



INCOME TAX LAW DESIGN AND EQUITY: LESSONS FROM HONG KONG

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The tax system in Hong Kong is often presented as a model for efficiency in terms of tax compliance and administration. The design features of the tax system contributed to the jurisdiction's status as a preferred hub for international investment, but the equity impact of the system in terms of Hong Kong residents has scarcely been examined. The article analyses how tax exclusions, concessions and preferential rates have benefited the wealthy more than the poor and have prevented the income tax system from playing a role in mitigating the striking disparity in income distribution in the jurisdiction comparable to the role it plays in Hong Kong's developed counterparts. The lessons from Hong Kong offer a striking example of the extent to which tax law design can impact on equity and social stability. In a world of growing income inequality, any effort to make a tax system more equitable is worth serious consideration.

I. INTRODUCTION

With a Commonwealth common law legacy, Hong Kong is recognised as a developed economy and its tax system is often presented as a model for efficiency in terms of tax compliance and administration. The basic tax law, the Inland Revenue Ordinance (“IRO”), imposes three separate taxes on different types of income—salaries, business profits and rental income—sourced within Hong Kong. This limited income taxation, along with a very few other levies, was designed to provide a business friendly environment and a simple tax regime to facilitate the development of a free market and the maintenance of the city as an international financial centre.¹ Compounding the impact of the exclusion from taxation of income of a

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¹ In Institute for Management Development (“IMD”) World Competitiveness Rankings 2021, Hong Kong was ranked the 7th most competitive economy in the world. Prior to that, Hong Kong had enjoyed top rankings for several years: the world's most competitive economy in 2017 and the second most competitive economy in 2018 and 2019. Its tax regime was identified as a key attractive indicator for competitiveness. See IMD World Competitiveness Center, *World Competitiveness Ranking*, online: IMD World Competitiveness Center <<https://www.imd.org/centers/world-competitiveness-center/rankings/world-competitiveness/>>; IMD World Competitiveness Online, *Competitiveness Ranking*:



‘capital’ nature, a feature not usually found in the income tax systems of most developed jurisdictions, are an array of tax concessions available for businesses and individuals. Statutory income tax rates are kept low, also, by international standards.²

At the same time, Hong Kong has among the highest levels of income inequality in the developed world, aligning the city more closely to transitional or low-income economies than to its counterpart developed economies.³ Inequality in Hong Kong appears higher than in most other cities with large financial centres such as Singapore, and inequality remains relatively high even when measured after taxes and social transfers.⁴ The Gini coefficient, a commonly used measurement of income inequality from 0 to 1 with 0 reflecting complete equality of income in the jurisdiction and 1 reflecting the most extreme inequality possible, is among the highest in the world. The original or market income Gini coefficient in Hong Kong was 0.539 according to the most recent data as at 2016, whereas in Singapore it was 0.459 in 2016 and 0.452 in 2020.⁵ After accounting for taxes and social transfers, the net income Gini coefficient became 0.473 in Hong Kong in 2016 whereas in Singapore it fell to 0.401 in 2016 and 0.375 in 2020.⁶ The enormous gulf between the wealthy and the impoverished and the implications it has for political stability have only become more alarming and apparent, yet remains without sufficient attention and policy solutions from policymakers.

While the causes of income inequality may be complex, it is clear that the Hong Kong income tax system has not played a redistributive role that might

Hong Kong SAR, online: IMD World Competitiveness <<https://worldcompetitiveness.imd.org/country-profile/HK/wcy>>. Hong Kong has also been ranked highly in the World Economic Forum’s *Global Competitiveness Index*. In the Forum’s most recent available rankings, the 2019 rankings, Hong Kong was ranked as the third most competitive economy among 141 economies and was only second to Singapore on taxation indicators, see Klaus Schwab, eds, *The Global Competitiveness Report 2019* (World Economic Forum, 2019) at 268, online: World Economic Forum <http://www3.weforum.org/docs/WEF_TheGlobalCompetitivenessReport2019.pdf>.

² The Hong Kong tax rate for corporate businesses is 16.5% and the standard rate on individual salaries is 15%. For a global view, see KPMG, *Individual Income Tax Rates Table*, online: KPMG <<https://home.kpmg/xx/en/home/services/tax/tax-tools-and-resources/tax-rates-online/individual-income-tax-rates-table.html>>; KPMG, *Corporate Tax Rates Table*, online: KPMG <<https://home.kpmg/xx/en/home/services/tax/tax-tools-and-resources/tax-rates-online/corporate-tax-rates-table.html>>. See also OECD, *Taxing Wages 2020*, Taxing Wages Series (2020), online: OECD <<https://www.oecd.org/tax/taxing-wages-20725124.htm>>.

³ See eg, International Monetary Fund (“IMF”), Asia and Pacific Dept, *People’s Republic of China – The Government of the HKSAR Press Releases: Selected Issues* (IMF, 2019), online: International Monetary Fund <https://www.elibrary.imf.org/view/IMF002/25742-9781484395776/25742-9781484395776/25742-9781484395776_A001.xml?redirect=true> [IMF Report]; World Population Review, *Gini Coefficient by Country 2021*, online: World Population Review <<https://worldpopulationreview.com/country-rankings/gini-coefficient-by-country>>.

⁴ IMF Report, *supra* note 3 at 3, 4.

⁵ For statistics in Hong Kong, see Census and Statistics Department of the Government of the Hong Kong Special Administrative Region (“HKSAR”), *Population By-Census 2016 Thematic Report: Household Income Distribution in Hong Kong* at 7, online: Census and Statistics Department <<https://www.censtatd.gov.hk/hkstat/sub/sp459.jsp?productCode=B1120096>> [Thematic Report]. For statistics in Singapore, see Department of Statistics Singapore, *Key Household Income Trends, 2020* at 14, online: Department of Statistics Singapore <<https://www.singstat.gov.sg/-/media/files/publications/households/pp-s27.pdf>>.

⁶ Thematic Report, *supra* note 5 at 8; Department of Statistics Singapore, *supra* note 5 at 14.



be expected from the adoption of a progressive income tax. This may be due to the limited application of taxation to only a small percentage of taxpayers and a narrow tax base for revenue generation, in addition to a relatively low level of top marginal rates. Although a simple and low tax system might appear attractive to investors, the narrow tax base greatly limits the government's ability to address serious challenges, may be too volatile to serve as a reliable buttress for long-term development plans, and may exacerbate equity concerns as well as undermine the efficacy of investment and resource allocation in the market.⁷ Concomitant with the limited tax base has been a heavy reliance on land-based, non-tax revenue for government finance purposes. As explained in Part III.B, this significant reliance on land revenue helps push up living and business costs and leads to implicit taxation falling on almost every individual and business in the city. This aspect is an oft-neglected side of the seemingly simple and efficient tax system in Hong Kong.

Income tax concessions and exclusions may have benefited a small group of taxpayers and yet the price of the resulting distortions is likely to be borne by the entire community. The outcome appears inconsistent with the notion of equity, a pillar principle in taxation, albeit with flexible and often elusive meanings.⁸ The intellectual interests and inquiries seem to have primarily focused on the technical aspects of the Hong Kong income tax system, including examinations of the source principle, deduction rules and international aspects of income taxation.⁹ There has been

⁷ See generally Andrew Halkyard, "The Hong Kong Tax Paradox or Why Jurassic Park Exists in the Pearl River Delta" (1998) 8 Revenue LJ 1 [Halkyard, *Jurassic Park*]; Daniel KC Cheung, "Debate on the Hong Kong Tax Base – Its Criteria, Principles, and Problems" (2001) 27 Intl Tax J 57; Advisory Committee on New Broad-based Taxes, *A Broader-Based Tax System for Hong Kong?* (August 2001), online: The Government of the HKSAR Press Releases <<https://www.info.gov.hk/archive/consult/2001/condoc-e.pdf>>; Grant Richardson, Alan Davis & Hon Keung Chan, "The Potential of a Wealth Tax for Hong Kong: A Critical Review and Analysis" (2003) 18 Austl Tax Forum 327.

⁸ A voluminous literature has discussed the notion of equity from various perspectives. See *eg.*, Richard A Musgrave, "In Defense of an Income Concept" (1967) 81:1 Harv L Rev 44 [Musgrave, *In Defense*]; Richard A Musgrave, "Horizontal Equity, Once More" (1990) 43 Natl Tax J 113 [Musgrave, *Once More*]; Richard A Musgrave, "Horizontal Equity: A Further Note" (1993) 1 Fla Tax Rev 354 [Musgrave, *Further Note*]; John Rawls, *A Theory of Justice* (Massachusetts: Harvard University Press, 1971); Anthony B Atkinson & Joseph E Stiglitz, "The Design of Tax Structure: Direct versus Indirect Taxation" (1976) 6 J Public Econ 55; Louis Kaplow, "Horizontal Equity: Measures in Search of A Principle" (1989) 42:2 Natl Tax J 139 [Kaplow, *Measures*]; Louis Kaplow, "A Note on Horizontal Equity" (1992) 1 Fla Tax Rev 191 [Kaplow, *A Note*]; Hobart Peyton Young, "Progressive Taxation and Equal Sacrifice" (1990) 80 Am Econ Rev 253; Paul McDaniel & James Repetti, "Horizontal and Vertical Equity: The Musgrave/Kaplow Exchange" (1993) 1 Fla Tax Rev 607; David Elkins, "Horizontal Equity as a Principle of Tax Theory" (2006) 24:1 Yale L & Poly Rev 43; and Joel Slemrod & Jon Bakija, *Taxing Ourselves: A Citizen's Guide to the Debate Over Taxes* (Massachusetts: MIT Press, 2017).

⁹ There is an extensive literature discussing technical issues of the Hong Kong income tax system. See *eg.*, Andrew Halkyard, "Hong Kong Profits Tax: The Source Concept, Part I" (1990) 20:2 Hong Kong LJ 232 [Halkyard, *Hong Kong*]; Daniel KC Cheung, "Reform of Hong Kong's Interest Deduction Rules" (2003) 29:2 Intl Tax J 72; Andrew Halkyard, "Common Law and Tax Avoidance: Back to the Future?" (2004) 14:1 Revenue LJ 19 [Halkyard, *Common Law*]; Michael Littlewood, "The Legacy of UK Tax Law in Hong Kong" (2008) 3 Brit Tax Rev 253 [Littlewood, *Legacy*]; Jefferson VanderWolk, "Sourcing Profits for Hong Kong Tax Purposes: The Jurisprudence of the Court of Final Appeal" (2008) 62 Bull Intl Tax 475 [VanderWolk, *Sourcing*]; Jefferson VanderWolk, "Source, Transfer Pricing and Anti-Avoidance: Further Developments" (2010) 64 Bull Intl Tax 350 [VanderWolk, *Source*]; Michael



only limited analysis of the impact of the narrow tax base and potential responses to address it,¹⁰ and equity aspects of the system are rarely considered. While a rich literature has been devoted to the discussion of income inequality and the redistribution role of taxation against a broad backdrop of increased disparity of income and wealth across the world in recent decades,¹¹ most studies are general, or focus on specific jurisdictions other than Hong Kong—a small, open economy viewed as wealthy and prosperous.

Experience elsewhere has shown that taxation, and in particular income taxation, plays an essential role in redistributing income and improving social justice. Revision of the design of Hong Kong income taxes, particularly the removal or reduction of existing concessions and exclusions, could enhance fair distribution of tax burdens in Hong Kong. Tax reforms of this kind may raise concerns about Hong Kong's competitiveness as the existing features of the tax system have been considered an important factor in maintaining Hong Kong as a desirable hub for international investment and trade. It is impossible to speculate on the impact of tax reform, particularly individual income tax reform, on competitiveness but it must be conceded that there is a risk of economic costs from reform. However, a society that highly values reduced inequality achieved by tax progressiveness and a wide income base will tolerate some economic cost as the price of greater equity.¹²

This article considers tax equity from a legal perspective, focusing on the impact of exclusions and concessions under Hong Kong income tax law. The principle of equity in law requires persons in similar circumstances to be treated similarly by the law; in the context of an income tax, it means two persons with similar incomes should bear the same tax liability. In jurisdictions with a commitment to redistribution, vertical equity, regarded as a foundation pillar of the income tax, is understood to mean that the proportion of income remitted as tax should rise as

Littlewood, *Taxation Without Representation: The History of Hong Kong's Troublingly Successful Tax System* (Hong Kong: Hong Kong University Press, 2010) [Littlewood, *Taxation*]; Samuel YS Chan & KC Cheung, "Strategic Tax Planning Opportunities Using Service Companies – A Recent Update and Its Implications to Hong Kong Taxpayers and Foreign Investors" (2010) 36 *Intl Tax J* 37; and Andrew Halkyard, Jefferson VanderWolk & Wilson WC Chow, *Hong Kong Tax Law: Cases and Materials* (Hong Kong: LexisNexis, 2013).

¹⁰ See Lap Chui, Shong Tung Leung & Chun Hin Yip, *Income Inequality in Hong Kong*, online: Hong Kong Statistical Society <http://www.hkss.org.hk/images/SPC/2011_12/PDF/S11-12-DP4.pdf>; Xiping Wang, "An Analysis of Income Redistributive Effect of Hong Kong Tax System" (2015) 3 *Contemporary Finance & Economics* 34; Cheung, *supra* note 7.

¹¹ See *eg*, Janet Gornick & Markus Jäntti, eds, *Income Inequality: Economic Disparities and the Middle Class in Affluent Countries* (Stanford: Stanford University Press, 2013); Chong-Bum An & Barry Bosworth, *Income Inequality in Korea: An Analysis of Trends, Causes, and Answers* (Cambridge: Harvard University Asia Center, 2013); Thomas Piketty, *Capital in the Twenty-First Century* (Cambridge: Harvard University Press, 2014); Orsetta Causa & Mikkel Hermansen, *Income Redistribution through Taxes and Transfers across OECD Countries*, OECD, Economics Department Working Paper No 1453 (2017); Claudia Gerber *et al*, *Income Tax Progressivity: Trends and Implications*, IMF Working Paper WP/18/246 (2018); United Nations Economic and Social Commission for Asia and the Pacific ("UNESCAP"), *Inequality in Asia and the Pacific in the Era of the 2030 Agenda for Sustainable Development* (2018).

¹² See Slemrod & Bakija, *supra* note 8 at 88. The embrace of tax equity is a distinctive feature in Scandinavian countries such as Denmark and Sweden.



income rises. The extent to which an income tax system is progressive will depend on value judgements, that is, subjective views on the desirability of redistribution. The extraordinary disparity in income and wealth in Hong Kong suggests that its tax system could play a greater role in mitigating the disparity and thereby improving equity in taxation. The article unveils implications of existing concessions and exclusions for individual tax burdens in light of the principle of equity in taxation. It considers measures that might enhance the redistributive role of the current tax system, taking into account legal and policy constraints that may impose on the adoption of those measures. The article also considers the international dimensions of potential modifications as tax equity has become an issue beyond borders and jurisdictional boundaries in the globalised era. Certainly, the issue of income inequality and the redistributive role of taxation could be analysed from an economic viewpoint. While it is insufficient to evaluate the exact incidence of proposed tax measures on a purely legal basis without a comprehensive analysis of the potential economic impact on the measures suggested, the legal analysis can provide insights necessary to look into the Hong Kong tax system more holistically rather than merely technically.

The article focuses on Hong Kong to illustrate the impact of an income tax that is not designed to achieve equity objectives. The distinctive features of Hong Kong's income tax system that may contribute to its low impact on income inequality may offer regional jurisdictions cautionary lessons. To the extent features of the tax system are unique to common law jurisdictions, some aspects of the Hong Kong income tax will resonate more in some jurisdictions than in others. It is due to the striking income inequality and the distinctive design features of the income tax in Hong Kong that implications of the design for equity in the Hong Kong case will provide lessons for other jurisdictions to draw.

The article proceeds as follows. Part II reviews the design of the Hong Kong tax system. While it examines the three schedular income taxes—salaries tax, profits tax, and property tax, it mainly focuses on issues related to individuals with reference to benchmark design principles and jurisdictional experiences. Part III critiques and evaluates the implications for equity of tax concessions and exclusions identified in Part II, following a review of the principle of equity and the literature on the effects of preferential tax treatments. The analysis highlights issues of the current income tax law design and its socioeconomic impacts in Hong Kong. Part VI considers potential measures and constraints to improve the equality of the tax system. The consideration looks not only to constitutional configuration within Hong Kong but international dimensions of the new taxation paradigm that may shape the development of tax policies in the jurisdiction. The article concludes in Part V.

II. DESIGN FEATURES OF THE HONG KONG TAX SYSTEM

A. *The Origins of Taxation of Income*

General design features of a tax system may lead to certain types of income being excluded from the tax base and others being taxed preferentially. The design of



the tax system in Hong Kong has deep historical roots.¹³ In a development pattern similar to many jurisdictions, war financing prompted an introduction of taxes on income to Hong Kong. The basic tax statute, the IRO, was enacted in 1947,¹⁴ after the implementation of a short-lived law, the War Revenue Ordinance (“WRO”) in 1940.¹⁵ The WRO, which had a far-reaching influence on the design and development of the IRO, was based on: Addington’s *Income Tax Act of 1803*, which introduced the concept of a schedular tax system, and the *Model Colonial Territories Income Tax Ordinance of 1922*, which stipulated exemption of offshore income from tax.¹⁶ From the outset, the tax law was never meant to levy a comprehensive tax on income for a number of reasons, including bitter resistance from business communities.¹⁷ Despite the government’s efforts to enact a general income tax at the time, the IRO was ultimately passed with the same fundamental features of the WRO, and despite many technical changes to the IRO since 1947 the basic tax statute remains broadly similar to the WRO.¹⁸

B. Design Features

There are several major design features of the tax statute, which are often touted as an appealing factor for Hong Kong’s global competitiveness. Five features in particular have significant equity implications and their impact is compounded by the fact that all operate in parallel with one another at the same time.

First, in contrast to the far more comprehensive income bases used in most modern income tax regimes such as the ones in Australia and the United Kingdom (“UK”), the Hong Kong income tax system is limited in base and scope.¹⁹ The IRO adopts a schedular approach to taxing the three types of income listed above. Salaries tax applies to “income from office or employment”,²⁰ profits tax to profits derived from a trade, profession or business,²¹ and property tax to the value of real property.²² As in other common law jurisdictions outside the United States (“US”), the courts have read down the concept of income or profits on the basis of doctrines derived from trust law to exclude capital gains and the charging provision for profits tax explicitly excludes “profits arising from the sale of capital assets”.²³ The definition of income from employment is narrow and is understood to exclude

¹³ For a comprehensive historical review of Hong Kong tax law, see Littlewood, *Taxation*, *supra* note 9.

¹⁴ Ordinance No 20 of 1947.

¹⁵ Ordinance No 13 of 1940.

¹⁶ Littlewood, *Taxation*, *supra* note 9 at 25-68; see also Littlewood, *Legacy*, *supra* note 9 at 253; Andrew Halkyard & Stephen Phua Lye Huat, “Common Law Heritage and Statutory Diversion – Taxation of Income in Singapore and Hong Kong” [2007] Sing JLS 1 at 3, 4.

¹⁷ Littlewood, *Legacy*, *supra* note 9 at 256, 257; see also Littlewood, *Taxation*, *supra* note 9 at 25-68, 69-104.

¹⁸ Halkyard & Phua, *supra* note 16 at 4.

¹⁹ Littlewood, *Legacy*, *supra* note 9 at 256.

²⁰ *Inland Revenue Ordinance* (Cap 112, Hong Kong), s 8 [IRO].

²¹ IRO, s 14.

²² IRO, s 5.

²³ IRO, s 14. Whether the word “profits” includes capital gains is not readily obvious. For an explanation of Hong Kong courts’ interpretation, see Littlewood, *Legacy*, *supra* note 9 at 263.



non-cash fringe benefits unless specifically enumerated. Except for residential premises provided below market value,²⁴ almost no fringe benefits are included in the tax base, a feature of the Hong Kong income tax not replicated in jurisdictions such as Australia, the UK, or Singapore.

Second, Hong Kong income tax legislation adopts a territorial source principle.²⁵ A tax system adopting a territorial source principle applies to a far narrower tax base than one assessing income derived from worldwide sources. The territorial source principle means only income or profits sourced within the domestic territory of a jurisdiction are taxable in the jurisdiction. By contrast, the worldwide principle extends taxation to all income and profits derived by a business or an individual, regardless of source. In addition to the general exclusion of offshore income and profits from taxation, the IRO contains specific exemption provisions which primarily relate to the profits tax, indicating the government's interest in using tax law to boost its status as an international financial centre.²⁶

Although the territorial source principle is no longer unique to Hong Kong,²⁷ it has been applied in Hong Kong as the most fundamental design feature of the tax system since the outset of Hong Kong income taxation over seventy years ago. This is against the background that at the time of introducing an income tax in Hong Kong, most other Commonwealth jurisdictions had already extended their originally source-based tax to offshore income and the British system did not impose taxation solely on source.²⁸ Notwithstanding the inherent difficulty in defining the concept of source, especially in the current world of increased capital mobility and increased share of hard-to-value assets, the principle has been applied by courts to determine whether or not an income is taxable in Hong Kong.²⁹ As colossally important as it is, the principle has not been given clear statutory meaning nor judicial guidance.³⁰ Unsurprisingly, this principle has generated much confusion about the income tax statute and it is difficult to generalise a clear rule to apply the principle.³¹ The ambiguity of the source principle, however, suggests that there is space for taxpayers to argue that an income is not sourced in Hong Kong and thus not taxable.

²⁴ IRO, s 9(1)(b), (c).

²⁵ For a general review of interpretation and application of the principle, see Halkyard, VanderWolk & Chow, *supra* note 9 at 63-132 and 273-301.

²⁶ *Inland Revenue (Amendment) (No 2) Ordinance 2017* (Hong Kong); *Inland Revenue (Amendment) (No 6) Ordinance 2018* (Hong Kong).

²⁷ Thornton Matheson, Victoria Perry & Chandara Veung, *Territorial vs. Worldwide Corporate Taxation: Implications for Developing Countries*, IMF Working Paper 13/205 (2013), online: International Monetary Fund <<https://www.imf.org/external/pubs/ft/wp/2013/wp13205.pdf>>.

²⁸ Littlewood, *Legacy*, *supra* note 9 at 264, 265.

²⁹ IRO, ss 8, 14.

³⁰ The charging provisions on salaries tax and profits tax under IRO simply provide that tax is charged on every person in respect of his income or assessable profits "arising in or derived from Hong Kong" without any further guidance. To assist taxpayers to understand the principle and to state its own view about the principle, the Hong Kong Inland Revenue Department ("IRD") issued Departmental Interpretation and Practice Notes ("DIPN") No 21 *Locality of Profits* in 2009, which was revised in 2012. This DIPN can only be used as reference and does not carry formal legal authority.

³¹ Halkyard, *Hong Kong*, *supra* note 9; VanderWolk, *Sourcing*, *supra* note 9; VanderWolk, *Source*, *supra* note 9; Littlewood, *Legacy*, *supra* note 9 at 264-267; Antonietta Wong, "Resolving the Source Problem: A General Review with a Particular Focus on Hong Kong" (2012) 42:1 Hong Kong LJ 169.



The third key feature of Hong Kong income taxation is the exclusion of capital gains from the tax base. The legislative history clearly shows the IRO was never intended to tax capital gains.³² Although not immediately obvious, court decisions on the interpretation of “profits” in the charging provision which excludes “profits arising from the sale of capital assets” from taxation as noted above³³ produce probably the same results as those achieved by the UK and other cases.³⁴ That is, income or profits of a revenue nature are taxable whereas capital gains, *ie* receipts of a capital nature, are not. Consequently, gains from real property, foreign exchange and shares are not taxable, unless they are regarded as profits from employment or a trade, profession or business carried on in Hong Kong.³⁵ While the inclusion of capital gains in the income tax base can increase the equity of the tax, concessional rules for these gains will undermine it and in addition enhance compliance and administrative costs and invite arrangements to convert fully-taxed ordinary income into less taxed capital gains.³⁶ While a number of jurisdictions tax capital gains on a concessional basis when realised by individuals,³⁷ the impact is undoubtedly greater in Hong Kong where the difference between characterisation of a gain as ordinary income or capital gains is the difference between full taxation and zero taxation.³⁸ The general exclusion of capital gains from tax has allowed individuals who have the ability to invest in capital assets, particularly expensive properties in the city,³⁹ to accumulate a good amount of wealth with little tax burden.

Related to the third feature is the tax-free treatment of dividends, even if the profits from which the dividends are paid have not been taxed, such as capital gains or profits derived outside Hong Kong. This exclusion for individuals is rare by international standards. Interest income is also exempt from taxation, unless derived in the

³² Littlewood, *Legacy*, *supra* note 9 at 262. Expenditures of a capital nature are correspondingly disallowed. *IRO*, s 17.

³³ *IRO*, s 14. While this provision is for the profits tax, it has been similarly applied to individuals with the effect of non-taxability of capital gains.

³⁴ Littlewood, *Legacy*, *supra* note 9 at 263.

³⁵ There have been cases in the Hong Kong courts regarding the determination of whether profits are of revenue or capital nature. Halkyard, VanderWolk & Chow, *supra* note 9 at 135-145.

³⁶ For discussions about capital gains tax and jurisdictional experiences, see Michael Littlewood & Craig Elliffe, eds, *Capital Gains Taxation: A Comparative Analysis of Key Issues* (Cheltenham: Edward Elgar Publishing, 2017). For tax rates on capital gains worldwide, see PwC, *Capital Gains Tax (CGT) Rates*, online: PwC <<https://taxsummaries.pwc.com/quick-charts/capital-gains-tax-cgt-rates#anchor-H>>.

³⁷ For example, capital gains are subject to half exemption in Australia and Canada or subject to lower rates in the UK under certain circumstances. See Michael Littlewood, “Capital Gains Taxes – A Comparative Survey” in Michael Littlewood & Craig Elliffe, eds, *Capital Gains Taxation: A Comparative Analysis of Key Issues* (Cheltenham: Edward Elgar Publishing, 2017) 3-4.

³⁸ Michael Littlewood, “How Simple Can Tax Law Be?: The Instructive Case of Hong Kong” (2005) 1:2 *J Australasian Tax Teachers Association* 259 at 275 [Littlewood, *Instructive Case*].

³⁹ Hong Kong was ranked the world’s least affordable housing market for the 11th year, and its median property price was 20.7 times its median household income in 2020. See Urban Reform Institute and Frontier Centre for Public Policy, *Demographia International Housing Affordability 2021 Edition* at 15, online: Demographia <<http://www.demographia.com/dhi.pdf>>; see also Shawna Kwan, “Hong Kong Homes Ranked Least Affordable for 11th Year” *Bloomberg* (23 February 2021), online: Bloomberg <<https://www.bloomberg.com/news/articles/2021-02-23/hong-kong-homes-ranked-world-s-least-affordable-for-11th-year>>.



course of carrying on business in Hong Kong.⁴⁰ Similarly, royalties are generally excluded from taxation, the only significant exception being when royalties are paid to non-residents for the use of certain intellectual property in Hong Kong, but even then, at an effective rate of only 4.95 percent,⁴¹ lower than the preferential withholding tax rates on passive income under many double tax agreements. Moreover, there is no tax on gifts, and, unsurprisingly, no inheritance tax which was abolished in 2006. This, again, contrasts with the practice in many western developed economies such as Australia and the UK. These exclusions are likely to provide far greater benefits to the wealthy who derive most investment income.

The fourth feature is the availability of various tax deductions, allowances, and credits. In particular, residential property owners may deduct mortgage interest payments up to HKD100,000 per year for 20 years.⁴² This deduction can be made under the salaries tax or via a mechanism called personal assessment, and it is even available for those who are subject to tax at the standard rate—those at the very top income level.⁴³ Personal assessment is a mechanism allowing taxpayers who have more than one type of income to opt to pay tax on their total income at the same rates as the salaries tax.⁴⁴ The mechanism has two attractive features. One is that it retains the benefit of the personal allowances afforded to taxpayers under the salaries tax but are not available under the other two taxes. The other is that it allows the taxpayer to consolidate all types of income—salaries, profits and rental income—to offset a loss in respect of one type of income against income or profits of another type. Clearly, the residential property loan interest deduction is a benefit for landlords and self-employed who are eligible for the personal assessment mechanism and for those high-income persons, and of no value to home renters who constitute around half of the population living and working in Hong Kong.⁴⁵

⁴⁰ IRO, s 15(1)(f), (g); *Exemption from Profits Tax (Interest Income) Order 1998* (Cap 112, Hong Kong). Hong Kong's non-taxation of certain passive income such as interest and royalties sourced offshore has raised attention of some jurisdictions such as the European Union ("EU"). The Hong Kong government announced on 5 October 2021 that it will amend the IRO to address cross-border evasion, which was made in a response to the inclusion of Hong Kong in the EU watchlist on tax cooperation because of concerns about the non-taxation of passive income. The proposed legislative amendment will however only target corporations and individuals will not be affected. The Government of the HKSAR Press Releases, "HKSAR Government Responds to Inclusions of Hong Kong in EU's Watchlist on Tax Co-operation", 5 October 2021, online: The Government of the Hong Kong Special Administrative Region Press Releases <<https://www.info.gov.hk/gia/general/202110/05/P2021100500291.htm>>.

⁴¹ IRO, ss 15(1)(a), (b), (ba) and 21A. Assessable profits are deemed to be 30% of the payment and payable at the rate of 16.5% for corporations, provided relevant anti-avoidance provisions do not apply.

⁴² IRD, *Concessionary Deductions: Sections 26E and 26F Home Loan Interest, Departmental Interpretation and Practice Notes No 35 (Revised)*. HKD100,000 is approximately S\$17,408 at the exchange rate on 11 October 2021. Unless otherwise indicated, HKD: Singapore dollar equivalents cited herein are calculated at the exchange rate on the same day.

⁴³ The income level for the standard rate to apply is high. For example, the threshold for a single person without children is more than HKD2 million (approximately S\$348,232) and for a couple with 2 eligible children is over HKD5 million (approximately S\$870,549) in 2020-21. The standard rate has been kept at 15%. See PwC, *2020/21 Hong Kong Tax Facts and Figures*, at 5, online: PwC <<https://www.pwchk.com/en/budget/2020/tax-facts-and-figures-en.pdf>>.

⁴⁴ IRO, ss 40B-43.

⁴⁵ Home ownership in Hong Kong had been below 50% for several decades until 2019. The current government just recently boosted the ownership rate to be slightly above 51% as at January 2021 from 49.2% in 2017. Census and Statistics Department of the Government of the HKSAR, *Population*



The IRO also provides deductions for various personal allowances for persons liable to salaries tax or under personal assessment.⁴⁶ These deductions effectively exempt about two-thirds of salary workers from tax,⁴⁷ leaving a narrow base of individual taxpayers. Tax credits are regularly granted to taxpayers to offset taxes that are otherwise payable.⁴⁸ Although the credits are a fixed amount for every taxpayer who does need to pay, they do not benefit those whose income is too low to be liable.⁴⁹

Lastly, the application of a standard rate of 15 percent on employment income means that an individual's tax liability is effectively capped at this rate, however high their income is.⁵⁰ As a reference, the currently highest marginal rate under the progressive rate structure for employment income is 17 percent. By international standards, both types of rates are remarkably low, for example lower than the highest individual income tax rate of 22 percent in Singapore and of 45 percent in Australia. The top income earners in Hong Kong face a much lighter burden in terms of the statutory rates than their counterparts in other developed economies (assuming no tax planning activities are undertaken).

Several other features are also worth noting. As mentioned above, Hong Kong has no "income tax" *per se* but rather imposes a series of separate taxes on different types of income. The tax imposed on rental income, labelled the "property tax" in the IRO, is levied at a flat rate of 15 percent. By comparison, many developed economies including Singapore include rental income in taxable income that is subject to progressive tax rates, which often have marginal tax rates well in excess of the flat rate imposed in Hong Kong. The income nature of the Hong Kong property tax also means it has no bearing on equalising wealth between homeowners and home-renters and it is not a tax on wealth. Elsewhere, a property tax is usually applied, annually, to those who own properties, and an empty homes tax or vacant residential land tax has been newly introduced in some major cities to prevent property speculation.⁵¹ In Hong Kong's case, there is almost no tax deterrence of owning as many properties as one possibly can.

Estimates Table 005: Statistics on Domestic Households, online: Census and Statistics Department <<https://www.censtatd.gov.hk/hkstat/sub/sp150.jsp?tableID=005&ID=0&productType=8>>. The Hong Kong Government proposed inclusion of a tax deduction for domestic rental expenses paid by renters with the same annual deduction limit of HKD100,000 in the 2022-23 budget. See IRD, 2022-23 Budget – Tax Measures, online: Inland Revenue Department <<https://www.ird.gov.hk/eng/tax/budget.htm>>.

⁴⁶ IRO, s 13.

⁴⁷ Littlewood, *Instructive Case*, *supra* note 38 at 265, 287; see also IRD, *Annual Report 2019-20*, Schedules 5 and 6, online: Inland Revenue Department <https://www.ird.gov.hk/eng/ppr/are19_20.htm>; Takungpao, "Tax Relief: 1.32 Million Individuals no Need to Pay Taxes" *Takungpao* (27 February 2020), online: Takungpao <<http://www.takungpao.com.hk/news/232109/2020/0227/420161.html>>.

⁴⁸ The Government of the HKSAR, *The 2021-22 Budget*, online: The 2021-22 Budget <<https://www.budget.gov.hk/2021/eng/index.html>>. Tax credits for the tax year of 2020-21 are up to HKD10,000 (approximately S\$1,741), down from HKD20,000 (approximately S\$3,482) in previous years.

⁴⁹ The basic allowance for a single person for the tax year of 2020-21 is HKD132,000, approximately S\$22,981. Depending on the person's circumstances, he or she may be entitled to several other allowances including dependent allowances. IRO, ss 27-33.

⁵⁰ IRO, ss 13, 43, Sch 2.

⁵¹ For example, City of Vancouver, Canada introduced an empty homes tax in 2016 and the State of Victoria, Australia introduced a vacant residential land tax in 2018.



Tax planning opportunities also exist, given disparities in tax treatment between employees, independent contractors and those using firms to derive income. Independent contractors and firms are liable to the profits tax and the rules for deductibility under such tax are much more generous than the rules under the salaries tax.⁵² Independent contractors and firms can further reduce their tax liabilities based on a two-tiered profits tax system introduced in 2018,⁵³ which reduces the tax rate for the first HKD2 million of taxable profits to half the standard rate of the profits tax, *ie* 8.25 percent for corporations and 7.5 percent for unincorporated bodies.⁵⁴ The result is that tax liability varies considerably depending on whether a taxpayer is an employee, a contractor, or a business entity. Such disparities also exist in the tax laws of many developed economies, but unlike those laws, the tax statute in Hong Kong contains almost no provision to address such discrepancies.⁵⁵ The two-tier system could cause unintended consequences and disincentivise businesses from growing bigger in view of tax savings generated from it.⁵⁶

Obviously, tax equity is undermined in an income tax system that is fraught with exemptions and exclusions that benefit the wealthy disproportionately. There are universal givens in tax law design and while all tax systems deviate to some extent from an ideally equitable tax, as can be seen, the Hong Kong income tax system sits far from the norm.

III. TAX EQUITY AND THE HONG KONG CASE

A. *The Principle of Equity*

The principle of equity is one of the most fundamental principles in taxation.⁵⁷ Despite a lack of consensus on what the principle means, equity is generally viewed as encompassing two pronounced aspects: horizontal equity and vertical equity, as described above.⁵⁸ A conceptually difficult question regarding horizontal equity is what personal circumstances are to be considered in determining whether two persons are equal for tax purposes, and similarly, a difficult question in respect of vertical equity is what degree of differentiation between dissimilar persons is appropriate. If it is agreed that the most equitable manner of raising revenue to finance

⁵² *IRO*, s 12. This provision states employees can deduct expenditure only if it is wholly, exclusively, and necessarily incurred in producing taxable income.

⁵³ *Inland Revenue (Amendment) (No 3) Ordinance 2018* (Hong Kong).

⁵⁴ HKD2 million is approximately S\$348,232.

⁵⁵ There is one provision under the *IRO* which prevents using companies to make a person who would otherwise be an employee an independent contractor. *IRO*, s 9A.

⁵⁶ See Yan Xu, "Simple and Competitive: Proposed Tax Measures in Hong Kong" (2018) 89:5 *Tax Notes Intl* 455 at 457.

⁵⁷ The principle of equity can be found as early as in Adam Smith's four canons of taxation in his seminal book on wealth of nations. See Adam Smith, *An Inquiry into the Nature and Cause of the Wealth of Nations* (Hampshire: Harriman House Ltd, 2007) (Book V, Chapter II, Part II) at 536.

⁵⁸ See, generally, Slemrod & Bakija, *supra* note 8 at 88 & Ch 3; see also Atkinson & Stiglitz, *supra* note 8; Kaplow, *Measures*, *supra* note 8; Young, *supra* note 8; Musgrave, *Once More*, *supra* note 8; Kaplow, *A Note*, *supra* note 8; Musgrave, *Further Note*, *supra* note 8; McDaniel & Repetti, *supra* note 8; Elkins, *supra* note 8.



public goods and services is to require people to make an equal sacrifice of well-being, and that income is an acceptable and manageable proxy for sacrifice, horizontal equity can mean those with the same income pay the same amount of taxes. Vertical equity can then boil down to the question of whether tax burdens should be allocated progressively and, if so, how progressive it should be.

The two dimensions of equity raise a myriad of important yet difficult policy issues that go beyond economic analysis to value judgements. In the case of horizontal equity, these primarily relate to tax policies which discriminate or privilege certain activities or certain taxpayers, the unit of taxation (*ie*, individuals or families), timing of tax liability, cross-generational distribution of tax burdens, and transitional rules arising from tax policy changes. A key question in respect of the vertical equity objective is the degree of progressivity sought. A tax system is considered more progressive if tax liability as a percentage of income rises more quickly with income,⁵⁹ but the appropriate degree is ultimately based on subjective conclusions on the desirability of redistribution, not an absolute objective presumptive formula. Depending on how a tax system is designed, progressive taxation may reduce incentives to work and to invest.⁶⁰ Tax incidence also impacts the analysis of vertical equity. It is beyond the scope of this article to thoroughly discuss the two dimensions of equity. However, suffice it to say that tax burdens should be fairly allocated across people based on the general ideas of horizontal and vertical equity. Equity or fairness is not merely an abstract ideal. As Rawls has argued, justice is meant to make the least advantaged in society as well off as possible,⁶¹ and taxation can be an important institution for redistribution to the benefit of the least advantaged.⁶² In Rawls's view, taxes and transfers can be made more progressive so long as it makes the least-off better off.⁶³

Income inequality has been rising rapidly in many jurisdictions in recent decades, and the threats it poses for economic and social development have become a focal point of attention at both international and national levels.⁶⁴ Wealth distribution is growing even more unequally.⁶⁵ Research findings indicate that inequality in

⁵⁹ Slemrod & Bakija, *supra* note 8 at 88; Elkins, *supra* note 8 at 51.

⁶⁰ The incentive to work may not be reduced but increased by a higher rate if the worker expects the same level of income. This suggests the real effects of higher rates depend on whether one expects an income effect or a substitution effect.

⁶¹ Rawls, *supra* note 8 at 83.

⁶² John Rawls, *A Theory of Justice*, Rev ed (Cambridge: Harvard University Press, 1999) at 246. Rawls argues that taxation is needed to raise the revenues so that the government can provide for the public goods and make transfers necessary to satisfy the difference principle. For the difference principle, see Rawls (1999) at 65.

⁶³ Cited in Slemrod & Bakija, *supra* note 8 at 95.

⁶⁴ See Alan Heston & Robert Summers, "The Penn World Tables (Mark 5): an Expanded Set of International Comparisons 1950-1988" (1991) 106 Q J Econ 327; Robert Hunter Wade, "The Rising Inequality of World Income Distribution" (2001) 38:4 Finance Dev 37; Thomas Piketty & Emmanuel Saez, "The Evolution of Top Incomes: A Historical and International Perspective" (2006) 96:2 Am Econ Rev 200; Thomas Piketty & Emmanuel Saez, "Top Incomes and the Great Recessions: Recent Evolution and Policy Implications" (2013) 61:3 IMF Econ Rev 456; Piketty, *supra* note 11.

⁶⁵ Slemrod & Bakija, *supra* note 8 at 106. Although the relevant data is based on the US, the phenomenon may similarly appear in other jurisdictions and at some historical points. For example, in ancient China, the most important form of wealth, land, tends to be concentrated in a small group of individuals; and excessive land concentration (or wealth concentration) could lead to the demise of an empire. See Yan



income and wealth leads to low economic growth and breeds political instability.⁶⁶ Putting aside what causes inequality, which can be a controversial question in specific jurisdictions, the gravity of inequality calls for policymakers to seek measures to address it. Taxation has been recognised as an important instrument to redistribute income and thereby reduce inequality and promote equitable development. Empirical research findings attest to the redistributive role of taxation, particularly income taxation, as well as government transfers.⁶⁷ Market income inequality has been notably decreased by progressive tax as well as transfers in many developed economies, such as Finland and Germany, where the market income Gini coefficient of 0.509 and 0.494 respectively, was reduced to the net income Gini coefficient of 0.269 and 0.289 respectively.⁶⁸ Notably, these countries also tend to have very high marginal rates on top income earners and in some cases, the highest marginal rate of personal income taxes is over 50 percent.⁶⁹

Progressive taxation means more than a progressive rate schedule. Concessionary treatments such as deductions and exemptions can impact on the overall progressivity of an income tax system. Tax concessions are broadly understood to mean tax measures that lead to revenues forgone, whether by exclusions, credits, deductions, preferential tax rates, deferral of tax liability, or other benefits.⁷⁰ Some of these have nothing to do with tax collection and administration but relate to other policy

Xu, "Land Tax without Land and Land without Land Tax: A History of Land Tax in China" in John Tiley, ed, *Studies in the History of Tax Law*, Volume 6 (Oxford: Hart Publishing, 2013) at 523-556.

⁶⁶ For inequality and low economic growth, see Alberto Alesina & Dani Rodrik, "Distributive Politics and Economic Growth" (1994) 109:2 Q J Econ 465; George Clarke, "More Evidence on Income Distribution and Growth" (1995) 47:2 J Dev Econ 03; and Philippe Aghion, Eve Caroli & Cecilia García-Peñalosa, "Inequality and Economic Growth: The Perspective of the New Growth Theories" (1999) 37:4 J Econ Lit 1615. For inequality and political instability, see Alberto Alesina & Roberto Perotti, "Income Distribution, Political Instability, and Investment" (1996) 40:6 European Econ Rev 1203; Terry Lynn Karl, "Economic Inequality and Democratic Instability" (2000) 11:1 J Democracy 149; and Robert MacCulloch, "Income Inequality and the Taste for Revolution" (2005) 48:1 J Law Econ 93.

⁶⁷ See eg, Richard Bird & Eric Zolt, "The Limited Role of the Personal Income Tax in Developing Countries" (2005) 16:6 J Asian Econ 928; Louis Kaplow, "Taxation and Redistribution: Some Clarifications" (2007) 60 Tax L Rev 57; Richard Bird & Roy Bahl, "Tax Policy in Developing Countries: Looking Back – and Forward" (2008) 61:2 Natl Tax J 279; Neil Brooks, "A Restatement of the Case for a Progressive Income Tax" in John Head & Richard Krever, eds, *Tax Reform in the 21st Century* (Netherlands: Wolters Kluwer, 2009) at 277-351; Neil Brooks & Thaddeus Hwong, "Tax Levels, Structures, and Reforms: Convergence or Persistence" (2010) 11:2 Theoretical Inquiries in Law 791; Peter Diamond & Emmanuel Saez, "The Case for a Progressive Tax: From Basic Research to Policy Recommendation" (2011) 25:4 J Econ Perspectives 165; and Richard Krever & Hui Zhang, "China: Progressive Income Taxation and Urban Individual Income Inequality" (2011) 17:3 Asia Pacific Tax Bull 192.

⁶⁸ See OECD, *OECD Income Distribution Database*, online: OECD <<https://stats.oecd.org/Index.aspx?DataSetCode=IDD>>.

⁶⁹ For example, the top marginal rate in Denmark as of 2020 was 55.89% and Finland 56.95%. However, studies find there has been an overall decline in redistribution in OECD countries since the mid-1990s and there were various reasons to explain the decline. See Orsetta Causa & Mikkel Hermansen, OECD, Economics Department, *Income Redistribution through Taxes and Transfers across OECD Countries*, Working Paper No 1453 (2019) (cancels & replaces the same document of 15 December 2017), online: OECD <[https://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=ECO/WKP\(2017\)85&docLanguage=En](https://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=ECO/WKP(2017)85&docLanguage=En)>.

⁷⁰ Eric Zolt, *Tax Incentives: Protecting the Tax Base*, (United Nations Workshop on Tax Incentives and Base Protection: New York, 23-24 April 2015), online: United Nations <https://www.un.org/esa/ffd/wp-content/uploads/2015/04/2015TIBP_PaperZolt.pdf>; Gerber *et al*, *supra* note 11.



goals.⁷¹ For example, certain forms of compensation, such as employer contributions to retirement saving plans, are excluded from tax to encourage pension savings in some countries. The fiscal costs of these provisions are tax revenue forgone and thus the provisions are often called tax expenditures.⁷²

Various studies have critically examined the effect on equity of tax concessions and exclusions. Some show that tax benefits in the US may vitiate the doctrine of equity and that a territorial system does not accord with equity and efficiency.⁷³ Some find that tax expenditures in Canada are hidden in its welfare system and many tax expenditures disproportionately benefit the well-to-do.⁷⁴ Some argue that the use of tax concessions in respect of superannuation in Australia is both inefficient and inequitable as it provides the greatest value to those at the upper end of the income scale and concessions may be given to those who would make their retirement plans regardless of the concessions.⁷⁵ Also, exemptions and concessions in Australia often fall well short of desired equity outcomes, as with the deductibility of residential property loan interest which is less beneficial to lower-income taxpayers than to their wealthier counterparts and which inflates home prices and encourages borrowing against equity.⁷⁶ A very recent study by the International Monetary Fund concludes, with caution, that reducing tax progressivity (implying more lenient tax treatments on high-income groups) has not been proved to foster growth.⁷⁷ Overall, studies on concessionary tax treatments have not found evidence that they yield desired policy outcomes, but rather, they often run counter to tax equity, create complexity and motivate tax avoidance.

B. The Case of Hong Kong

The question of whether the tax system in Hong Kong is inequitable may depend on how equity is defined. Views of what is equitable vary from individual to individual

⁷¹ Stanley Surrey, *Pathways to Tax Reform: The Concept of Tax Expenditures* (Cambridge: Harvard University Press, 1973). The author argues that “tax expenditures” are those provisions of the tax laws that are not really tax provisions but are government spending programs disguised in tax language. See also Victor Thuronyi, “Tax Expenditures: A Reassessment” [1988] Duke LJ 1155 at 1155; Neil Brooks, “The Under-Appreciated Implications of the Tax Expenditure Concept” in Chris Evans & Richard Krever, eds, *Australian Business Tax Reform in Retrospect and Prospect* (Sydney: Thomson Reuters, 2009) at 233.

⁷² See the literature in footnote 71; see also Linda Sugin, “Tax Expenditure Analysis and Constitutional Decisions” (1999) 50:4 Hastings LJ 407; J. Clifton Fleming & Robert Peroni, “Can Tax Expenditure Analysis be Divorced from a Normative Tax Base: A Critique of the New Paradigm and Its Denouement” (2010) 30:1 Va Tax Rev 135.

⁷³ See William Brown, “Towards Equity and Efficiency in Federal Taxation” (1975) 36:4 U Pitt L Rev 835; MacCulloch, *supra* note 66.

⁷⁴ See Neil Brooks, “The Tax Expenditure Concept” (1979) 1 Can Taxn 31 at 33; Citizens for Public Justice, *Taxes for the Common Good: A Public Justice Primer on Taxation*, (May 2015), at 14, 15, online: Citizens for Public Justice <<https://cpj.ca/wp-content/uploads/FS5-Tax-Expenditures-on-the-Rise.pdf>>.

⁷⁵ Ann O’Connell, “Superannuation and Tax – Some Equity Issues” (2000) 28:3 Fed L Rev 477.

⁷⁶ Rebecca N Morrow, “Billions of Tax Dollars Spent Inflating the Housing Bubble: How and Why the Mortgage Interest Deduction Failed” (2012) 17:3 Fordham J Corp & Fin L 751; Nicholas Norvell, “Transition Relief for Tax Reform’s Third Rail: Reforming the Home Mortgage Interest Deduction after the Housing Market Crash” (2012) 4:4 San Diego L Rev 1333.

⁷⁷ Gerber *et al*, *supra* note 11 at 5.



and from society to society. Although Hong Kong's tax system is seen as inequitable by some,⁷⁸ others in Hong Kong may perceive the system as equitable or view the inequity of the system as largely tolerable. Also, in absolute terms, rich persons do pay more taxes than poor persons. The simple tax system has led many ordinary salary earners to pay little or no taxes, as discussed earlier. Why and how can Hong Kong afford such a system that is loaded with concessions and exclusions, and who is to finance the taxes forgone? Some normative analysis of the major design features of the Hong Kong tax system from the perspective of equity may shed light on these questions.

First, the adoption of the schedular system excludes all income outside the three schedules from tax, wherever it is derived. In tax law, a schedular system is opposed to a general system, which encapsulates all types of income by way of a broad definition, and which often subjects the broadly defined income to a progressive rate structure. The schedular system is questionable on the grounds of equity as compared to a general or global system. This is mainly because it creates gaps in the tax base and incentivises unproductive tax planning activities to circumvent the definitions of income falling within the tax net or to seek a lower rate if tax rates differ between schedules, which can be more intense when rates differ considerably. Moreover, a schedular system usually applies progressive tax rates to only one type of income, typically salaries and wages,⁷⁹ but it does not make sense to impose progressivity on only part of total individual income.⁸⁰ This is because of the equity concern that nowadays, many personal income taxes with schedular elements subject all taxable income to a progressive rate structure.

A schedular system that taxes some forms of income while excluding others is incompatible with the goal of horizontal equity.⁸¹ In Hong Kong, a salaried worker must pay tax on the receipt of employment income while a person with similar income from the disposal of investment property pays no tax on the capital gains realised from the sale. The schedular approach is also inconsistent with vertical equity, as tax burdens do not rise proportionally with the rise of income thanks to the exclusion of all income other than those under the three schedules. Vertical equity will be severely undermined if income derived by higher-income individuals is excluded from assessment as a result of the limitations of the schedular system. This seems to have happened in Hong Kong. As most wealthy individuals in the

⁷⁸ See *eg*, Michael Littlewood, "Tax System Design and the Instructive Case of Hong Kong" (2011) 63:3 *Tax Notes Intl* 193 at 193 [Littlewood, *Tax System Design*]. As the author suggested, the view of Hong Kong's tax system is "inherently inequitable" was first raised in 1940 and has been repeated since.

⁷⁹ The personal income tax law in China prior to its most recent amendment is a good example. It applied a schedular system, covering 11 types of income, and adopted a progressive rate structure on wages and salaries with the highest marginal rate of 45% and another progressive structure on business income derived by industrial and commercial households with the highest marginal rate of 35%. All other income was taxed at 20%. *Law on Individual Income Tax* (PRC) (National People Congress, 1980, as amended 2011), art 3. The impact of such schedular system is analysed by some studies. See Krever & Zhang, *supra* note 67.

⁸⁰ See generally Lee Burns & Richard Krever, "Individual Income Tax" in Victor Thuronyi, ed, *Tax Law Design and Drafting*, (International Monetary Fund, 1998), at Ch 14, online: International Monetary Fund <<https://www.imf.org/en/Publications/Books/Issues/2016/12/30/Tax-Law-Design-and-Drafting-Volume-1-1550>>.

⁸¹ This is found in income tax systems with schedular elements. See Henry Ordover, "Schedularity in U.S. Income Taxation and Its Effect on Tax Distribution" (2014) 108:3 *Nw UL Rev* 905.



jurisdiction derive their wealth from capital but not employment income,⁸² they appear much better off than those middle or low-income workers thanks to the significant disparity in tax treatments between employment income and capital gains by excluding the latter from tax liability.

Further, taxing rules under Hong Kong's schedular system vary from one type of income to another. As these rules lead to different results in respect of assessable income and tax payable, tax arbitrage is inevitable. This is particularly so when the lines between different types of income are murky, such as income derived from employment and income from personal services, or income paid as salaries and income paid as dividends. Under the Hong Kong system, employment income is generally taxable whereas dividends are not, and income from personal services may be taxed with more generous deductions coupled with a lower rate of 7.5 percent on the first HKD2 million of assessable income under the two-tiered profits tax as discussed in Part II.B.⁸³ Were the HKD2 million of assessable income taxed as salaries, it would attract the standard rate of 15 percent. Tax savings from these exclusions and concessionary treatments are thus striking for ordinary individuals. This notable difference suggests, at the very least, that people with the same income do not pay the same tax—raising concerns about horizontal equity; and taxes do not rise when income arises as shown in the contrast of results between income from personal services and income from employment—leading to vertical equity concerns. The different tax treatments appear far from Rawls's difference principle, which contemplates unequal distribution of income and wealth, provided it is to everyone's advantage.⁸⁴ While the issue of different tax treatments on various types of income similarly exists in the income tax systems of many developed economies, the differences do not seem to contrast so sharply as they do in Hong Kong.

Furthermore, not all income under each of the three schedules is included in the respective tax base in Hong Kong. Fringe benefits are a good example. Exclusions or concessionally-taxed employment benefits, such as employer-provided housing with imputed rental value below fair market value, will benefit high-income employees more than low- and moderate-income employees.⁸⁵ For most people working in Hong Kong, the largest expense is housing. The concessionary treatment on employer-provided housing further reduces progressivity of the income tax system, if any.

Second, the territorial source principle, embedded in the IRO from the start, excludes income from foreign sources, a rule that discriminates against those deriving immobile income. Wealthy individuals usually have more mobile income than poor individuals and the exclusion helps them to invest and to hold their assets in

⁸² See Grace Chung & Naazneen Karmali, eds, "Hong Kong's Richest 2020" *Forbes* (Feb 2020), online: <https://www.forbes.com/hong-kong-billionaires/#58729dc13e46>.

⁸³ Hong Kong applies profits tax to income or profits derived by every person, such as a firm or an unincorporated body, from carrying on a trade, profession, or business in Hong Kong. Unincorporated bodies are taxed at 15%, and with the newly introduced two-tiered profits tax legislation they only need to pay taxes at half of 15% on their first 2 million of assessable income. For the two-tiered profits tax, see footnotes 53 and 54.

⁸⁴ Rawls, *supra* note 62 at 53.

⁸⁵ *IRO*, ss 9(1)(b), 9(1)(c), 9(2). The provisions provide housing provided by the employer is taxable based on the rental value of the place of residence, which is defined as 10% of salary, bonus, *etc.*



desirable locations to maximise profits. The exclusion also encourages them to take advantage of differences and gaps between tax laws of jurisdictions to reduce overall tax liability. Conceptually, adopting the source principle is not simply providing a tax expenditure measure, but a more fundamental policy choice by the government. It is different in kind, and it is more basically a component of the definition of the tax base under the tax statute, specifying the extent to which income is taxed. The application of the source principle determines, to some extent, how other tax concessions and exclusions are evaluated, and it affects the expected impact of these concessions and exclusions.

Application of the source principle in practice is the most contentious issue in determining taxability of income or profits in Hong Kong.⁸⁶ This is unsurprising given the enormous difference in tax outcomes of the determination. The ambiguity and uncertainty of the principle provides opportunities for tax avoidance,⁸⁷ which has bearings on equity in taxation as wealthy individuals are usually better resourced to benefit from such activities.

Third, the exclusion of capital income is likely to primarily benefit better-off individuals. What constitutes a sale and what is an asset are not always obvious and determinations of whether a profit or income is of capital nature—and thus non-taxable—have constantly been a contentious area in appeals and court cases in Hong Kong.⁸⁸ The exclusion of capital gains has naturally induced taxpayers to use various techniques to turn income into capital gains, particularly in relation to real property, the most important and valuable capital asset in the view of most people in Hong Kong.⁸⁹ There are, however, few anti-avoidance provisions under the IRO due to the policy of keeping a simple tax system.⁹⁰

While the extent to which tax avoidance practices are used and are materially important is hard to identify due to the very nature of transactions being confidential and unpublishable, the practices undermine efficiency and equality. In theory, the exclusion of capital gains from tax is available to everyone in Hong Kong, but in practice it is the high-income individuals who benefit most, as low- and middle-income individuals lack the capital to invest in the very expensive and lucrative

⁸⁶ For discussion of court cases on the source principle, see *eg*, Halkyard, VanderWalk & Chow, *supra* note 9; Halkyard, *Hong Kong*, *supra* note 9; VanderWolk, *Sourcing*, *supra* note 9.

⁸⁷ As Littlewood observed, Hong Kong's tax system is "susceptible to avoidance and evasion of kinds and on a scale that elsewhere would be regarded as scandalous". See Littlewood, *Tax System Design*, *supra* note 78 at 193.

⁸⁸ In 1955, the British Royal Commission on the Taxation of Profits and Income published a Final Report, summarising six basic factors, called "the badges of trade", for deciding whether a transaction in question is a trade or involves a capital gain. The summary has been ordinarily used by the courts and Board of Review in Hong Kong. See Halkyard, VanderWalk & Chow, *supra* note 9.

⁸⁹ A popular technique identified by earlier studies is the use of "creative accounting". See Berry FC Hsu & Chi-Wa Yuen, *Tax Avoidance due to the Zero Capital Gains Tax: Some Indirect Evidence from Hong Kong* (2000 Symposium on Capital Gains Taxation, 15-17 September 2000) at 45, online: Fraser Institute <<https://www.fraserinstitute.org/sites/default/files/IntlEvidenceNoCapitalGainsTaxSec2A.pdf>>.

⁹⁰ The most relevant specific anti-avoidance provision is IRO, s 15A. The two general anti-avoidance provisions, ss 61 and 61A, may be used to prevent tax avoidance activities related to converting income into capital gains.



asset category—real property, given the soaring property prices in the city.⁹¹ It is observed that capital gains are a key driver of inequality,⁹² and the absence of capital gains tax could make the inequality worse.

Fourth, the various deductions, particularly residential property loan interest deductions, undermine the redistributive potential of the tax system. The same may be said of tax credits in the Hong Kong case that are used to offset taxes otherwise payable, as credits benefit only when individuals have enough income to pay tax. A major problem with tax deductions, exemptions or exclusions is the upside-down effect, that is, the higher the income—and the applicable marginal tax rate—the greater the value of deductions and exemptions to the taxpayer.⁹³

The upside-down effect suggests that allowing deductions of home mortgage interest payments to encourage and assist home ownership is not a good policy. First, in the Hong Kong context, capital gains on the sale of not only principal residences but all other residences are excluded from tax.⁹⁴ This measure discriminates against renters in favour of homeowners as noted above. Further, allowing homeowners to deduct some part of their mortgage interests unfairly advantages high-income taxpayers as their interest costs would often be greater with the purchase of more expensive properties than low-income taxpayers (assuming they have bigger mortgages). Moreover, the deduction will encourage people to move into larger and more expensive properties in order to take advantage of the tax savings. By reducing the after-tax cost of homes and hence increasing the demand for properties, the deduction will push up the price of all properties in the market and make it hard for new home buyers to purchase a property. This appears to be the case in Hong Kong where low- and moderate-income people find it almost impossible to enter the property market, despite various measures taken by the government to cool down the overheated property market.⁹⁵ Lastly, the deduction of mortgage interest

⁹¹ See Midland Property, *Price Index 1998-2020*, online: Midland Realty <<https://www.midland.com.hk/en/market-insight/>>. Notwithstanding high property prices, Hong Kong's households are found to have a high safe assets-to-liabilities ratio due to government strict regulations on banks' mortgage lending and other reasons. See Hong Kong Monetary Authority, *Understanding Household Indebtedness in Hong Kong* (14 September 2018), online: Hong Kong Monetary Authority <<https://www.hkma.gov.hk/media/eng/publication-and-research/research/research-memorandums/2018/RM07-2018.pdf>>. For a general discussion, see Graham Webb, "Tax Equity and Homelessness: A Tax Policy Analysis of the Golden Report" (2001) 16 J L & Soc Poly 15.

⁹² See Jesper Roine & Daniel Waldenström, "Chapter 7 Long-Run Trends in the Distribution of Income and Wealth" in Anthony B Atkinson & François Bourguignon, eds, *Handbook of Income Distribution Vol 2* (Oxford: Elsevier, 2015) at Part 2.2.3. The study cautions that only using taxable realised capital gains to study impact of capital gains—both realised and unrealised—on measured income inequality may confuse the timing of inequality changes and may overstate increases in top income shares.

⁹³ See Surrey, *supra* note 71 at 234-246; see also Thuronyi, *supra* note 71 at 1159.

⁹⁴ The exclusion is applied unless sales are determined as carrying on a trade or business in Hong Kong.

⁹⁵ One recent measure is to allow first-time buyers to borrow up to 90% of the value of a property up to US\$1 million, doubling the previous limit. See Hudson Lockett, "Hong Kong Reforms Risk Overheating High-Priced Property Market" *Financial Times* (22 October 2019), online: Financial Times Hong Kong <<https://www.ft.com/content/d9ffd43a-f41e-11e9-b018-3ef8794b17c6>>. The Hong Kong government has introduced a range of stamp duties since the 2000s to prevent speculation. IRD, *Stamp Duty*, online: Inland Revenue Department <<https://www.ird.gov.hk/eng/tax/sdu.htm>>. For home affordability in Hong Kong, see footnote 39.



does not seem to have helped increase home ownership,⁹⁶ and it would distort the allocation of resources in the economy in the long run as individual savings will be used to finance homes for high-income individuals but not to finance new productive investments. This will impair the productivity of the economy as well as social stability of the city. Overall, the upside-down expenditures in the form of tax deductions, exclusions or exemptions contrast with government direct subsidies which primarily benefit the less advantaged; and tax expenditures typically have other drawbacks, such as complicating the tax laws and imposing uncertain costs.⁹⁷

The design features of Hong Kong income tax—exclusion of offshore income, non-taxation of capital receipts, low tax rates with a tax ceiling of 15 percent, absence of a global system and provision of various deductions and allowances—may appear to varying degrees in other income taxes. However, the existence of all these features simultaneously with the comparable level of tax benefits would not usually be found elsewhere. Some of these features encourage tax avoidance. To be sure, tax avoidance is a common problem in many jurisdictions. One might argue that there is less incentive to avoid tax in Hong Kong because of the low tax rates. However, tax avoidance is not merely affected by tax rates. In jurisdictions with broad tax bases and the same progressive rates for all types of income, there is limited opportunity to avoid tax by changing the character or the source of income. In Hong Kong, by contrast, there are many opportunities for avoidance. A good example is the juridical characterisation of receipts as ordinary income or capital gains, a distinction that can mean the difference between full taxation and zero taxation. In some other jurisdictions, tax arrangements to convert ordinary income into capital gains only reduce the rate of taxation, not eliminate it entirely. Also, the exclusion of offshore income, coupled with the low tax rates for both individuals and businesses, raises not only equity concerns, but makes Hong Kong a desirable place for tax avoidance and arbitrage, which undermines its revenue interests and smears its international reputation.

What follows from these design features is the limited or negligible role of the income tax in redistribution in Hong Kong. The latest official statistics show that the Gini coefficient increased to 0.539 in 2016 from 0.533 in 2006 based on the original income, and the inequality measure was only slightly reduced by tax to 0.524 in 2016 and 0.521 in 2006, respectively.⁹⁸ The inequality was further reduced by social transfers, but only to a moderate extent—around 0.47 in both census years.⁹⁹ By comparison, the pre-tax inequality is similarly high in many developed economies as in Hong Kong, but such inequality can be considerably reduced to a Gini coefficient of around 0.25 to 0.3, a more equitable level, by taxes and transfers.¹⁰⁰

⁹⁶ Wadu Mesthrige Jayantha & Olugbenga Timo Oladinrin, *An Analysis of Factors Affecting Homeownership: A Survey of Hong Kong Households* (2020) 35 *J Housing & Built Environment* 939. Home ownership in Hong Kong has stagnated and been below 50%. Studies elsewhere show tax deductions of mortgage interest has little effect on home ownership. In the US, for example, most of households that use the deduction are in the highest tax brackets. See William Gale, *Fiscal Therapy: Balancing Today's Needs with Tomorrow's Obligations* (New York: Oxford University Press, 2019) at 219, 220.

⁹⁷ Thuronyi, *supra* note 71 at 1159, 1161, 1162.

⁹⁸ See Thematic Report, *supra* note 5 at 27.

⁹⁹ *Ibid.*

¹⁰⁰ For data and statistics in OECD countries, see OECD, *supra* note 68.



In Singapore, income inequality has also been noticeably reduced by taxes and transfers as noted in Part I.

The limited application of income tax in Hong Kong means the government must have alternative revenue sources to fund its public function. One important source is land revenue, especially land premiums, which alone have been a key revenue source since the 1980s,¹⁰¹ and in some years the largest revenue source.¹⁰² Land premiums are paid by land developers to the government for the temporary right to occupy land in the form of leaseholds, or to renew or modify the right carried in a lease, as by law the government is the ultimate owner of all property in Hong Kong.¹⁰³ The premium is a large lump-sum payment which approximates the land value. Land revenue is not limited to land premiums but also includes proceeds from lease modifications, stamp duties, property tax that is levied on property rentals, profits tax from developers, and government rates on property. Although stamp duties are imposed on all kinds of transaction documents, the major revenue source is from property transactions, and the levy has become the second largest tax revenue source after the profits tax in recent years, with the introduction of some special stamp duties to contain speculation.¹⁰⁴ If all these land-related revenues are taken into account, land would be the largest government revenue source in Hong Kong.¹⁰⁵

Land development has been controlled by a few business conglomerates which have attained enormous wealth with the high land development prices being shifted

¹⁰¹ See Stan Hok-wui Wong, "Real Estate Elite, Economic Development, and Political Conflicts in Postcolonial Hong Kong" (2015) 15:1 *China Rev* 1 at 5, 6. See also Census and Statistics Department of the Government of the HKSAR, *Table 193: Government Revenue (General Revenue Account and the Funds)*, online: Census and Statistics Department <<https://www.censtatd.gov.hk/hkstat/sub/sp110.jsp?tableID=193&ID=0&productType=8>>.

¹⁰² For example, land premium in 2017-18 was the largest revenue source, accounting for 26.6% of the total revenue, more than 22.4% from the Profit Tax. Research Office of Legislative Council Secretariat, *Major Sources of Government Revenue (Data as at 24 May 2019)*, online: Legislative Council <<https://www.legco.gov.hk/research-publications/english/1819issf04-major-sources-of-government-revenue-20190529-e.pdf>>.

¹⁰³ *The Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China*, art 7. Hong Kong's legislature has explained the land tenure system in Hong Kong in a recent legal document. See Legislative Council of the HKSAR of the People's Republic of China, *Land Tenure System in Hong Kong*, online: Legislative Council <<https://www.legco.gov.hk/research-publications/english/essentials-1617ise07-land-tenure-system-in-hong-kong.htm>>.

¹⁰⁴ The Special Stamp Duty was introduced to apply to all residential properties acquired on or after 20 November 2010, with different rates charged based on holding period of the properties. The Buyer's Stamp Duty was introduced to apply to all residential properties acquired by non-permanent residents on or after 27 October 2012. The ordinary ad valorem stamp duty was increased to 15% on any instruments executed on or after 5 November 2016 for the acquisition of residential properties in Hong Kong unless otherwise specified in the Stamp Duty Ordinance. See *Stamp Duty (Amendment) Ordinance 2018* (Hong Kong); see also IRD, *Annual Report*, online: Inland Revenue Department <<https://www.ird.gov.hk/eng/ppr/are.htm>>.

¹⁰⁵ Some study finds that land revenue, including premiums, annual rent, rates and property tax, accounted for on average 33% of government revenue between 1970 to 1996 and if profits tax from development companies and taxes on mortgage portfolio profits were included, the share would be up to 45%. See Alice Poon, "Hong Kong's Land Policy: A Recipe for Social Trouble" (January 2011), Hong Kong Journal Archive, online: Carnegie Endowment <https://carnegieendowment.org/hkjournal/archive/2011_spring/3.htm>.



onto everyone buying or renting properties developed in Hong Kong.¹⁰⁶ Housing prices are high in the city for several reasons, particularly because land for housing accounts for a meagre 6.9 percent of land among around 24 percent of land allowed to be built up in Hong Kong.¹⁰⁷ With a population of over 7.5 million people living and working in the city, the demand for housing is unsurprisingly high. The fact suggests huge profits going to a few business tycoons (and the government), while the prices are borne by the entire community.¹⁰⁸ This feature of land revenue is rare among developed economies, including Singapore.

The tax system and related land revenue regime in Hong Kong is interwoven inextricably with implications for inequality of income and wealth in the city. The various design features have considerably benefited those most advantaged.¹⁰⁹ The level of income inequality measured by the Gini coefficient in the international financial hub is just striking—higher than in most of its counterparts, *ie*, cities with large financial centres, and among the highest in the world too,¹¹⁰ albeit with some reduction in very recent years.

IV. THE DESIGN REVISITED: ATTAINING MORE EQUITY IN HONG KONG?

In the design of tax law, simplicity is often considered a desired objective. However, having a simple tax system is not enough, particularly if it comes at the cost of equity. Equity or fairness, however vague and plastic the concept may be, is widely claimed as one of the most important tax policy objectives. Hong Kong's tax system was introduced as a temporary measure without any deliberate intention of achieving equity or fairness.¹¹¹ It is flawed and inequitable, albeit with some success in attracting international investors, with observable limited revenue-raising capacity, considering taxes account for a far smaller proportion of government revenue than in any comparable western developed economy. If the overall social distribution scheme is just and other economic regulations are concerned about distribution rather than focused on maximisation of market results, the particular design of the tax system might not matter much in theory.¹¹² But this is not the case in Hong Kong. The absence of an effective overall distributive scheme in Hong Kong sets the

¹⁰⁶ *Ibid.*

¹⁰⁷ Task Force on Land Supply, *Land for Hong Kong: Our Home, Our Say!* (April 2018), online: Legislative Council <<https://www.legco.gov.hk/yr17-18/english/panels/dev/papers/dev20180529-booklet201804-e.pdf>> at 2.

¹⁰⁸ Poon, *supra* note 105. This article explains how the practice of selling land lease rights via government auctions and the lease modification procedures has been used by large developers to achieve comparatively low average land costs and high profits.

¹⁰⁹ As found in earlier studies, some of Hong Kong's richest and well-known people pay no, or very little, personal tax. See Halkyard, *Jurassic Park*, *supra* note 7 at 7, footnote 29.

¹¹⁰ See footnotes 3 and 4.

¹¹¹ For a brief account of the legislative history of Hong Kong's basic tax law, the IRO, see Littlewood, *Legacy*, *supra* note 9 at 255-257.

¹¹² Similar observation can be found in studies based on other jurisdictional experiences. See Linda Sugin, "Theories of Distributive Justice and Limitations on Taxation: What Rawls Demands from Tax Systems" (2004) 72 *Fordham L Rev* 1991 at 2013, 2014.



scene for an environment in which the tax system assumes a greater redistributive role.

Tax law cannot change the disparities in the distribution of original or market income, but it can be a major instrument of redistribution to mitigate the disparities.

A. *Rethinking the Design*

The peculiar design of the Hong Kong tax system resulted in an excessively narrow and volatile tax base to meet the development challenges facing the jurisdiction. Broadening the tax base would increase tax revenue and promote fairness in the tax system. This has been recognised by the government, which came down firmly in favour of a Goods and Services Tax (“GST”) in both of its consultation papers in 2001 and 2006.¹¹³ A GST was, however, rejected by an overwhelming majority of Hong Kong residents, not least because a GST is by nature regressive. The underlying concern is how a potential increase of tax burden from the proposed GST—and probably other broadening measures—interacts with the already high burden associated with land-related finance in the city. The government’s failures suggest that any attempt to broaden the tax base, or more broadly any tax reform, must consider the equity issue against the backdrop of a broad revenue system. The aspiration of maintaining a simple tax regime needs to be reconciled with the fundamental principle of equity for sustainable development, and ultimately it is about weighing between interests for business-friendliness against interests for the well-being of most people at the lower end of income scales in the society.

A more equitable tax system with enhanced redistributive functions does not simply mean imposing a highly progressive rate structure. To improve the equity of the tax system and to achieve its redistributive goal, tax concessions and exclusions or exemptions that cause the upside-down effect can be removed. Both theoretically and empirically, tax expenditures such as exclusions, deductions, and preferential rates can lower the progressivity of a tax system, undermine transparency of tax law, encourage tax arbitrage, and create uncertain costs to the government. The extent to which tax expenditures impact on the government budget will reveal the magnitude of tax expenditures and the group of persons who unduly benefit from them. Closing tax expenditure loopholes or substituting some for direct government subsidies that fulfil government policy objectives more effectively would improve equality of taxation and remove unnecessary complexity in the tax system.¹¹⁴

The design of the income tax law in Hong Kong reveals several lessons. First, transparency is much needed regarding tax expenditures. Their magnitude and impact should be disclosed in annual government budgets. Unlike many developed economies (and an increasing number of developing economies) which have

¹¹³ The Government of the HKSAR *Consultation Document: Broadening the Tax Base, Ensuring our Future Prosperity*, (2006), online: <https://www.taxreform.gov.hk/eng/doc_and_leaflet.htm>; Advisory Committee on New Broad-based Taxes, *Consultation Document: A Broader-Based Tax System for Hong Kong* (August 2001), online: <<https://www.info.gov.hk/archive/consult/2001/condoc-e.pdf>>.

¹¹⁴ See Surrey, *supra* note 71 at 182-203, 204-207.



included tax expenditures as part of their budget,¹¹⁵ Hong Kong has, to date, not implemented any tax expenditure analysis and publication. The government needs to evaluate the costs of revenue forgone from tax exclusions, exemptions, deductions, and other preferential treatment with results being communicated to the public. Enhancing transparency of tax expenditures will better inform public debate about how to broaden Hong Kong's tax base and promote greater equity. This measure appears legally and practically feasible and relatively easy to implement.

Second, the schedular approach to taxing income could be reformed to include at least capital gains, dividends, and interest, if not all types of income. Historically, this approach was never meant to be permanent, and the use of personal assessment was meant to be a way of transitioning to a general income system.¹¹⁶ The current schedular system in Hong Kong is outdated and inequitable, and most jurisdictions have moved towards a general system or a combination of both due to the inequality issues of a purely schedular system. Broadening the tax base by including income of a capital nature will prevent much dispute in the determination of a receipt as income or capital, reduce property speculation, and improve equality between labour and capital income. It would not impact on low- and medium-income persons who own either no home or only one principal home. Capital gains can be taxed according to the taxpayer's marginal rate, *ie*, either subject to the progressive rate structure or the standard rate. If the current rates—which are internationally low—are to continue, the tax on capital gains would not significantly impact on Hong Kong's international competitiveness.¹¹⁷ Dividends and interest can be taxed via the withholding regime, which is already in place regarding royalty payments under certain circumstances.¹¹⁸ The tax burden on low- and medium-income people should be minimal as they tend to have little of such income.

Related to the schedular system is the inclusion of a comprehensive fringe benefits tax. The current benefit-in-kind provisions under the salaries tax are limited: not all employer-provided benefits are taxed, and some benefits are taxed very generously as discussed above. The limited taxation gives rise to inequality between high-income earners and low-income employees and even between employees with the same nominal salaries but different benefit packages. The inclusion of fringe benefits taxation will improve the redistributive effect of the income tax system.

Third, the deductibility of residential property mortgage interest should be repealed. The highly perverse effect analysed above warrants a complete removal. If the government wishes to assist home ownership, a direct grant or subsidy to low-income households would be more sensible and equitable.

Also, tax credits that have been used to offset tax payable can be abolished as they have no value to the very poor as discussed earlier, if the goal of the credits is to provide benefits to everyone's advantage, in particular those least advantageous. Alternatively, the credits can be retained and complemented with a direct cash transfer to the very poor up to the same limit set up for the credits.

¹¹⁵ International Budget Partnership, *Open Budget Survey 2019*, online: International Budget Partnership <https://www.internationalbudget.org/sites/default/files/2020-04/2019_Report_EN.pdf>.

¹¹⁶ Littlewood, *Legacy*, *supra* note 9 at 255-257; Littlewood, *Taxation*, *supra* note 9 at 120.

¹¹⁷ Capital gains have been taxed at a concessionary rate in some jurisdictions when they are derived from long-term investment.

¹¹⁸ See discussion in Part II.B and footnotes 40, 41.



Further, an annual property tax, which differs from the existing property tax levied on rentals, should be considered. Currently, there is almost no tax cost on holding properties in Hong Kong,¹¹⁹ which benefits only those who can afford to purchase and hold as many properties as they can. This does not only worsen wealth inequality in the city but create other issues such as scarcity of home supplies. Very few jurisdictions adopt such a policy. A further step to address wealth inequality is to reinstate the estate duty, which was effectively abolished in 2006, removing an obstacle for those wealthy individuals to pass wealth onto their next generations without or with only trivial tax costs. As land financing closely interacts with the tax system, a special levy on undeveloped property could be introduced to prevent land hoarding for price speculation by developers.¹²⁰ It would also be necessary to abolish restrictions on land supply and to publicise land auction timetables to increase transparency in producing land revenue.¹²¹

Moreover, anti-avoidance rules need strengthening. As discussed earlier, the tax statute contains few prescriptions preventing abusive or arbitrage activities that exploit differences between independent contractors, self-employed individuals, and employees, between capital and revenue, and between offshore and onshore income. If tax loopholes can be fixed, improved tax compliance will help improve equity.

For Hong Kong to continue to compete in the global economy, the territorial source principle may be retained, given the international trend towards a territorial system, but tax avoidance must be tightened. In the same vein, the current rates under the three schedules of income taxes may be largely retained in the short term, even though low rates benefit the wealthy more than the poor. Some changes are however needed. The two-tiered profits tax rate structure should be discarded. The newly-introduced lower rates invite tax arbitrage and cause unequal tax treatments between formally employed and self-employed or independent workers, among other things.¹²² The current rates for individuals, including the standard rate of 15 percent, are notably low by international standards. There is much scope to raise these rates in order to enhance progressivity in the long run. In the short- and medium terms, an additional levy at the same rate as the standard rate could be introduced to those who are taxed at the standard rate, namely by doubling rates for the highest income-earners. This would increase redistributive effects of the tax system without complicating it. The higher rate would still be internationally competitive, considering the highest marginal rate in a number of developed economies is around 50 percent.

In the absence of a tax expenditure budget, there has been no comprehensive evaluation of the extent to which tax expenditures contribute to the regressivity in Hong Kong. The dire inequality in income and wealth in the jurisdiction and the various empirical findings suggest there is a strong case for a revisit of the design

¹¹⁹ The Hong Kong government charges rent on property owners which may be a fixed amount or may vary with change in the rateable value of the property according to the *Government Rent (Assessment and Collection) Ordinance* and *Rating Ordinance*. Charge concessions have been offered by the government from time to time.

¹²⁰ Poon, *supra* note 105.

¹²¹ *Ibid.*

¹²² Xu, *supra* note 56.



of the tax system. Removal of tax concessions and exclusion would be a logical starting point for reform.

B. *Constraints Within and Outside*

Despite the urgent need to address inequality, reforming the income tax design in Hong Kong is difficult for several reasons. First, the simple tax system with low tax policy has led to the assumption that the tax burden is comparatively light, and many people do not pay any income tax in Hong Kong. The simple and low tax traits have rendered the inequitable effect of the system not readily self-evident to many people and even politicians in the jurisdiction.¹²³ Another reason can be attributable to the provisions regarding taxation under the Basic Law, Hong Kong's mini constitution, which stipulates that Hong Kong should strive for a fiscal balance and take the historically low tax policy as a reference when formulating tax policies.¹²⁴ As such, an increase in tax rates, a broadening of the tax base, or an introduction of new taxes may conflict with the constitutionally enshrined low tax policy. Also, providing a comprehensive social welfare system as found in developed economies to help mitigate inequality is believed to violate the fiscal requirement in the Basic Law. Finally, Hong Kong's economy heavily relies on a few key industries, including finance, trade, and professional and producer services, and any removal of or change to tax provisions offering preferential treatments may adversely impact these industries (as well as related vested interest groups).

The abovementioned reasons might appear true on the surface but would not withstand scrutiny. Nonetheless, they indicate that there are barriers to changing the status quo, especially when they relate to institutionalised and deeply entrenched interests. The most critical constraint is the low tax policy prescribed in the Basic Law. Important as it is, the policy has never been lucidly explained by the legislature, nor the courts. Depending on how to define the term "low tax" and subjective views of "low tax", a rate of 30 percent may appear to be low enough for persons from some European countries. Adoption of an additional levy at 15 percent charged to those who are subject to this rate, or the introduction of an extra bracket of highest marginal rate, or a substantial increase of the current top marginal rate of 17 percent while keeping the lowest marginal rate of two percent intact would arguably not violate the low tax policy, and the increased burden would fall only on a small group of high-income persons. The removal of the newly introduced two-tiered profits tax structure will not contradict the low tax policy if the standard rate

¹²³ As noted in earlier studies, Hong Kong people seem content with the lightness of the tax burden as well as the balance of taxation and a very low-level public spending, despite a deplorable degree of poverty and miserable living conditions of a large part of people. See Littlewood, *Legacy*, *supra* note 9 at 254. Another study based on a survey on public perceptions of the Hong Kong tax system shows there is no general dissatisfaction with the current level of taxation in Hong Kong or the way in which it spent, but the population in general perceives inequalities in the distribution of the tax burden and that these favour the rich. See Richard Cullen & Richard S Simmons, "Tax Reform and Democratic Reform in Hong Kong: What Do the People Think?" (2008) 6 *Brit Tax Rev* 667 at 679.

¹²⁴ *The Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China*, arts 107, 108.



remains unchanged. The repeal of various concessions and exclusions would not challenge the low tax policy and would reduce unnecessary complexity and associated tax arbitrage practices.

Importantly, the low tax policy is said to be applied as a reference, which arguably means the policy is not inviolable. Moreover, the policy “previously pursued” may not justify its value in guiding the formulation of tax rules and policies in a changed circumstance—widening inequality, uneasy social conflicts, fast ageing, a shrinking working population and other like issues present in Hong Kong today. A more progressive system would enhance redistribution effects and the rebalance of tax burdens between rich and poor would be unlikely to contradict the low tax policy.

Externally, Hong Kong’s simple and low tax system is considered an important factor boosting Hong Kong’s global competitiveness and at the same time it is criticised as providing opportunities for tax avoidance and evasion.¹²⁵ The low tax policy might be attacked by some jurisdictions or international organisations in the anti-base erosion and profit shifting campaign, which accentuates tax cooperation and rejects tax competition as it drives harmful tax activities, eroding the tax base and shifting profits to favourable tax jurisdictions.¹²⁶ The paradigm shift of international taxation to cooperation would push Hong Kong to change its simple and low tax policy, even though it is unclear whether the “cooperation” envisaged by the OECD would actually improve outcomes for Hong Kong. Indeed, the emphasis on tax cooperation has been questioned by some studies as it would not yield desired outcomes for individual jurisdictions.¹²⁷

To some extent, improving tax equity through the measures suggested above would indirectly help make Hong Kong a cooperative member of the international tax community as it would result in the closure of its current tax expenditure loopholes. From Hong Kong’s perspective, maintaining its simple and low tax system would help sustain its fiscal capacity to provide and improve social welfare and obtain opportunities for economic growth. To effectively combat tax avoidance, Hong Kong needs to cooperate with other jurisdictions but at the same time, as a small open economy, it needs to be competitive—efficiently—to grow in the global market.¹²⁸ The real strength or competitive advantage of Hong Kong’s tax system, in the author’s view, is good administrative services, legal certainty, and sound

¹²⁵ Hong Kong used to be listed in the EU watchlist for deficiencies in good tax governance and it was removed from the list on 12 March 2019. However, as noted in footnote 40, with effect from 5 October 2021, Hong Kong has been added to the EU watchlist of non-cooperative jurisdictions for tax purposes. Lewis Lu & John Timpany, “The EU Adds Hong Kong SAR on Its ‘Grey List’ for Tax Purposes” *International Tax Review* (19 October 2021), online: International Tax Review <<https://www.internationaltaxreview.com/article/b1v25q11rxrpl/the-eu-adds-hong-kong-sar-on-its-grey-list-for-tax-purposes>>.

¹²⁶ OECD, *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5 – 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project Series, (OECD, 2015), online: OECD <<https://www.oecd.org/tax/countering-harmful-tax-practices-more-effectively-taking-into-account-transparency-and-substance-action-5-2015-final-report-9789264241190-en.htm>>.

¹²⁷ Tsilly Dagan, *International Tax Policy: Between Competition and Cooperation* (Cambridge: Cambridge University Press, 2018) at 4, 5, Ch 3-5.

¹²⁸ Some studies argue that efficient competition could offer a better solution to promote just and efficient international taxation. See *ibid* at 4, 5, Ch 7.



dispute resolution mechanisms. Nevertheless, a more equitable income tax system would be beneficial to the Hong Kong society as well as international investors and businesses. That said, external pressure, along with internal equity concerns, can be an impetus to urge the government to rethink the design of the tax system to make distribution of the tax burden more fairly between the rich and the poor.

A more equitable system does not necessarily mean a more complicated system. Rather, removing tax expenditure loopholes that provide unduly advantageous treatment to some taxpayers who are not the needy would simplify the system. Also, a low tax policy does not necessarily mean that improved progressivity cannot be achieved. A simple and equitable tax system should not be mutually exclusive.

V. CONCLUSION

The design features of the Hong Kong tax system have attracted much attention from a business perspective, but the equity impact of the system has scarcely been examined. The article analyses how tax exclusions, concessions, and preferential rates have benefited the better-off against a broad backdrop of persistent and striking income inequality in the jurisdiction, at a level not seen in its counterparts in the developed world. The current income tax system has contributed little to the mitigation of disparities in income distribution while the narrow tax base is unlikely to be sufficient to provide the funds needed to meet pressing social needs in the medium and long terms.

Tax reforms elsewhere show that broadening the tax base and eliminating tax expenditures is generally the right direction for reform. By mitigating unnecessary complexity and opportunities for tax arbitrage, a foundation can be laid for a more progressive and efficient way of generating revenue. It may be claimed that there is a trade-off between the social benefits of a more equitable distribution of income and wealth on one hand and economic growth on the other. The two may not be mutually exclusive, however, as there is empirical evidence that suggests progressive taxation and economic growth complement each other and economic growth can be assured in more equitable societies. Even if this evidence were rejected and it was argued that growth is linked to inequity, equity or fairness is a central component of a society and if Hong Kong is to remain a society in all senses of the word, a better balance is needed between the “costly luxuries”¹²⁹ of economic growth and justice.

¹²⁹ Henry Simons, *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy* (Chicago: University of Chicago Press, 1938) at 24.

