. Although this truncated term for the replacement CE was controversial (see: Beijing’s view on HK’s new chief, South China Morning Post, 28 August 2005, A3; and Ghai, Yash, Just what can Beijing teach us, South China Morning Post, 13 April 2005, A17… Tsang’s Government has enjoyed a boost in popularity. Think tank SynergyNet recently explained that: “Compared with the results from the past two years, SynergyNet’s surveys found that the result in 2005 … indicated a clear improvement in [the] public’s perception of all aspects of governance.” (See, New Era of Governance: Lessons from the Past, at: http://www.synergynet.org.hk/en_main.htm.) See too, Loh, Christine, Applying Sustainability Tools: Exploring Constitutional Development (2003 – 2004),(Civic Exchange, Hong Kong, 2005) 3, where the author explains that: “Trust appears to be in a crisis because people are concerned that politicians and the political process have been corrupted by being too closely aligned with money politics.” Goodstadt, in turn, has noted that the public has responded with considerable outrage to the favouritism shown to wealthy businessmen, and the lack of support for political reforms and a sense of social responsibility within this elite group (Goodstadt, op. cit. note 22, 221).
It is widely recognised today that significant reform of these two systems is required as Hong Kong seeks to meet the challenges facing it in the 21st century. The HKSAR Government accepts that reform of both systems is on the agenda, though it takes a different view on the degree of reform needed, especially in the case of political reform, from that taken by numerous commentators.

The debate over reforming Hong Kong’s awkward political system has been running with some intensity for well over a decade. The effects of foot-dragging on this issue by Beijing and those in Hong Kong who wish to delay change as long as possible are starkly evident in the second Basic Law Interpretation on the procedure for achieving political change in the lead up to 2007-2008.

Hong Kong’s “democratic deficit” has been widely noted and discussed. The HKSAR Government is, effectively, entirely appointed by Beijing. LegCo remains seriously flawed as a law making body primarily because of its system of Functional Constituencies. It is clear that Hong Kong people want consistent, good governance and they do not feel they get this under Beijing-appointed HKSAR Governments. Next, they know that they are ready for full democratisation and they see this as the best long-term solution to Hong Kong’s governance shortfalls. What is perhaps most disturbing about the current position is that it prevents Hong Kong from using a “free political market” to choose the best leaders available. The pool from which leaders are currently chosen is significantly limited by the persistence of colonial-style government-by-appointment (where the loyalty of potential appointees to Beijing remains a key selection criterion). Another fundamental concern is that it is impossible to vote out of office any HKSAR Government which is perceived to be seriously under-performing.

The debate about reforming Hong Kong’s revenue system is of a different nature. It does not deal with issues as fundamental as how Hong Kong should choose its Government and elect LegCo. It remains contentious, of course, but the argument is primarily about the political-economy consequences of different tax policy options and about the legislative and administrative arrangements needed to implement change.

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202 The HKSAR’s official high ambitions for itself were signaled in 1999 when the Government began to identify Hong Kong as “Asia’s world city”. Hong Kong is ranked, according to one measuring system, within the second tier of world cities (along with Chicago, Frankfurt, Los Angeles, Milan and Singapore). The first tier comprises London, New York, Paris and Tokyo. See, Loh and Foong, op. cit. note 194.

203 Article 158 of the Basic Law gives power to the PRC Standing Committee of the National People’s Congress (SCNPC) to interpret the Basic Law. The second SCNPC Article 158 Interpretation came in April, 2004. This Interpretation was designed to dampen discussion building within Hong Kong about a significant move towards increased democratisation in 2007 (when a Chief Executive election is due under the Basic Law) and 2008 (when a LegCo election is due under the Basic Law). For further details on the Interpretation (and the first and third Interpretations) see, Cullen, Richard, The Rule of Law in Hong Kong, at: http://www.civic-exchange.org/publications/2005/rolawe.pdf. There is significant debate about exactly what the term “democracy” means. There is, however, general agreement amongst many political scientists that for a system to qualify as democratic, there needs to be: genuine political competition; regular, free and fair elections; voter accountability; and all citizens must have an equal right to participate in the political process (see, Loh, Christine, Conclusion (in Loh, Christine (ed.) Functional Constituencies (Hong Kong University Press, Hong Kong, 2005) (forthcoming))

204 See discussion in Loh, Christine, Introduction (in Loh, Christine (ed.) Functional Constituencies (Hong Kong University Press, Hong Kong, 2005) (forthcoming)). See too, Goodstadt, op. cit. note 22, vii and 228: “This Chinese community created a society that attained superior standards of social order and stability …in spite of inadequate housing, grim working conditions and a Government reluctant to accept responsibility for fostering a quality of social development to match the city’s economic progress until relatively late in the colonial era….In consequence, the challenge for Hong Kong’s rulers did not change at the end of the colonial era in 1997: how to serve a people who’s exceptional qualities entitled them to the best of governments.”
Barker is correct, when he notes the way in which tax systems typically have the closest relationship with a nation’s political system. But they also have an existence separate from the political system, not least of all in Hong Kong, as this study has shown. The fundamental issues which need to be addressed as Hong Kong prepares for tax reform include:

1. How can the Government best be “weaned” from its continuing, excessive dependency on revenues derived from land-related transactions?

2. Would Hong Kong benefit from the introduction of a new general Goods and Services Tax (GST)?

3. Is it time to reconsider Hong Kong’s reliance on sourced-based or territorial taxation?

4. Is it time to consider replacing the operationally separate, schedular system in the IRO with a single general income tax?

5. Should other reforms be considered in order to widen the tax base?

Item one is perhaps most important of all. The “transformation” of land into an oil-like, government monopolised commodity in Hong Kong was not without its benefits in times past. It drew many land transaction profits directly into the public purse, where those profits have often been put to good use, such as in the provision of basic housing for most residents. In almost all other developed jurisdictions, the bulk of such direct profits have long since accrued to private developers and have not been available for spending on public goods. This unusual system has also underpinned the maintenance of some of the lowest nominal tax rates on profits and income from exertion in the developed world. This, in turn, has enhanced Hong Kong’s attractiveness as a place to do business. But these benefits have come at an increasing cost. The comparative land revenue dependence of successive Hong Kong Governments has produced major distortions in the system for pricing and selling land. This has reduced Hong Kong’s attractiveness as a place to do business. It has also given Hong Kong a strangely misshapen residential housing system where low rent but wretchedly cramped public housing jostles with also tiny private, mass market flats. The entire enterprise has evolved so that a handful of hugely wealthy developers crowd out real competition in the market whilst building a too cosy relationship with government.

The very heavy involvement of the Hong Kong Government in land revenue collections has also played a role in the generation of a series of speculative real estate “bubbles”, the last of which helped pitch the new HKSAR into a multi-year recession. Finally, the deployment of this important revenue source has had an inhibiting impact on the development of Hong Kong’s political system – and also retarded the evolution of a more modern taxation system. The “use by” date for the still current form of this genuinely extraordinary system has passed.

The questions above raise many other important issues, of course. Two quite fundamental (and related) ones are: (a) how should tax system changes proceed so that the taxation

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205 Barker, op. cit. note 34.

206 Another feature of Hong Kong’s “public policy museum” is the lack of any general legislation outlawing anti-competitive collusion and other similar behaviour amongst commercial operators. Not surprisingly, Hong Kong also lacks any general, legislated consumer protection laws. For further discussion, see, for example: Webb, David, *Hong Kong Needs a Competition Law*, at: [http://www.webb-site.com/articles/noncompete.htm](http://www.webb-site.com/articles/noncompete.htm); and Mancke, Hans, *Playing favourites in a free market*, at: [http://www.thestandard.com.hk/stdn/std/Focus/GH18Dh01.html](http://www.thestandard.com.hk/stdn/std/Focus/GH18Dh01.html).
burden is shared equitably under a reformed system; and (b) should any new GST be earmarked to help meet the needs of the many less fortunate in Hong Kong society given that a GST would be bound to have the greatest adverse impact on that sector of the population.\footnote{207}

As we noted in Part 4, the research suggests that, \textit{prima facie}, the HKSAR Government is well placed, based on the historical fiscal record, to proceed with taxation reform as a project largely separated from the process of political reform. The erosion of the credibility of government in Hong Kong, post-1997, raises doubts about whether – as a matter of political fact - this conclusion holds so well today, however. The HKSAR Government knows, too, that its unelected status fundamentally undercuts its legitimacy. All of which has tended to make the Government, overall, rather timid when it comes to much major policy development and implementation.\footnote{208} The irony is, perhaps, that although the historical track record suggests strongly that the Hong Kong Government enjoys a comparatively sound fiscally, the Government’s own behaviour, post-1997, betrays a recurring lack of fundamental confidence. Given this political reality, the most sensible way forward would be to mesh serious tax reform in Hong Kong with meaningful political reform. This would assist the implementation of tax reform and boost Government credibility. More importantly, it would be in the best interests of Hong Kong.

\footnote{207 For a useful review of the history of previous discussions (and failed attempts) to introduce a general tax on consumption in Hong Kong see, Tang, Shu-Hung, \textit{The Political Economy of Tax Reform in Hong Kong} (2005) Asia-Pacific Journal of Taxation, 52. This article also summarizes the many discussions about wider tax reform which have taken place in Hong Kong since World War II.}

\footnote{208 Tang argues that the successive [unelected] Hong Kong Governments have, both before and after 1997, lacked “the determination to push for tax reform”, ibid., 72.}
GLOSSARY OF ABBREVIATIONS USED

AFC  Asian Financial Crisis
DIPN  Departmental Interpretation and Practice Note
EDO  Estates Duty Ordinance
FC  Functional Constituency
GDP  Gross Domestic Product
GNP  Gross National Product
GST  Goods and Services Tax
HKD  Hong Kong Dollar
HKMA  Hong Kong Monetary Authority
HKSAR  Hong Kong Special Administrative Region
IRD  Inland Revenue Department
IRO  Inland Revenue Ordinance
LegCo  Legislative Council
OECD  Organisation for Economic Cooperation and Development
PLC  Provisional Legislative Council
PRC  People’s Republic of China
SARS  Severe Acute Respiratory Syndrome
SCNPC  Standing Committee of the National People’s Congress
SDO  Stamp Duty Ordinance
UAE  United Arab Emirates
UK  United Kingdom
US  United States of America
USD  United States Dollar