



# THE HONG KONG TAX SYSTEM: ITS HISTORY, ITS FUTURE AND THE LESSONS IT HOLDS FOR THE REST OF THE WORLD

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*This article consists of three parts. The first part, which is also the lengthiest, reviews Hong Kong's tax history from 1940 (when taxes on income were first introduced) until the present day. The second part considers the future. It argues that democracy in Hong Kong will probably not lead to a steeply progressive income tax, so long as the government introduces neither PAYE (that is, withholding of tax on income from employment) nor GST. The third part of the article considers what the rest of the world might be able to learn from the spectacular successes of Hong Kong's tax system. The main lessons are: (a) that it is possible to structure a combination of very light taxes and very low public spending so that it enjoys very broad public support; (b) that it is possible for a developed jurisdiction's tax legislation to be simple; and (c) that a progressive consumption tax is feasible.*

## Introduction

Hong Kong's tax system is perhaps the most successful the world has ever seen. The burden is exceptionally light, yet the government has generally operated at a substantial surplus. Consequently it has accumulated enormous reserves, often standing at more than 12 months total public spending. More impressively still, the Hong Kong people seem more content than other peoples not only with the lightness of the burden (as one would expect) but also (more intriguingly) with the combination of very light taxes and very low public spending. This article reviews the history of Hong Kong's tax system, considers also its future, and concludes with some suggestions as to what it might be possible for governments elsewhere to learn from it.

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## 1. Hong Kong's Tax History

### The Introduction of Taxes on Income during World War II

Prior to the Second World War, there was no income tax in Hong Kong, but in 1940 the colonial government proposed to establish one, for the purpose of financing “gifts” to Britain in support of the war effort.<sup>1</sup> The proposal was for the kind of income tax the British regarded as normal. That is, there would be a single tax on income as such and this tax would cover both (a) the world-wide incomes of all persons resident in Hong Kong and also (b) income derived from Hong Kong by persons resident elsewhere.<sup>2</sup>

The business community objected. The expatriates regarded income tax as inevitable, sooner or later, and so were mainly concerned to ensure that it came later, rather than sooner, and that the rates of tax were as low as possible. But the Chinese businessmen were uncompromisingly opposed to income tax in principle; and the expatriates, sensing that a normal income tax might not be inevitable after all, joined the Chinese in opposing it.<sup>3</sup>

The government could have used the official majority in the Legislative Council to outvote the unofficials and so establish a normal income tax, because at that time a majority of the members of the Legislative Council were civil servants and they always voted with the government. But the government was not prepared to use the official majority to outvote the unofficials. Nor would the Colonial Office have approved.<sup>4</sup> So, instead, the Governor, Sir Geoffrey (sic) Northcote, established a committee dominated by businessmen. In this way, a deal was tacitly done, whereby the businessmen agreed to go along with some sort of income tax and the government abdicated the design of it to them.<sup>5</sup>

#### *The War Revenue Ordinance 1940*

What the businessmen came up with differed from a normal income tax in two basic respects. First, there was no tax on income, as such, at all.

<sup>1</sup> For a more comprehensive account of Hong Kong's tax history, see Michael Littlewood, *Taxation Without Representation: The History of Hong Kong's Troublingly Successful Tax System* (Hong Kong: HKU Press, 2010).

<sup>2</sup> CO129/582/7. CO129 is the series of Colonial Office files containing the correspondence between the Colonial Office and the Governors of Hong Kong, together with miscellaneous other documents. The original files are all in the British Public Record Office at Kew but copies are held by various libraries in Hong Kong, for example the main library at the University of Hong Kong.

<sup>3</sup> See the 1939 Budget Debate, *Hong Kong Hansard*, 9 and 16 Nov 1939.

<sup>4</sup> CO129/582/7.

<sup>5</sup> *Report of the War Revenue Committee*, Sessional Paper No 1, Noronha & Co, Government Printer, Hong Kong, 1940.

Instead, there was a schedular system of three separate taxes on three different kinds of income: property tax was charged on the rental value of property; salaries tax was charged on income from employment; and profits tax was charged on the profits of business.<sup>6</sup> Second, the system was based on the *source* principle, meaning that tax was only charged on income derived from a source in Hong Kong. In other words, income derived from outside Hong Kong was not taxable.<sup>7</sup>

It is sometimes thought that it makes little difference whether there is a single tax on income as such, or separate taxes on income of different kinds. But that is not so. The difference it makes is that a single tax on income as such can be charged at very high rates (for example in the United Kingdom income tax at one point reached 98 per cent<sup>8</sup>), whereas a schedular system of separate taxes on different kinds of income can work well enough at low rates of tax but it simply cannot work at high or even moderate rates of tax. The reason is that schedular tax systems are (to use the Hong Kong government's own epithet) "inherently inequitable".<sup>9</sup> And the reason for *that* is that if there are separate taxes on different kinds of income, a person whose income all comes within a single schedule will pay much more tax than one whose income is the same but split among two or more schedules.

If the rates of tax are low, a person might not object to paying more tax than his neighbour, even though their total incomes are the same. But if the rates of tax are increased, the system's inherent inequity will be accentuated, with the result that it will become politically impossible to administer the tax system. As Adam Smith put it, "in a light tax a considerable degree of inequality may be supported; in a heavy one it is altogether intolerable".<sup>10</sup> Whether it would *really* have become impossible to administer the tax system is impossible to say; the point remains,

<sup>6</sup> Strictly speaking, there were not three taxes but four, because there were two profits taxes: *corporation* profits tax was imposed on the profits of corporations and *business* profits tax was imposed on the profits of firms other than corporations (meaning mainly partnerships and sole proprietorships): War Revenue Ordinance 1940 ss 13 and 14. But the scope of these two taxes was practically identical and in 1971 they were fused into a single tax, called simply profits tax: Inland Revenue (Amendment) Ordinance 1971 s 9.

<sup>7</sup> *Report of the War Revenue Committee* (n 5).

<sup>8</sup> Peter G. Whiteman et al, *Whiteman on Income Tax* (London: Sweet and Maxwell, 3rd edn, 1988), p 8.

<sup>9</sup> The first person to describe Hong Kong's tax system as inherently inequitable seems to have been H. J. Huxham, a Colonial Office tax expert, in 1940. See CO129/586/8; *Report of the War Revenue Committee* (n 5), p 12, reservation entered by Thomas Black; and Littlewood (n 1), pp 46–47. But the description encapsulates a truth so fundamentally important that it was adopted by various subsequent commentators, notably all three of the Inland Revenue Ordinance Review Committees (in the 1950s, 1960s and 1970s; see below).

<sup>10</sup> *The Wealth of Nations*, V.ii.j.4.

however, that the Hong Kong and British governments both believed that it would be impossible.<sup>11</sup>

In any event, the schedular tax system designed by the businessmen was established by the War Revenue Ordinance 1940. The highest rate of tax was 10 per cent<sup>12</sup> and the allowances were set at levels that effectively exempted 99 per cent of the people from tax altogether.<sup>13</sup> It was supposed to be a temporary wartime measure. The government's plan was to replace it after the war with a normal income tax; but that never happened, so the temporary system designed by the businessmen in 1940 remains in force today.

#### *The War Revenue Ordinance 1941*

In 1941, the War Revenue Ordinance 1940 was repealed and replaced by the War Revenue Ordinance 1941. This kept the basic structure of the system intact, but refined the drafting and added a new, fourth tax – interest tax – to the original three (property tax, salaries tax and profits tax).

A few months later, Hong Kong was occupied by the Japanese, so the British administration of the territory was suspended.

### **After the War**

After the war, the British and Hong Kong governments again proposed to establish a normal income tax; and they planned also that the rates of tax should be “as high as possible” – those were the words used by Arthur Creech Jones, who was the Secretary of State for the Colonies at the time.<sup>14</sup> By “as high as possible” he probably meant about 50 per cent.<sup>15</sup> But the business community was again opposed, and the Chinese businessmen were again unyielding in their opposition. They formed an organization called the Chinese Anti-Direct Tax Commission; they marched in protest on government house; and they wrote letters of complaint to the Colonial Office in London.<sup>16</sup>

<sup>11</sup> See for example C. W. Norris (Acting Commissioner of Inland Revenue), letter to John Cowperthwaite (Financial Secretary), 26 May 1961, HKRS 163-9-242, (16). The prefix HKRS indicates a file held by the Hong Kong Public Records Office.

<sup>12</sup> War Revenue Ordinance 1940 ss 12, 13, and 14.

<sup>13</sup> War Revenue Ordinance 1940 ss 8 and 11.

<sup>14</sup> Arthur Creech Jones, telegram to Sir Mark Young (Governor of Hong Kong), 26 Jan 1947, CO129/595/3, 11.

<sup>15</sup> See CO129/595/3.

<sup>16</sup> See HKRS 41-1-2776-1.

As a compromise, the schedular system devised in 1940 was revived in 1947.<sup>17</sup> Its name was changed (it was called the Inland Revenue Ordinance rather than the War Revenue Ordinance) but its basic schedular structure remained much the same; and the highest rate of tax was 10 per cent – or, at least, although the highest *marginal* rate of tax was 20 per cent, total liability was capped at 10 per cent. The reason it was called the Inland Revenue Ordinance, rather than the Income Tax Ordinance, is that the whole point of the schedular structure was that it was *not* an income tax. The Inland Revenue Ordinance was supposed to be a temporary measure. The plan was to repeal it in 1948 or 1949 at the latest and establish a normal income tax in its place;<sup>18</sup> but that never happened.

The only change in the system's basic structure in 1947 was the introduction of personal assessment, which is like a normal income tax, except that it is elective. So a taxpayer could *either* pay the schedular taxes on the several components of his income; *or* elect personal assessment, in which case he would add up those components and pay tax on the total. The aim of personal assessment was to pave the way for a normal income tax. The idea was to set the rates of tax and the allowances so that the overwhelming majority of taxpayers would gain by electing personal assessment. Almost all taxpayers would therefore elect it and then it would be possible to abolish the schedular taxes, leaving *only* personal assessment. Personal assessment would then be compulsory, so that it would constitute a more or less normal income tax, albeit one confined to income derived from Hong Kong.<sup>19</sup>

But that never happened. Rather, what happened was that personal assessment ameliorated the more serious inequities inherent in the schedular system and so, far from leading to the *abolition* of the schedular system, made feasible its *preservation*. In other words, personal assessment had exactly the opposite effect of what the government intended.

### From 1947 to 1980: the Three Review Committees

From 1947 until about 1980, the British government continued to put pressure on the Hong Kong government to reform the colony's tax system. As before, the basic aim was to establish a normal income tax – that is, a tax on income as such, including offshore income – and then

<sup>17</sup> *Report of The Taxation Committee*, apparently unpublished, Hong Kong, 1946: HKRS 41-1-802, (1-1). See also CO129/595/3, 106.

<sup>18</sup> CO129/595/3.

<sup>19</sup> Eric Pudney (Hong Kong's first Commissioner of Inland Revenue), memorandum, 8 Jan 1947, CO129/595/3, 29.

to crank up the rates of tax.<sup>20</sup> But this never happened, for two main reasons. First, the business community, especially the Chinese businessmen, remained resolutely opposed.<sup>21</sup> Second, the Inland Revenue Ordinance immediately demonstrated its one great redeeming virtue: despite its gross theoretical inadequacy, it almost always produced more money than the government wanted to spend.<sup>22</sup>

This chapter of Hong Kong's tax history fall into three periods of about 10 years each. In each of the three periods the process of tax reform was dominated by the financial secretary. In the 1950s the financial secretary was Sir Arthur Clarke; in the 1960s, it was Sir John Cowperthwaite; and in the 1970s, it was Sir Philip Haddon-Cave. Clarke, Cowperthwaite and Haddon-Cave all thought that it was obvious that what Hong Kong required was a normal income tax – that is, a single, comprehensive tax covering both (a) the worldwide income, including offshore income, of all persons resident in Hong Kong and also (b) all income derived from Hong Kong by persons resident elsewhere.<sup>23</sup>

In the hope of achieving the goal of a normal income tax, Clarke, Cowperthwaite and Haddon-Cave each persuaded the governor under whom he served (respectively, Sir Alexander Grantham, Sir David Trench and Sir Murray Macle hose) to establish a committee. These were the First, Second and Third Review Committees: the First Committee was established by Grantham in the 1950s;<sup>24</sup> the Second Committee was established by Trench in the 1960s;<sup>25</sup> and the Third Committee was established by Macle hose in the 1970s.<sup>26</sup> But all three committees failed to achieve the financial secretaries' goal of a normal income tax.

It was repeatedly alleged throughout this period that the colonial government was acting on instructions from London and that the idea that Hong Kong should have a normal income tax charged at rates comparable to those in the United Kingdom was not devised by the colonial

<sup>20</sup> See for example E. Melville (of the Colonial Office), letters to John Cowperthwaite, 14 Apr 1961 HKRS 163-9-242, (10) and 30 May 1961, HKRS 163-9-242, (17).

<sup>21</sup> See for example C. Y. Kwan, *Hong Kong Hansard*, 19 Mar 1962, pp 93–94.

<sup>22</sup> See for example Sir John Cowperthwaite's 1971 Budget Speech, *Hong Kong Hansard*, 24 Feb 1971.

<sup>23</sup> See for example HKRS 163-9-242; Sir John Cowperthwaite, *Hong Kong Hansard*, 24 Feb 1966, p 79; Sir Philip Haddon-Cave, 1975 and 1976 Budget Speeches. In the course of his time in office, however, Cowperthwaite revised his views. In the beginning, like Clarke and Haddon-Cave, he thought it obvious that what was required was a normal income tax, covering both Hong Kong income and offshore income. But later, whilst remaining of the view that what was required was a single tax on income as such, he thought it would be appropriate to confine this tax to income derived from Hong Kong. See *Hong Kong Hansard*, 24 and 25 Mar 1966, pp 209–210.

<sup>24</sup> *Report of the Inland Revenue Ordinance Committee*, Government Printer, Hong Kong, 1954.

<sup>25</sup> *Report of the Inland Revenue Ordinance Review Committee Parts I (1967) and II (1968)*, S. Young, Government Printer, Hong Kong, 1967 and 1968.

<sup>26</sup> *Report of the Third Inland Revenue Ordinance Review Committee*, publisher not identified, but presumably Government Printer, Hong Kong, 1976.

government, acting on its own initiative, but dictated by Britain. All three financial secretaries – Clarke, Cowperthwaite and Haddon-Cave – denied that the British government was attempting to dictate tax policy to Hong Kong, but it is clear from documents that are now publicly available that dictating Hong Kong's tax policy was exactly what London was trying to do.<sup>27</sup>

#### *The First and Second Review Committees*

In any event, the first and second committees were stymied at the outset: on both occasions, the business community persuaded the governor (Sir Alexander Grantham in 1952; Sir David Trench in 1966) to draft their terms of reference so narrowly that they were not permitted to consider the possibility of a normal income tax.<sup>28</sup> Consequently these two committees were reduced to recommending a variety of relatively trivial technical refinements to the schedular system. As a result, neither Clarke nor Cowperthwaite made any progress at all towards their goal of a normal income tax.

Cowperthwaite's failure is notable, because he is widely regarded as a towering figure, who used his control of the government's finances to dictate government policy generally. For example, Frank Welsh, the author of one of the best general histories of Hong Kong, refers to the 1960s as "the Cowperthwaite years".<sup>29</sup> But this apparent paradox is easily explained: the proposal for a normal income tax was the only proposal Cowperthwaite ever made that was seriously contrary to the interests of business. He could do whatever he liked, it seems, so long as he did what business wanted.

#### *The Third Review Committee*

The Third Committee failed too, but its story is a little different. This time the Financial Secretary (Sir Philip Haddon-Cave) succeeded in getting the Governor (Sir Murray Maclehoze) to appoint a committee with terms of reference sufficiently broad to permit it to consider the possibility of a normal income tax;<sup>30</sup> and the committee duly proposed something resembling a normal income tax.<sup>31</sup> Specifically, the Third Review Committee proposed that there should be a single tax on income as such, though it also proposed that this tax should be confined to income derived from Hong Kong.

<sup>27</sup> See for example the letters referred to in n 20. See also Littlewood (n 1), pp 201–205.

<sup>28</sup> *Report of the First Review Committee* (n 24), para 1; *Report of the Second Review Committee (Part I)* (n 25), p iii.

<sup>29</sup> Frank Welsh, *A History of Hong Kong* (London: Harper Collins, revised edn, 1997), p 475.

<sup>30</sup> *Report of the Third Review Committee* (n 26), para 1.

<sup>31</sup> *Report of the Third Review Committee* (n 26), Ch 2.

That is, offshore income would continue to be exempt from tax, as before. But having got that far, Haddon-Cave got no further: the government rejected all of the committee's major recommendations. Most importantly, it rejected the proposal that there should be a single tax on income as such, instead of the four schedular taxes.

The official reason given by the government for *not* establishing something resembling a normal income tax (as recommended by the Third Review Committee) was that the Inland Revenue Department had recently purchased a new computer and was consequently too busy to deal with the administrative burden of basic tax reform "at this time".<sup>32</sup> Since then, nothing has happened, so the official position seems to be that the reason Hong Kong still has the tax system designed in 1940 is that in the 1970s the Inland Revenue acquired a new computer. This is obviously absurd. The real reason must be that the business community declined to go along with the proposal (and the government, as before, shied away from using the official majority to outvote the unofficials).

The question arises therefore: why did the government set up the Committee at all, if it had neither the support of the business community to establish a normal income tax, nor the will to proceed without it? The answer seems to be that the government set up the committee expecting it to fail; and that the reason it did *that* was simply to get London off its back. Several years earlier, in 1973, the Governor, Maclehoose, had wanted to promote Haddon-Cave from Financial Secretary to Chief Secretary; but the British government vetoed the promotion, on the grounds that Haddon-Cave had failed to establish a steeply progressive income tax.<sup>33</sup> Then, in 1976, Maclehoose and Haddon-Cave set up the Third Review Committee, which proposed that there should be a more or less normal income tax. And in 1981, Haddon-Cave was at last promoted from Financial Secretary to Chief Secretary. He had not established a normal income tax, but apparently he had satisfied London that he had done all that was feasible.

### 1981–1997: the Modern City-State

Haddon-Cave's successor as Financial Secretary was Sir John Bremridge, whose appointment was unprecedented in that he was not a career civil servant, but a businessman. There was much speculation at the time as to why the Governor (Maclehoose) had made such an unexpected appointment.

<sup>32</sup> Sir Philip Haddon-Cave, 1979 Budget Speech, Annex 15, *Hong Kong Hansard*, 28 Feb 1979, p 600.

<sup>33</sup> See Norman Miners, *The Government and Politics of Hong Kong* (Hong Kong: Oxford University Press, 5<sup>th</sup> ed, 1991), pp 142–143; Littlewood (n 1), pp 201–205.

The answer is perhaps that the businessmen had tired after 40 years of financial secretaries attempting to foist a British-style tax system on them; that they had therefore persuaded the Governor to appoint someone who could be relied on to leave the tax system alone; and that it was Bremridge's well known opposition to tax reform<sup>34</sup> that won him the job. In any event, since 1981 the Hong Kong government has never seriously suggested that the territory should have a normal income tax. Also at this point (about 1981) the *British* government seems to have lost interest in Hong Kong's tax system – though it is difficult to be sure, because the public record from this period remains closed.

Bremridge was followed by Sir Piers Jacobs, Sir Hamish Macleod and Sir Donald Tsang (who served as the last Financial Secretary under British rule, the first under the new regime, and, on Tung Chee Hwa's retirement, the second Chief Executive of the Hong Kong SAR). As before, there were no changes in the Hong Kong tax system's basic structure. On the contrary, Bremridge immediately implemented reforms that effectively entrenched the schedular system. Most importantly, he started making changes to the tax treatment of interest, culminating, in 1989, in the abolition of interest tax.

#### *The Judicial Expansion of the Tax System*

An intriguing episode in this chapter of Hong Kong's tax history is the sweeping extension of the tax system effected by the territory's courts between 1980 and 1997.

As has been explained, one of the basic features of the Hong Kong tax system is that it is based on the source principle, meaning that tax is only imposed on income derived from Hong Kong. In other words, income derived from outside Hong Kong is not taxable. In this respect, Hong Kong's tax system is unusual. Most developed countries' tax systems are based on both residence *and* source. Thus, a person who is resident in the jurisdiction is obliged to pay tax on his worldwide incomes, meaning both income derived from the jurisdiction and also income derived from anywhere else. And income derived from the jurisdiction is taxable there, whether the person to whom it accrues is resident there or not.

As has also been explained, it was not the Hong Kong government's idea to exempt offshore income from tax. Rather, this was proposed and insisted upon by the businessmen who dominated the committee that designed the colonial tax system in 1940. The government wanted to tax Hong Kong residents on their total income, including offshore income,

<sup>34</sup> See for example *Hong Kong Hansard*, 25 Mar 1976, p 703.

and only agreed to exempt offshore income from tax because otherwise there would have been no income tax at all (the government having already decided not to use the official majority to outvote the unofficials). Having conceded the exemption as a supposedly temporary measure, the government spent the next 40 years (from 1940 to 1980) trying to withdraw it, or at least reduce its scope.

This it failed to do, but over the period from about 1980 to 1997, the courts reinterpreted the legislation so as to dramatically extend its scope. Section 14 of the Inland Revenue Ordinance imposes tax on profits “arising in or derived from Hong Kong”. These words were first adopted in 1941;<sup>35</sup> they were revived after the war in 1947; and they have remained unchanged ever since. When it came to interpreting them, there was a large body of case law upon which the Hong Kong courts could rely, because in the late nineteenth century and the early twentieth, source-based income taxes were the norm throughout the British Empire (excepting only the United Kingdom itself, which had taxed offshore income since introducing income tax in 1803). Most importantly, Australia, New Zealand, Canada, India and South Africa all had source-based income taxes; and the courts of all these colonies and dominions, and also the Privy Council, had repeatedly been called upon to distinguish between taxable domestic income and non-taxable offshore income.<sup>36</sup>

The first important case was *In re Tindal*,<sup>37</sup> decided by a New South Wales court in 1897. This case established the basic principle that a profit made by selling goods is derived from the place where the goods are sold. So a firm carrying on business in New South Wales and selling goods in England was not taxable on the profit, under source-based tax system of New South Wales. Then, in *Commissioners of Taxation v Kirk*,<sup>38</sup> the Privy Council held that in the case of a profit made by *manufacturing* and selling goods, some qualification to this principle might be necessary, and that in some circumstances it might be appropriate to attribute *part* of the profit to the manufacturing.

Thus, depending on the circumstances, a profit made by manufacturing and selling goods should be either (a) attributed entirely to the place where the goods are sold or (b) attributed partly to the place where the goods are manufactured and partly to the place where they are sold. Next,

<sup>35</sup> War Revenue Ordinance 1941 ss 15 and 16.

<sup>36</sup> See for example Peter Willoughby and Andrew Halkyard, *Encyclopaedia of Hong Kong Taxation* (Hong Kong: Butterworths, 1993); Jefferson VanderWolk, *The Source of Income: Tax Law and Practice in Hong Kong* (Hong Kong: Sweet & Maxwell, 3<sup>rd</sup> edn 2002); and Michael Littlewood, “The Privy Council, the Source of Income and *Stare Decisis*” [2004] *British Tax Review* 121.

<sup>37</sup> (1897) 18 NSWLR 378.

<sup>38</sup> [1900] AC 588 PC.

in *Lovell & Christmas Ltd v Commissioner of Taxes*,<sup>39</sup> the Privy Council confirmed that the rule in *Tindal's* case still applied where the taxpayer makes a profit by selling goods that he has not manufactured. So if the taxpayer makes a profit by *buying* and selling goods, the profit is derived from the place where the goods are sold. And likewise, if the taxpayer makes a profit by selling goods as an agent, the profit is derived from the place where the goods are sold.

These principles were confirmed and refined in a large number of other cases, for example *Commissioner of Taxation v D & W Murray Ltd*<sup>40</sup> and *International Harvester Co of Canada Ltd v Provincial Tax Commission*.<sup>41</sup> For 40 years, the Hong Kong government administered the colony's tax system on this basis. In fact, the government seems generally to have accepted that *all* profits made by exporting goods or services were derived from outside Hong Kong and therefore not taxable.<sup>42</sup> In other words, the government accepted the general rule laid down in *Tindal* and ignored the exception created in *Kirk*. Consequently, many Hong Kong firms paid no tax at all.

Starting in about 1980, however, the Inland Revenue persuaded the Hong Kong courts to take a much more expansive approach. The most important cases are *Sinolink Overseas Ltd v Commissioner of Inland Revenue*,<sup>43</sup> *Commissioner of Inland Revenue v Hang Seng Bank Ltd*,<sup>44</sup> *Commissioner of Inland Revenue v HK-TVB International Ltd*,<sup>45</sup> and *Commissioner of Inland Revenue v Orion Caribbean Ltd*.<sup>46</sup> The combined effect of these cases is that, if a firm carries on business in Hong Kong, and it does not have a branch outside Hong Kong, then the *whole* of its profits are regarded as being derived from Hong Kong, and therefore taxable – except in “rare cases”.<sup>47</sup>

In other words, although the government failed to *amend* the legislation to tax offshore profits, it succeeded in persuading the courts to *reinterpret* it, to much the same effect. This judicial expansion of the tax system raises two questions. First, is it appropriate for the judges to have expanded the scope of the tax system in this way? And second, are there

<sup>39</sup> [1908] AC 46 PC.

<sup>40</sup> (1929) 42 CLR 332 HCA.

<sup>41</sup> [1949] AC 36 PC.

<sup>42</sup> Michael Littlewood, “The Taxation of Manufacturing Profits: A Re-interpretation” (1997) 27 HKLJ 313.

<sup>43</sup> (1985) 2 HKTC 127.

<sup>44</sup> [1991] 1 AC 306.

<sup>45</sup> [1992] 2 AC 397.

<sup>46</sup> [1997] STC 923.

<sup>47</sup> *Commissioner of Inland Revenue v HK-TVB International Ltd* [1992] 2 AC 397, p 409; Commissioner of Inland Revenue, *Departmental Interpretation and Practice Notes No 21* (Revised Dec 2009), para 17(o).

any other instances of the Hong Kong courts engaging in law-making on this scale?

### The Post-Handover Period

Since 1997, not much has happened, in terms of the development of Hong Kong's tax system. The Inland Revenue Ordinance has been repeatedly amended, but all the amendments have been trivial; none has made any difference to the Ordinance's basic structure. Consequently, Hong Kong still has the supposedly temporary wartime system of taxation invented in 1940 and revived in 1947.

There have, however, been three developments that have left the Ordinance itself unchanged, but which nonetheless relate to the basic functioning of the tax system, namely (1) the enactment of the Basic Law, (2) the proposal to introduce a value-added tax (to be called Goods and Services Tax or GST), and (3) the Hong Kong government's policy of entering into double tax agreements with other governments.

#### *The Handover and the Basic Law*

The handover left Hong Kong's tax system basically unchanged. Most importantly, the Basic Law preserved what is colloquially referred to as the "fiscal firewall": that is, the tax systems and public finances of Hong Kong and the Mainland remain completely separate.<sup>48</sup> But the Basic Law also contains provisions intended to ensure that there is no change to the traditional low tax policy<sup>49</sup> and that the Hong Kong government does not operate at a deficit.<sup>50</sup>

These provisions are interesting in several respects. Most importantly, Article 108 of the Basic Law provides (in part) as follows:

"The Hong Kong Special Administrative Region shall, taking the low tax policy previously pursued in Hong Kong as reference, enact laws on its own concerning types of taxes, tax rates, tax reductions, allowances and exemptions, and other matters of taxation".

This raises a number of problems. First, what exactly is the low tax policy? How low is low? Second, is Article 108 justiciable, or merely symbolic? What would happen if the Hong Kong government were for some reason to enact a law imposing a tax that was *not* in accordance with the low tax

<sup>48</sup> Basic Law Arts 18, 106 and 108.

<sup>49</sup> Basic Law Art 108.

<sup>50</sup> Basic Law Art 107.

policy? Would it be unconstitutional and therefore void? Would it be lawful for people to refuse to pay the tax, on the basis that it was not in accordance with the Basic Law? Third, who would get to decide? Would it be the Court of Final Appeal in Hong Kong? Or would it be a matter of interpretation for the Standing Committee of the National People's Congress in Beijing?<sup>51</sup>

It seems reasonable to suppose that the purpose for which Article 108 was enacted was to protect Hong Kong's richer residents from the possibility that democracy might one day lead to a steep progressive income tax. Thus, if a heavy tax were ever to be imposed on large incomes, it would be possible for the courts to strike it down for non-compliance with Article 108 – or, failing the courts, the Standing Committee. But it is also possible that a tax *favoured* by the establishment – for example, GST – could be challenged under Article 108. For instance, it could be said that a tax on rice, even at a low rate, would not be in accordance with Hong Kong's traditional low-tax policy (especially since a value-added tax, such as GST, even if charged at a very low rate – say 3 per cent – would produce very substantial revenues). If the courts were to hold that Article 108 is simply not justiciable, it would fail to serve its purpose (protecting large incomes from populist tax increases). But if they were to hold that it is justiciable, they would presumably find it necessary to define the “low tax policy”, which seems troublesome.

#### *The Proposal to Introduce GST*

In the late 1980s the Financial Secretary, Sir Piers Jacobs, attempted to introduce a sales tax.<sup>52</sup> His idea was partly that the new tax would stabilise the government's rather volatile revenues and also that it would make it possible to reduce the rates of tax on income. But nothing came of Jacobs's proposal, mainly because it was opposed not only by the majority of Hong Kong people but also by the business community.<sup>53</sup> This is intriguing because elsewhere in the world business interests have typically been in favour of sales taxes and other general indirect taxes because they see them as a means of shifting a substantial part of the burden of taxation downwards onto ordinary working people, thus making it possible to cut the taxes on business profits and large personal incomes. But be that as it may, nothing came of Jacobs's proposal.

Shortly after the handover, however, the SAR government decided to introduce GST.<sup>54</sup> Again, its aim was to use the new tax to finance

<sup>51</sup> See Basic Law Art 158.

<sup>52</sup> See the 1987 Budget Speech, paras 43–51 and Hong Kong Government Secretariat (Finance Branch), *Consultative Paper: Sales Tax*, Hong Kong, 1989.

<sup>53</sup> See in particular the 1988 Budget Debate.

<sup>54</sup> See Antony Leung, 2003 Budget Speech and Hong Kong Government, *Consultation Document: Broadening the Tax Base: Ensuring our Future Prosperity*, 2006.

very substantial income tax cuts. This proposal, too, has so far come to nothing, for the same reason – that is, it was opposed by the business community.<sup>55</sup> Notwithstanding this setback, the government still seems committed to what it calls “broadening the tax base” – which is really a euphemism for “making ordinary working people pay more tax”. Whether it succeeds remains to be seen.

#### *Double Tax Agreements*

The third post-handover trend is the SAR government’s new policy of entering into Double Tax Agreements (or DTAs) with other governments. To date, it has entered into DTAs with the Mainland, Belgium, Thailand, Luxembourg, Vietnam, Brunei, the Netherlands and Indonesia. One reason for this policy is that as the years have gone by the OECD countries (the United States, the western European countries, Japan and so on) have become increasingly concerned about the various jurisdictions around the world that function as tax havens – that is, making it possible for people living in OECD countries to avoid or evade the taxes they should have been paying there.

In the mid-1990s, the OECD became serious about shutting down the tax havens and launched a campaign against them.<sup>56</sup> To this end, the OECD countries have put tremendous pressure on other governments to agree to hand over information about taxpayers.<sup>57</sup> Thus, in order for Hong Kong to be regarded as a good global citizen it is necessary for the SAR government to appear to be willing to enter into treaties providing for the exchange of information. And so the Hong Kong government, attempting to extract some benefit from this situation, seems to have adopted the position that it is prepared to provide information to any government that in return is prepared to grant relief from withholding taxes imposed on dividends, royalties and interest – for the standard form DTA produced by the OECD provides for both the exchange of information and reduced withholding taxes. The governments of the OECD countries appear reluctant to accede to this, however, because the effect of a standard-form DTA with Hong Kong would typically be not merely to save cross-border income from being taxed twice, but to prevent it from being taxed at all. How many governments take up this offer remains to be seen.

<sup>55</sup> See *Hong Kong Hansard*, 19 Oct 2006, pp 479–580.

<sup>56</sup> See OECD, *Harmful Tax Competition: An Emerging Global Issue*, 1998.

<sup>57</sup> See OECD, *Tax Cooperation: Towards a Level Playing Field: 2006 Assessment by the Global Forum on Taxation*, 2006.

## 2. The Future

As regards the future, it seems that Hong Kong is facing a problem: that many people very much like Hong Kong's tax system as it is; but they also like democracy; and they fear that it is impossible to have it both ways because, they think, everywhere else in the world, democracy has led to steeply progressive income taxes, not at all like Hong Kong's. It may be, however, that Hong Kong can have it both ways. That is, the introduction of a genuinely democratic system of government in Hong Kong, depending on how it is handled, is unlikely to lead to high taxes on business profits and large personal incomes. In other words, Hong Kong can probably have its cake and eat it, too.

There are two main reasons for this. The first is that, although the burden of taxation in Hong Kong is exceptionally light, it is also very heavily concentrated on large incomes. In other developed countries, ordinary working people are quite heavily taxed, and one consequence of this is, that they want something in return – such as relatively generous public spending. In Hong Kong, in contrast, poor people pay hardly any tax at all and ordinary working people likewise pay hardly any tax, so perhaps that is why they do not complain much about the relatively low level of public spending.

The second key point is that the tax systems of the developed democracies all rely on PAYE. That is, the tax on income from employment is not paid by the employee, but by the employer, who withholds the tax from the employee's salary, and pays it to the government, paying to the employee only what is left over. In Hong Kong in contrast, there is no PAYE. Instead, people in employment, if they are liable for tax, are obliged to pay it themselves.

The lack of PAYE in Hong Kong is usually looked on as no more than an administrative curiosity; but in fact, it is crucial. The reason is that other countries' heavy taxes are viable *only* because they are collected from the employer, rather than from the employee. In the rest of the developed world, if the government were to abruptly abolish PAYE, and taxpayers were required to pay their tax themselves, the result would be that a very large number would fail to pay. In order to collect the tax, the government would have to sue defaulters, which would be expensive. Worse, the political cost of dragging otherwise law-abiding citizens through the courts would be colossal. In short, the consequence of abolishing PAYE would be chaos.

Yet Hong Kong manages well enough without it. The reasons for this are self-evident: saving to pay Hong Kong's light taxes is relatively easy and almost all those who are obliged to pay are worth suing, if they fail to pay. But

the fact that Hong Kong has no PAYE gives the Hong Kong government a kind of legitimacy that cannot be claimed by the democracies – for surely a government that can rely on taxpayers' active compliance is more legitimate than one whose finances would be reduced to chaos if it tried to do the same.

PAYE also has a crucial but under-appreciated psychological effect: it functions as an anaesthetic. It dulls the pain of paying tax and it also dulls the mind. In Hong Kong, most taxpayers seem to have a reasonably accurate idea of how much tax they pay, because they pay it themselves and the experience of writing out a cheque, or handing over banknotes, or making an electronic transfer sticks in the mind. In the rest of the developed world, most people are deprived of this opportunity for reflection. They tend to think of their income in terms of "after-tax income" or "take-home pay" and mostly they have very little idea of how much tax they pay. Many do not even notice how much tax has been withheld by their employer. Even if they notice how much has been withheld, that is a very different experience from writing out a cheque oneself or handing over banknotes.

This is important because democracy is supposed to entail government in accordance with the *rational* preferences of the electorate. But if most voters are unaware of how much tax they pay, how are they supposed to make rational choices about the appropriate levels of taxation and public spending? So what happens in the rest of the world is that voters are very much aware of the *benefits* they get from the government, but they have only a vague idea of the *cost*. And for this reason perhaps there is a tendency for public spending to increase and for taxes likewise to increase.

What all this means is that Hong Kong's elite need not be afraid of democracy; what they should perhaps to be afraid of, assuming they want to preserve the low tax policy, is PAYE, for without PAYE a steep progressive income tax is impossible. So long as Hong Kong has no PAYE, the low tax policy is safe. Conversely, if the Hong Kong government were ever to introduce PAYE, it seems probable that it would lead to: (a) reductions in the allowances (thus subjecting a larger proportion of the workforce to tax) and (b) increases in the rates of tax, especially those applicable to large incomes.

More generally, what Hong Kong's elite might be sensibly apprehensive about is not just PAYE, but *any* tax that shifts the burden downwards and is collected by means of withholding. In other words, if one favours the low tax policy, then the absolutely last thing one wants is GST, because the whole point of GST is to impose tax on poor people and to collect it by means of withholding (in that the tax is not collected from consumers, but from suppliers).

Some people (the brash young capitalists and most accountants) think that shifting some of the burden of taxation onto the ordinary

Hong Kong people would be a very good thing to do. Others (the wise old capitalists) realise that if poor people are made to pay tax, they will demand something in return – namely, increased public spending and perhaps also a more meaningful vote – and, sooner or later, they will get it. Democracy is, of course, a good thing but, even so, it might not be wise to incite demand for it by goading the populace with regressive taxes. Substantially increased public spending might be a good thing, too; again, however, it might not be wise to whip up demand for it by means of provocatively regressive taxes.

Everywhere there is a GST, there is an inexorable tendency for public spending to increase; everywhere there is a GST, the government, when it introduced the tax, promised that, once the tax was introduced, the rate of tax would remain unchanged; and everywhere there is a GST, the government has broken that promise. All this is fairly straightforward. Adam Smith, 225 years ago, put it like this:

“The middling and superior ranks of people, if they understood their own interest, ought always to oppose all taxes upon the necessities of life, as well as all direct taxes upon the wages of labour”.<sup>58</sup>

### 3. Lessons for the Rest of the World

The lessons Hong Kong holds for the rest of the world are straightforward. There are three of them.

#### Low Flat Tax can Work

The first lesson is that a low-rate flat tax can work. That is, it is possible in a developed country to structure a system of very low taxes and very low government spending in such a way that it enjoys very broad public support. Hong Kong’s experience suggests that this requires two components. First, the burden must be concentrated on relatively large incomes. Poor people should be exempted from tax altogether and ordinary working people, if taxed at all, should be taxed as lightly as possible. Second, the tax system should be as visible as possible; it should not use withholding methods, such as PAYE and GST, that obscure the weight of the burden.

<sup>58</sup> *The Wealth of Nations*, V. ii. K. 9.

### Tax Law can be Simple

The second lesson is that it is possible for a developed country's tax legislation to be reasonably simple – say 200 pages. The key to this seems to be simply trusting the judges. In the rest of the developed world the tax legislation is amazingly complex, because the legislature has tried to provide for just about everything it could think of. Hong Kong's Inland Revenue Ordinance, in contrast, uses only general terms and leaves it to the courts to work out the detail – and this has worked.

Hong Kong's private-sector tax profession might complain about the quality of judicial decision-making every time the Commissioner wins a case, but really the Hong Kong courts have done very well. They have produced interpretations of the law which are for the most part adequately principled, economically sound, respectful of taxpayers' rights and protective of the government's revenues. Given that Hong Kong's judges have succeeded in doing this, it is difficult to conceive of any reason why judges elsewhere could not do the same.<sup>59</sup>

### A Progressive Consumption Tax is Feasible

The third lesson is that the history of Hong Kong's tax system supports the case for a progressive consumption tax. It is widely thought that it is better to tax consumption than income, because it is fairer to tax people on what they take out of the economy, rather than what they put into it; and because taxing consumption might deter productivity less than taxing income. But it is also widely thought that it is necessary for the tax system to be progressive – and this is problematic, because it is difficult to design a progressive consumption tax. There have however been many attempts to design such a tax – that is, a progressive consumption tax. In fact, designing a progressive consumption tax has been one of the central concerns of tax theory over the last 50 years or so.<sup>60</sup>

Obviously, it would be futile to require people to keep a record of their consumption so that the government could impose a progressive tax on it. But it is possible to get at consumption indirectly, on the basis that consumption equals income minus savings. Therefore, if the government knows how much a person's income is, and it knows how much he has saved, it can work out his consumption and impose a tax on it. In other

<sup>59</sup> For a lengthier examination of the simplicity of Hong Kong's tax system, see Michael Littlewood, "How Simple Can Tax Law be? The Instructive Case of Hong Kong" *Tax Notes International*, 23 May 2005, 689.

<sup>60</sup> See in particular Nicholas Kaldor, *An Expenditure Tax* (London: Allen & Unwin, 1955).

words, if there is an income tax, and it allows a deduction for savings and investment, then the result is a tax on consumption.<sup>61</sup> Such a tax could be charged at progressive rates and it could be collected in the same manner as an income tax. For instance, it could be collected by simply passing a law requiring taxpayers to pay (as under Hong Kong's existing tax system); or it could be collected by means of imposing a withholding requirement on employers (that is, PAYE) and allowing taxpayers a refund (of tax withheld) for savings and investment.

Hong Kong's tax history bears on the debate about progressive consumption taxes because the Inland Revenue Ordinance, although generally thought of as imposing taxes on income, in fact approximates a progressive consumption tax. More particularly, one of the more important theories as to how a progressive consumption tax might work is called Hall/Rabushka, after the two theorists who designed it;<sup>62</sup> and the Hall/Rabushka system is very similar to the system of taxation provided for by the Hong Kong Ordinance. This is not a coincidence; the Hall/Rabushka system is in fact largely based on the Hong Kong system (as Hall and Rabushka have acknowledged).<sup>63</sup>

But why does the Inland Revenue Ordinance approximate a progressive personal consumption tax? The reason is that the Ordinance is very generous in its treatment of savings and investment: there is no tax on dividends; no tax on interest; and no tax on capital gains; and there are very generous allowances for expenditure on plant and machinery. The combined economic effect of these aspects of Hong Kong's tax system is much the same as allowing a deduction for savings.<sup>64</sup> This means that Hong Kong's tax system, although nominally a system of taxes on income, is largely in fact a tax on consumption. The fabulous successes of the territory's tax system thus support the case for a progressive personal consumption tax – and, in particular, they support the case for something resembling the Hall/Rabushka system. It might be said, therefore, that Hong Kong's tax system is both seriously out-of-date and ahead of its time.

<sup>61</sup> See Kaldor (n 60) and Robert E. Hall and Alvin Rabushka, *The Flat Tax* (Stanford: Hoover Institution Press, 2<sup>nd</sup> edn, 1995).

<sup>62</sup> See Hall and Rabushka (n 61).

<sup>63</sup> Hall and Rabushka (n 61) and Alvin Rabushka, "The Flat Tax" in Alvin Rabushka and Manfred Rose, *The Flat Tax: American and European Perspectives* (Massachusetts: American Institute for Economic Research, 2000).

<sup>64</sup> See International Monetary Fund, Fiscal Affairs Department (Howell H. Zee, Graham Holland and Michael Welling), *Hong Kong SAR: Policy and Administrative Issues in Introducing a Goods and Services Tax: Further Considerations*, May 2004, p 9.

## Conclusion

The central question presented by Hong Kong's tax history is whether the system – designed by a group of businessmen in wartime haste 70 years ago – is adequate to meet the needs of modern Hong Kong. On the one hand, the government itself thinks the current system is inadequate, which is why it attempted to establish a GST. On the other hand, most Hong Kong people seem to disagree. But the question is not susceptible to a purely technical answer; rather, what is required is an answer that is both technically sound *and* politically acceptable. It is true that Hong Kong's tax system is grossly inadequate when judged by the standards of the rest of the world; but it is true also that that matters not at all, if the Hong Kong people like it the way it is. The only criterion that really matters is, what do the Hong Kong people want? The best way to find out would be ask them; and the best way to do *that* would be to establish a genuinely democratic system of government; and then to wait and see what happens.

As for the rest of the world, Hong Kong's fiscal successes are so impressive it seems unlikely that *nothing* can be learned from them. The territory is often cited as evidence of the merits of extremely light taxation; but on its own, that is simplistic, trite and unhelpful – for Hong Kong's real achievement is not merely that the burden of taxation is very light, but that the system is so structured as apparently to enjoy a strangely high level of popular support. The keys to this, it seems, are (a) that the burden, although much lighter than in other places, is very heavily concentrated on large incomes and (b) that the Hong Kong government, unlike most other governments, makes almost no use of withholding mechanisms such as, in particular, PAYE and GST.