Will Tax Reform Drive Political Reform In Hong Kong?

by Richard Cullen and Tor Krever

Richard Cullen is a professor in the Department of Business Law and Taxation at Monash University. He is also a research associate with Civic Exchange. E-mail: rcullen@attglobal.net

Tor Krever is a research fellow with the Taxation Law and Policy Research Unit at Monash University. E-mail: tor.krever@gmail.com

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Tax reform is coming in Hong Kong — the question is "when" rather than "if."[1] 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.[2] When a GST is finally introduced (perhaps in 2009), it will represent the most radical taxation reform in Hong Kong since 1947,[3] 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Hong Kong's revenue law system is widely seen as outdated.[4] The Hong Kong Special Administrative Region (HKSAR) is also notable for retaining a comparatively outmoded political system.[5] Given that Hong Kong is plainly, by most measures, a first-world city-state and has been so for some time, that 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 it 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 article explains why. It also provides some answers to the first two questions.

Hong Kong's Political Structure

The HKSAR commenced political life on July 1, 1997, with a deliberately maintained, colonial-style

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[1]The Hong Kong government acknowledges that this is so; *see* "Public Finance — Need to Broaden Tax Base," at: http://www.info.gov.hk/yearbook/2003/english/chapter03/03_04.html. *See, also*, the proposals put forward by the British Chamber of Commerce in Hong Kong at http://www.britcham.com/asp/ArticleDetail.asp?ArticleId=259; Stephen Brown, Edward K. W. Fung, Christine Loh, Kylie Uebergang, and Stephen Xu, *The Budget and Public Finance in Hong Kong*, at: http://www.civic-exchange.org/publications/2003/BudgetReport.pdf; and Editorial, "Tsang should make a stand on GST," *South China Morning Post*, Nov. 17, 2005, A16.

[2]*See* British Chamber of Commerce and *South China Morning Post* Editorial, *id*.

[3]*See* Tang Shu-Hung, "The Political Economy of Tax Reform in Hong Kong," (2005) *Asia-Pacific Journal of Taxation*, 52. This article provides a useful review of the history of previous discussions (and failed attempts) to introduce a general tax on consumption in Hong Kong. It is reckoned that it would take three years to prepare and implement a GST in Hong Kong — 2009 is now seen as the earliest realistic date for its introduction.

[4]*See* references at footnote 1.

[5]For a comprehensive analysis of the development and consolidation of Hong Kong's system of nonelected government, see Yash Ghai, *Hong Kong's New Constitutional Order* (2nd ed.) (Hong Kong University Press, Hong Kong, 1999). *See also* Leo F. Goodstadt, *Uneasy Partners* (Hong Kong University Press, Hong Kong, 2005); and Norman Miners, *The Government and Politics of Hong Kong* (5th ed.) (Oxford University Press, Hong Kong, 1991).

governance system, following the change of sovereignty from the United Kingdom to the People's Republic of China.[6] The miniconstitution passed by the P.R.C. Parliament for the HKSAR, the Basic Law,[7] enabled Hong Kong's previous colonial "executive-led" system to continue essentially unchanged.[8]

> ***The Hong Kong income taxation system is peculiar in its use of operationally separate schedules.***

Nowhere else in the developed world in 2005 can one find a political structure that retains so many aspects of the late 18th century model on which it is based, including an entirely nonelected government; a fairly weak, only partly democratic Legislative Council (LegCo); and a comparatively independent judiciary.[9] Like Hong Kong, other developed jurisdictions maintain respect for the rule of law, but they have, over time, built democratic, multiparty, representative systems of government. Hong Kong has what one commentator characterizes as a "thin" rule of law regime — in contrast to the "thick" rule of law regimes that apply in almost all other advanced states.[10]

Hong Kong's Revenue Regime

Hong Kong first introduced an income tax in the War Revenue Ordinance (WRO) in 1940, ostensibly to contribute to the financing of Britain's war effort. Its (short-lived) operation was ended when the Japanese Imperial Army overran Hong Kong in late 1941, soon after the bombing of Pearl Harbor. 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. In 1947 a new income tax regime (the IRO) base was enacted. The IRO copied all of 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 in which profits or income arising outside Hong Kong are not subject to taxation.[11]

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

- a narrow taxation base that 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 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;

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[6]The key initial document governing the reversion of sovereignty over Hong Kong from the United Kingdom to the People's Republic of China was 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 December 19, 1984 (Joint Declaration).

[7]The Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China. The Basic Law was adopted by China's Parliament and the National People's Congress, and promulgated on April 4, 1990. The primary commentary on the Basic Law is Yash Ghai, *Hong Kong's New Constitutional Order* (2nd ed.) (Hong Kong University Press, Hong Kong, 1999).

[8]For a review of the operation of the HKSAR's executive-led (entirely appointed by Beijing) system of government, see Christine Loh and Richard Cullen, "Political Reform in Hong Kong," (2005) *Journal of Contemporary China*, 147.

[9]That governance structure is quite similar to that prevailing in Britain under George III in the late 18th century — a structure that was swept away in the United Kingdom by the 1830s with the introduction of Westminster or parliamentary government. The role of the monarchy was reduced to that of a figurehead at the same time. *See* David Walker, *The Oxford Companion to Law* (Clarendon Press, Oxford, 1980) 927.

[10]Briefly, a thin rule of law regime is characterized by: (1) clear procedural rules for lawmaking; (2) publicly promulgated laws; (3) no retrospective laws; (4) laws made by a duly authorized lawmaking entity; (5) relatively clear, consistent and stable laws; and (6) 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 stipulations about property and economic system rights. *See* Randall Peerenboom, *China's Long March Toward Rule of Law* (Cambridge University Press, Cambridge, 2002).

[11]For a detailed review of the historical development of Hong Kong's revenue regime, see Michael Littlewood, "Taxation Without Representation: The History of Hong Kong's Troublingly Successful Tax System," (2002) *British Tax Review* 212; and Michael Littlewood, "Tax Reform in Hong Kong in the 1970s: Sincere Failure or Successful Charade?" in John Tiley (ed.), *Studies in the History of Tax Law* (Hart, Oxford, 2004). *See, also*, Andrew Halkyard, "The Hong Kong Tax Paradox or Why Jurassic Park Exists in the Pearl River Delta," (1998) 8 *Revenue Law Journal* 1.

- almost no use (until recently) of double taxation treaties;
- comparatively constrained government spending;
- little government borrowing;
- infrequent (until recently) deficit budgeting; and
- massive accumulated fiscal reserves.[12]

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, Hong Kong has managed to amass public foreign currency reserves of over US $120 billion.[13]

The explanation for that apparent fiscal miracle has a number of facets. One important explanatory factor has been 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 characterized 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 that might be obtained, but within those constraints, the government remained well-placed to benefit significantly from its continuing primary role in the real estate market. It is now well recognized, though, that Hong Kong's narrow (land revenue related) tax base is a serious systemic fiscal flaw that needs to be fixed.

Does Increased Taxation Drive Increased Democratization?

Numbers of scholars have taken a range of perspectives on the interaction of taxation and political systems.[14] It appears that one of the rallying cries of

[12]These and some other aspects of the Hong Kong Revenue system are described in some detail in Richard Cullen, "Revenue Law in Hong Kong: The Future," in Raymond Wacks (ed.), *The New Legal Order in Hong Kong* (Hong Kong University Press, Hong Kong, 1999), chapter 12.

[13]"Economy," *The Economist*, Nov. 12, 2005, 106. These fiscal reserves are known, officially, as the Exchange Fund. The Exchange Fund, today, essentially comprises: the fiscal reserves (money saved from revenues raised but not spent over previous decades) of the government's general revenue account (roughly 40 percent of the Exchange Fund); and the balance of government foreign currency reserves that back the Hong Kong dollar (HKD) (roughly 60 percent of the Exchange Fund). The Exchange Fund is managed by the Hong Kong Monetary Authority (HKMA). The HKMA also manages the quasi-currency board pegging of the HKD to the U.S. dollar (USD). 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, among other things: the HKMA manages the HKD other than in accord with strict currency board principles; and the HKMA (unlike a true currency board) also operates like a central bank in some 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 — 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 unprecedented heavy reliance of the HKSAR government on deficit financing since 1998 has been paid for out of the government's fiscal reserves in the Exchange Fund. Unlike for accessing additional revenues through extra taxation, when the approval of LegCo is mandatory, the HKSAR government can access the fiscal reserves without LegCo approval.

[14]*See*, *e.g.*, Robert H. Bates and Da-Hsian Donald Lien, "A Note on Taxation, Development, and Representative Government," (1985) 14 (1) *Politics and Society* 53; James Field Willard, *Parliamentary Taxes on Personal Property 1290 to 1334: A Study in Medieval English Feudal Administration* (The Medieval Academy of America, Cambridge, Massachusetts, 1934); Michael Prestwich, *War, Politics and Finance Under Edward I* (Faber and Faber, London, 1972); Robert H. Bates, "A Political Scientist Looks at Tax Reform," in Malcolm Gillis (ed.), *Tax Reform in Developing Countries* (Duke University Press, Durham, 1989); Albert O. Hirschman, *The Passions and the Interests: Political Arguments for Capitalism before Its Triumph* (Princeton University Press, Princeton, New Jersey, 1977); Jane Frecknall Hughes and Lynne Oates, "John Lackland: A Fiscal Re-evaluation," in John Tiley (ed.), *Studies in the History of Tax Law* (Hart Publishing, Oxford, 2004); Douglas C. North and Barry R. Weingast, "Constitutions and Commitment: The Evolution of Institutions Governing Public Choice in Seventeenth-Century England," (1989) 49 (4) *The Journal of Economic History* 803; Martin Daunton, *Trusting Leviathan: The Politics of Taxation in Britain, 1799-1914* (Cambridge University Press, Cambridge, 2001); Charles Adams, *For Good and Evil: The Impact of Taxes on the Course of Civilization* (Madison Books, London, 1993); David F. Burg, *A World History of Tax Rebellions* (Routledge, New York, 2004); David A. Kemp, "Taxation: The Politics of Change," in John Wilkes (ed.), *The Politics of Taxation* (Hodder and Stoughton, Sydney, 1980); Thomas P. Bernstein and Lü Xiaobo, *Taxation without Representation in Contemporary Rural China* (Cambridge University Press, Cambridge, 2003); B. Guy Peters, *The Politics of Taxation: A Comparative Perspective* (Blackwell, Cambridge Massachusetts, 1991); B. Guy Peters, "Choices in Taxation Policy," in T.R. Dye and V. Gray (eds.), *The Determinants of Public Policy* (Lexington Books, Lexington, 1980); J. Haycraft, *Italian Labyrinth* (Penguin, Harmondsworth, 1985); F.G. Castles, "The Impact of Parties on Public Expenditure," in F.G. Castles

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the American Revolution in the late 18th century — "no taxation without representation" — was genuinely galvanizing at that time. Today, however, 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."[15] Ross looks at the historical commentary as well as data from 113 countries over more than 25 years before coming down firmly in favor 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.

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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 to that issue is value for the money they pay to government.

In other words, 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, 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 that case, any move to increase taxes may very well result in firm demands for serious political structure reform.[16]

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 outdated tax system. The fundamental, historical drivers of those 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 in that 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* that, from 1949, governed Britain's working relationship with the P.R.C.
- Stunning ("Mini-Dragon") economic growth rates post-World War II (until 1998), which took Hong Kong's per capita GDP from below that of India in 1946 to higher than that of Australia within 50 years and produced full employment and rising wages for an exceptionally adaptable and hardworking, mainly immigrant population.
- A "sojourner" population that 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 that 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 that has been described as the "residual welfare state.")[17]

(ed.), *The Impact of Parties* (Sage, London, 1982); O. Morrissey and Sven Steinmo, "The Influence of Party Competition on Post-War UK Tax Rates," (1987) 15 *Policy and Politics* 195; Sven Steinmo, "Political Institutions and Tax Policy in the United States, Sweden and Britain," (1989) 61 *World Politics* 500; Sven Steinmo, *Taxation and Democracy* (Yale University Press, New Haven, Connecticut, 1993); R. Dahl, *Polyarch: Participation and Opposition* (Yale University Press, New Haven, Connecticut 1973); P.C. Schmitter and G. Lehmbruch, *Trends Toward Corporatist Intermediation* (Sage, London, 1979); M. Olson, *The Logic of Collective Action* (Harvard University Press, Cambridge, Massachusetts, 1965); William B. Barker, "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; and Bruce Bueno de Mesquita and George W. Downs, "Development and Democracy," (2005) 84 *Foreign Affairs* 77.

[15]Michael L. Ross, "Does Taxation Lead to Representation?" (2004) 34 *British Journal of Political Science* 247.

[16]The American revolutionary experience may even have passed through that two-phase process — albeit with the two phases following so swiftly on one another as to seem like a single experience.

[17]Hong Kong's "residual welfare state" has been characterized by a somewhat paradoxical combination of heavy public involvement in financing and provision of direct public goods (*e.g.*, housing and transport, communication, educational, and health infrastructures), while at the same time maintaining comparatively low overall government spending

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The second question asked what relationship, if any, lies behind the development and maintenance of those two regimes. Our answer is that Hong Kong's underdeveloped 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 similar, however. Elite business groups in Hong Kong have, virtually from the inception of British rule, had an inordinate, self-focused influence on much public policy development. And that influence has been particularly important in the mix of factors that has left Hong Kong with a conspicuous democratic deficit in its system of government. Those business-related groups have generally worked in harmony with other key shapers of that system, including successive Hong Kong and U.K. governments — and Beijing. The influence of those 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 that bound to add significant impetus to the calls for increased democracy in Hong Kong. Even though it is now widely recognized that significant reform of both of those 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 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 lawmaking body, most of all because of its system of functional constituencies.[18] Hong Kongers know they are ready for full democratization and they see that as the best long-term solution to Hong Kong's governance shortfalls. What is perhaps most disturbing about the present 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 underperforming government.

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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 about the political-economy consequences of different tax policy options and about the legislative and administrative arrangements needed to implement change.

The fundamental issues that 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 GST?

(compared with revenues). *See* Eliza Wing-yee Lee, "The Politics of Welfare Developmentalism in Hong Kong," at: http://www.unrisd.org/unrisd/website/document.nsf/0/B764A113DEE628D4C125706D0032DA66?OpenDocument.

[18]The functional constituencies (FCs) were introduced into Hong Kong by the British in the 1980s. They are supposed to provide specific representation in the legislature for a range of business and professional groups and a few noncommercial groups. The franchise for FCs is heavily biased toward the business sector. They are, in the 21st century, a notable political structure embarrassment. FC members frequently represent narrow interests and FCs are, at worst, a travesty of electoral politics. The LegCo voting rules have also been distorted so that they amplify the negative impact of the FCs on fully representative lawmaking. The Standing Committee of the National People's Congress (SCNPC) has, through its Basic Law Interpretation of April 2004 and subsequent endorsement of the Chief Executive's report on constitutional development in Hong Kong, insisted that the FC system not be dismantled prior to the next LegCo election due in 2008. The 50-50 ratio of directly elected to FC lawmakers must be retained. Those SCNPC decisions mean that only less radical changes to the FC system may be contemplated. For a comprehensive discussion of the issues surrounding the operation of the FC system in Hong Kong, see http://www.civic-exchange.org under "Publications." Note, in particular (at that Web site): Simon N. M. Young, "Hong Kong's Functional Constituencies: Legislators and Elections"; Sing Ming, "To What Extent have the Members of the Functional Constituencies Performed the Balancing Role"; Simon N.M. Young and Anthony Law, "A Critical Introduction to Hong Kong's Functional Constituencies"; and Gladys Li and Nigel Kat, "Functional Constituencies: The Legal Perspective." Civic Exchange also has a comprehensive book on FCs due for publication in 2005 (Christine Loh (ed.), *Functional Constituencies* (Hong Kong University Press, Hong Kong, 2005)). That book has chapters featuring updated versions of the above articles, together with a number of other chapters. *See also* Richard Cullen, "The Rule of Law in Hong Kong," at: http://www.civic-exchange.org/publications/2005/rolawe.pdf.

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3. Is it time to reconsider Hong Kong's reliance on source-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 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-monopolized commodity in Hong Kong was not without its benefits in times past. But those benefits have come at an increasing cost. The "use by" date for that 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 that conclusion holds so well today, however.[19] The HKSAR government knows, too, that its unelected status fundamentally undercuts its legitimacy. All of that has tended to make the government timid when it comes to much major policy development and implementation. The irony is perhaps that, although the historical track record suggests that the Hong Kong government enjoys a comparatively sound record fiscally, the government's own behavior, 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 that is the case.[20]

Given the political reality, the most sensible way forward would be to mesh serious tax reform in Hong Kong with meaningful political reform. That would assist the implementation of tax reform and boost government credibility. More importantly, it would be in the best interests of Hong Kong. ◆

[19]The decline in confidence in the government in Hong Kong since 1997 and the reasons therefore are examined in Loh and Cullen, *op. cit*. note 8.

[20]Tang argues that the successive (unelected) Hong Kong governments have, both before and after 1997, lacked "the determination to push for tax reform" (Tang Shu-Hung, "The Political Economy of Tax Reform in Hong Kong," (2005) *Asia-Pacific Journal of Taxation* 52, at 72).