# ENTERING A NEW ERA: TIME FOR A HOLISTIC REVIEW AND REVAMP OF THE TAX SYSTEM IN HONG KONG?

WILSON CHOW*

## ABSTRACT

Its simple and low-rate tax system has helped Hong Kong to become a flourishing economy in the world post World War II and to get through challenges and crises over the last two decades. This article argues, however, that the time has come with forces from within and outside, locally, regionally and internationally, economically, socially and politically, individually and collectively, testing Hong Kong's not-yet-broken tax system to its limits and calls for a timely and research-informed, comprehensive and substantive review and reform to be applied to the regime.

**Keywords***:* Tax policy, tax system, review and reform, Hong Kong

## I INTRODUCTION

Once aptly described as the 'Jurassic Park in the Pearl River Delta',[1] the simple and low-rate tax system in Hong Kong has also been said to be 'troublingly successful'.[2] The Hong Kong income tax system as we know it today dates from the 1940s when the *Inland Revenue Ordinance* cap 112 (Hong Kong) ('*IRO*'), the key and only income tax law even for now in Hong Kong, was first enacted on 3 May 1947 with its origin from the *War Revenue Ordinance 1940* (Hong Kong).[3] It has helped Hong Kong to become a flourishing economy in the post-WWII world.[4] Based upon and contained within a common law tradition and framework, the system is still running well; but its unreformed age is showing. Since 1997 it has operated within a Special Administrative Region of the People's Republic of China ('PRC'), the latter being a civil law jurisdiction.

The system has endured and come through such challenges as the global financial crisis and the severe acute respiratory syndrome ('SARS') over the last two decades, with no comprehensive and substantive reforms having been applied to the regime itself since it was established. However, the local economic and social conditions underlying its original

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* Associate Professor, Faculty of Law, The University of Hong Kong. This article was presented as a paper at the Australasian Tax Teachers Association Annual Conference 2022. Development of the article has been done in light of comments from conference participants and further insight from Professor Richard Cullen, Adjunct Professor, Faculty of Law, The University of Hong Kong, for all of which the author is grateful. The author is also grateful for the comments from the reviewers.

1 Andrew Halkyard, 'The Hong Kong Tax Paradox or Why Jurassic Park Exists in the Pearl River Delta' (1998) 8 *Revenue Law Journal* 1.

2 Michael Littlewood, *Taxation without Representation: The History of Hong Kong's Troubling Successful Tax System* (Hong Kong University Press, 2010).

3 See ibid 5.

4 Ibid 2.

design have changed over the years and will continue to change. In addition, the plea for enhanced international tax cooperation, typically through the work of the Organisation for Economic Cooperation and Development ('OECD'), attributed mainly to the continuing growth of globalization, international trade and e-commerce, is growing louder. More recently the aftermath of substantial domestic social unrest with a series of events sparked off by an amendment bill regarding extradition proposed by the Hong Kong government in 2019 has amplified changes already underway in the demographics of Hong Kong, coupled with subtle twists and turns in the PRC's approach towards Hong Kong and the unprecedented public health risks associated with COVID-19. These factors have had, and will continue to have, an impact on the economy and society in Hong Kong, as well as regionally and internationally. In essence, they are testing Hong Kong's not-yet-broken tax system to its limits. The call for timely and research-informed responses to review, reform and develop a tax system that will address the domestic challenges and be more convergent with, rather than isolated and divergent from, the PRC and other international counterparts, has been intensifying.[5]

Part II of this article gives an account of the tax system in Hong Kong and the legislative changes made to it over the last decade.[6] Part III and IV, with respective references to local, regional and international contexts, put forth arguments for a timely and holistic review of the system to prepare for and meet the challenges for a new era from now to and beyond 2047, the initial 'expiry' (or primary review) date of the innovative 'one-country, two systems' regime.[7] This article will conclude, in Part V, by sketching out the way forward for a modernised and more 'fit-for-purpose' system. It would be better, as an ancient unattributed quote says, 'have not thy cloak to make when it begins to rain'!

## II THE HONG KONG TAX SYSTEM

### A *The 'troublingly successful' 'Jurassic Park in the Pearl River Delta'*

The Appendix contains a table that matches the key features of the Hong Kong tax system against a simplified tax matrix.[8] The system is best known for being 'simple' because of the following features. First, it has only one level of taxation which means that once a corporation is chargeable to tax, its after-tax profits distributed to its shareholders as dividends are not subject to tax again.[9] Second, it has only one single jurisdiction to tax and that is territorial source which means that offshore profits and income are generally

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5 See eg, YY Butt and Patrick Ho, The Changing Role of Hong Kong Taxation in Fiscal Policy in the Last Thirty Years and its Prospective Future' (2021) 25(1) *Asia-Pacific Journal of Taxation* 19; Stefano Mariani, 'Trajectories for the Development of the Inland Revenue Ordinance in Hong Kong' (2021) 25(2) *Asia-Pacific Journal of Taxation* 21, 25-31

6 See also Butt and Ho (n 5) that made a similar attempt over a longer period of time with a slightly different emphasis.

7 See Part IV A.

8 The author first encountered this as a teaching and learning tool used by Professor Andrew Halkyard at the Faculty of Law, The University of Hong Kong, more than a decade ago.

9 *Inland Revenue Ordinance* cap 112 (Hong Kong) ('*IRO*') s 26(a).

exempt from Hong Kong taxes, regardless of the domicile or residence of the person.[10] Third, it does not have any general income tax but instead, three separate and distinct taxes on: trading, business and profession income; income for the use of immovable property; and employment and office income.[11] Nevertheless, an individual having income from other than from just employment or office may elect for personal assessment by which he or she will be assessed on his or her aggregate income from various sources and enjoy favourable concessionary deductions and personal allowances as if he or she only earned employment or office income.[12] Last but not least, it does not have any indirect taxes or capital gains tax except to the extent and in the form of stamp duty, which is a duty on certain prescribed instruments for giving effect to certain transactions involving immovable property and company shares.[13] The tax base is therefore very narrow.

Apart from being 'simple', the system has relatively low tax rates. The standard rates for income taxes are set at 15% and 16.5% for individuals and corporations respectively.[14] Assessable profits from the trade, profession or business up to HK$2,000,000 (about AU$270,500) are subject to only 50% of the applicable standard rate.[15] Progressive tax rates from 2% to 17% apply to the net chargeable employment and office income,[16] subject to the maximum of having the standard rate charged on the whole of the net assessable income as reduced by allowable concessionary deductions.[17] According to the 2020-21 Annual Report of the Inland Revenue Department ('IRD') , for the year of assessment 2019-20, only 1.3% of salaries tax payers were charged at the standard rate but they contributed 35.7% of the final salaries tax assessed. Given its simplicity and low tax rates (and burden), it is not surprising that comparatively few tax incentives have been made available in Hong Kong.

Stamp duty is levied on prescribed chargeable documents, typically on the amount or value of the consideration[18] except a fixed duty of HK$5 (about AU$0.93) is payable on a duplicate of a chargeable document. [19] *Ad valorem* duty rates are generally low, notably at 0.26% on contract notes for sale and purchase of Hong Kong shares.[20] In contrast, *ad valorem* stamp duty rates on chargeable instruments on transactions involving residential

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10 Ibid ss 5, 8 and 14.

11 Ibid.

12 Ibid ss 41 and 42.

13 *Stamp Duty Ordinance* (Hong Kong) cap 117 ('*SDO*').

14 *IRO* (n 9) schs 1 and 8.

15 Ibid schs 8A and 8B.

16 Ibid sch 2.

17 Ibid s 13(2).

18 *SDO* (n 13) sch 1.

19 Ibid head 4.

20 Ibid head 2(1).

immovable property in Hong Kong can be as high as at 15% [21] unless the purchaser (or transferee or assignee) is a Hong Kong permanent resident acting on his or her behalf without beneficially owning another residential property in Hong Kong.[22] If the purchaser (or transferee or assignee) of the residential property is a non-Hong Kong permanent resident, the transaction attracts an additional buyers' stamp duty at the rate of 15%.[23] A subsequent quick disposal of the residential property will be subject to the special stamp duty at a rate of 10%, 15% or 20%, depending on the length of the holding period such that a shorter period of ownership attracts a higher duty rate.[24]

Save and except perhaps with the current stamp duty regime on residential properties in Hong Kong serving its specific purposes to curb speculation in the property market and to stabilise property prices,[25] a tax system of those features listed out above is an outliner and should probably have become 'extinct' by now. The system has been, however, 'troublingly successful'.[26] It has been 'successful' as it witnessed the rise of an economy from a fishing village to an international financial centre, accumulating vast fiscal reserves despite the exceptionally light levy of taxes.[27] Such success may have been attributed to the revenue brought by premiums charged by the government for 'leasing' land to property developers (including sales of lease and lease-conversion fees), [28] as well as the relatively low public spending.[29]

Meanwhile, the success is 'troubling' because firstly, judged by axiomatic criteria, the system is considered 'grossly flawed' as being 'inherently inequitable' permitting 'avoidance and evasion of kinds' and on a 'scandalous' scale.[30] For example, with regards to the benefits in kind, a residential unit provided rent-free by the employer, only a notional benefit called "rental value" will be added to the chargeable income of the employee, such rental value being calculated at 10% of the net income of the employee after deducting outgoings and expenses excluding self-education expenses, for a residential unit provided rent-free by the employer, irrespective of how much the unit

21 Ibid heads 1(1) and 1(1A), pt 1 of scale 1.

22 Ibid s 29BB.

23 Ibid sch 1, heads 1(1AAB) and 1(1C).

24 Ibid heads 1(1AA) and 1(1B).

25 See further Jianlin Chen, 'The Yet-to-Be Effective but Effective Tax: Hong Kong's Buyer's Stamp Duty as a Critical Case Study of Legislation by Press Release' (2014) 10 *University of Pennsylvania East Asia Law Review* 1, 18-26 for an introduction of those measures.

26 Littlewood (n 2).

27 Ibid 2.

28 Ibid 16 and 205. See further Richard Cullen and Antonietta Wong, 'How History Has Shaped the Hong Kong Revenue Regime' in Noland Sharkey (ed), *Taxation in ASEAN and China* (Routledge, 2012).

29 Littlewood (n 2) 2.

30 Ibid.

actually costs.[31] Secondly, having been an 'undemocratic' government, the Hong Kong approaches to light taxation and a low level of public spending has appeared to enjoy greater popularity and support than those in most democracies.[32] People in Hong Kong ostensibly have been tolerant of such a low level of public expenditure, given that most of them are hardly taxed at all.[33] Further, as illustrated below, it appears systematically difficult to increase taxes, to increase the progressivity of its tax system and to increase public spending or to operate at a deficit.[34] Such a tax system, functioning tangentially with the phenomena described above, might possibly be found instructive to other jurisdictions, not least to those 'democracies' which have been struggling between casting an appropriate tax burden and voters' preference.[35]

### B *'If it ain't broke, don't fix it'*

This expression is often quoted to explain the lack of motivation in carrying out any significant or wholesale review and reform of the tax system in Hong Kong. The Annual Reports of the IRD, from 2010/11 to 2021/22,[36] provide a snapshot of the key legislative changes over the last decade or so, from April 2010 to March 2022, [37] to the two major tax statutes in Hong Kong, the *IRO* and *Stamp Duty Ordinance* (Hong Kong) cap 117 ('*SDO*'). Evidently, the two major tax laws have both grown thicker and more complex over the years.

Regarding the IRO, the most noticeable feature over the course probably is the annual cut of the tax bill by a certain percentage subject to a ceiling while marginal tax bands for individual taxpayers has become more in number and wider apart, the lowest being 2% for the first HK$50,000 (about AU$9,265) of one's net chargeable income. Such tax concession typically applies to salaries tax and tax under personal assessment and occasionally, profits tax. For example, the reduction for the year of assessment 2021/22 applicable to all three taxes mentioned is 100%, subject to a ceiling of HK$10,000 (about AU$1,853) per case. This has taken, in estimate, a further 2.01 million individual taxpayers and 151,000 tax-paying businesses out of the tax net for that tax year, with the total public revenue forgone amounting to about HK$14.3 billion (about AU$2.65

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31 *IRO* (n 9) ss 9(1)(b) and 9(2). See also generally Inland Revenue Departmental Interpretation and Practice Notes (DIPN) No 16, and specifically DIPN Nos 38 and 41 <https://www.ird.gov.hk/eng/ppr/dip.htm>.

32 Littlewood (n 2) 2-3.

33 Ibid 2.

34 Ibid 3.

35 Ibid.

36 'Annual Report', *Inland Revenue Department* (Web Page, 12 December 2022) <https://www.ird.gov.hk/eng/ppr/are.htm>.

37 Interested readers may contact the author for a detailed table summarising those changes, which intends to serve as an initial step to continue Littlewood's treatise (n 2) which gives a historical account of the regime up to 2009/10.

billion).[38] This annual tax cut has seemingly become a convention and normal practice of the Hong Kong government not only in addition to or in lieu of relieving individuals and businesses from tax burden in the midst of any unfavourable economic situation, but also during years of fiscal surplus when, perhaps, the government had more money than it reckoned how to spend.[39] By any standards, this kind of 'habitual' annual tax cut is beyond imagination but 'something beguilingly attractive in Hong Kong's successes'[40] that other jurisdictions might find it interesting to investigate and explore.

Moreover, allowances and concessionary deductions are more favourable, typically with a policy reason behind. The following examples can all be considered to attempt to address the emerging, if not already emerged, ageing population[41] in Hong Kong: increase in child allowance to encourage giving births, increase in allowances for maintaining and residing with parents and grandparents, as well as increase in the maximum deduction of elderly residential care expenses to encourage the younger generation to take care of their elderly rather than 'abandoning' them in public institutions, increase in the maximum deduction for mandatory contributions to the Mandatory Provident Fund, premiums for voluntary health insurance and deferred annuity policies to mobilise the middle-aged group to plan ahead for their retirement life.

For businesses, the system now has two tiers of profits tax rates of which only half of the normal rate is applicable to the first HK$2,000,000 (about AU$370,225) of assessable profits. Small and medium enterprises should particularly welcome and be benefited by this initiative. There are also far more tax incentives and concessions than before, targeting special categories of businesses including, for examples, Islamic bonds, insurance businesses, aircraft and ship leasing, innovation and technology start-ups, acquisition of intellectual property rights, research and development, as well as fund management businesses. All these link to the current and future positioning of Hong Kong as the global financial, transportation, innovation and technology centre.

On the other hand, changes to the *SDO* over the last decade seem to have taken a different course. Said to be aimed at curbing the skyrocketing residential property price, the last decade saw the increase in the maximum ad valorem stamp duty rate from 3.75% to 4.25%, then to 8.5% and now at a flat rate at 15% unless an exception applies, among which the most relevant ones concern either a purchase by a Hong Kong permanent resident acting on his or her own behalf without beneficially owning another residential property in Hong Kong or a transfer between closely related individuals. On top of the ad valorem stamp duty, two additional types of duty have been introduced, both applicable to residential property transactions. The first is special stamp duty, the enhanced version of which is currently set at a maximum rate of 20% for quick disposal within 6 months after acquisition unless an exception applies, which includes, again, a transaction between

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38 'News Archive', *Inland Revenue Department* (Web Page, 6 April 2022) <https://www.ird.gov.hk/eng/ppr/archives/22040601.htm>.

39 See further Littlewood (n 2) 285-6.

40 Ibid (n 2) 286.

41 This issue will be elaborated below in Part III.

closely related individuals. The other one is buyer's stamp duty at the rate of 15% unless, for example, the purchaser is a Hong Kong permanent resident acting on his or her behalf. While relief is provided for individuals buying their new residence first and disposing of the previous one later, payment of duty can no longer be deferred. The mischief of buying more than one residential property under one single instrument has, after a court decision, been addressed and managed by further legislative amendments. Stamp duty on non-residential property transactions has also been subject to changes, first by bringing forth the time for stamp duty charge to the agreement for sale, instead of as was the case previously on the conveyance on sales, followed by doubling the ad valorem duty rates to a maximum of 8.5% when the flat rate of 15% was introduced to residential property transactions. It is only most recently that the rates have been reduced back to the original scale with a maximum rate at 4.25% while the duty rate on contract notes for sale and purchase of Hong Kong shares has increased to 0.26% in aggregate.

Other than those highlighted above, an earlier attempt in 2006 to introduce a goods and services tax ('GST') did not come to fruition. It has been suggested that it was essentially for lack of support of the representatives of the business sector that the proposal saw its failure.[42] Indeed, history has been repeating itself since 1947 in various attempts to radically reform the tax system in Hong Kong by introducing, for instance, a normal income tax to replace the schedular system, a tax on dividends and a sales tax.[43] Indeed, the business interests and elites seem to have played a significant role in shaping (and keeping intact) the tax system in Hong Kong, irrespective of the twists in political developments and the varying extent of democratisation in post-1997 Hong Kong.

The latest proposal of a vacancy tax targeting newly completed flats for domestic use being left unsold and not rented out for more than six months in a year had also been shelved. This proposal took the form of amending the *Rating Ordinance* (Hong Kong) cap 116 with the introduction of special rates which is defined under the bill to mean 'a tax chargeable on' such applicable tenement. Rates, in Chinese literally meaning 'payment for the Hong Kong Police' and used to support the police force and other public services in the old days, can be considered an indirect tax on landed property. They are charged at a percentage, currently at 5%, of the rateable value which is the estimated annual rental value of a landed property at a designated valuation reference date, assuming that the property was then vacant and to let. Both the owner and the occupier are liable for rates but in the absence of any agreement to the contrary, liability for rates rests with the occupier.

The Rating (Amendment) Bill was gazetted on 13 September 2019 with a Bills Committee formed on 8 May 2020. After two meetings of the Bills Committee in June and further consideration of the Housing Committee in July 2020, the Transport and Housing Bureau announced the withdrawal of the Bill on 19 October 2020, saying that views of the members at the Bills Committee were very divergent and there had been strong and

42 Littlewood (n 2) 274 and Jingyi Wang and Wilson Chow, 'Capital Gains Tax with Hong Kong Characteristics: Desirability, Feasibility and Design' (2018) 48 *Hong Kong Law Journal* 555, 564. See further generally Littlewood (n 2) 251-75.

43 Ibid 106, 159-60, 188-9 and 237-40. See further generally: ibid 210.

differing views in the community, taking into account the then economic situation as well.[44]

As will be elaborated in Section 4.1 below, expansion of public expenditure is generally restricted. It has indeed been the case well before 1997 and is consistent with 'positive non-interventionism' which, since 2005, has also been known as 'big market, small government'.[45] Changes in stamp duty excepted, the above account is an affirmation of such adherence to the doctrines in tax policy and reform. The pattern of ad hoc responses and changes suggest that any major and more systemic tax reform is not an easy mission in Hong Kong, let alone the old saying that there is never a good time to introduce a new tax: as when times are tough, it is necessary to stimulate the economy instead of burdening it with new taxes; yet when the economy is recovering and booming, new taxes are just not needed.[46]

### *1 Stress Test from within*

Nonetheless, the system has been, is, and will be, subject to stress tests internally.[47] From Figure 1 below, the financial year 2020-21 saw the largest ever fiscal deficit in Hong Kong. The larger-than-expected deficit was said to be mainly due to the government's expenditure related to the COVID-19 relief measures.[48]

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44 The Government of Hong Kong SAR, 'Government decides to withdraw Bills for introducing Special Rates on unsold first-hand units and franchised taxis' (Press Release, 19 October 2020) <https://www.info.gov.hk/gia/general/202010/19/P2020101900708.htm>. See further Legislative Council of the Hong Kong SAR, *Bills Committee on Rating (Amendment) Bill 2019* <https://www.legco.gov.hk/yr19-20/english/bc/bc02/general/bc02.htm>.

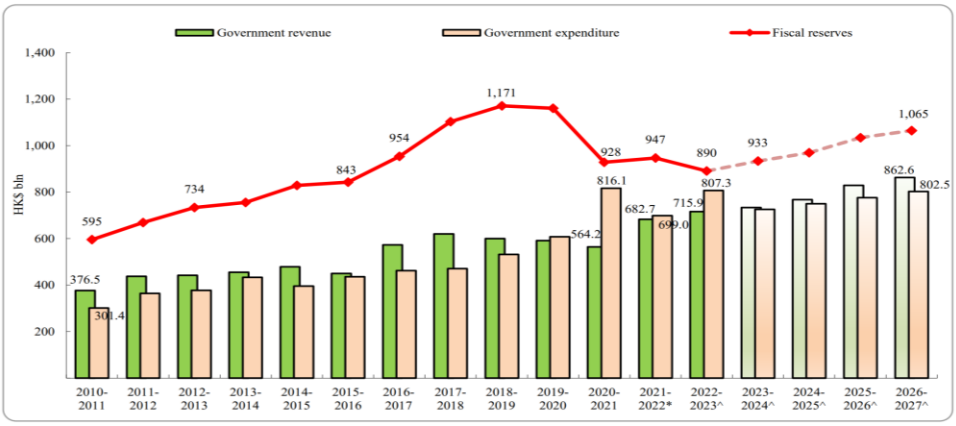
45 '"Big market, small government" a key policy', *news.gov.hk* (Web Page, 19 September 2006) <https://www.news.gov.hk/isd/ebulletin/en/category/administration/060919/html/060919en03 004.htm>. See further Lau Siu Kai, 'Basic Law may see some needed changes after 2047', *China Daily Hong Kong* (online, 8 August 2022) <https://www.chinadailyhk.com/article/284561>.

46 Littlewood (n 2) 286.

47 See eg, Wang and Chow (n 42) 557-63.

48 See 'Past budgets', Financial Secretary (Web Page, 22 February 2023) <https://www.budget.gov.hk/2023/chi/previous.html>.

**Figure 1 – Trend of government revenue, expenditure and fiscal reserves**[(1)]



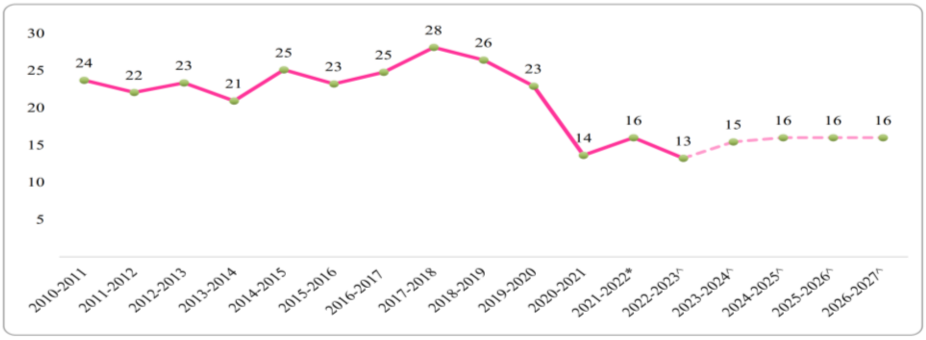

Notes: (*) Revised estimate.
(^) Estimate/forecast.
(1) Government revenue and expenditure do not include issuance and principal repayment of green bonds issued under the Government Green Bond ("GGB") Programme. Following the offering of the inaugural tranche of green bond in 2019, issuance under the GGB Programme amounted to HK$7.8 billion, HK$19.3 billion and HK$35.1 billion over 2019-2020 to 2021-2022 fiscal years respectively, and planned annual issuance during 2023-2024 to 2025-2026 is also set at HK$35.1 billion. Meanwhile, annual principal repayment of green bonds over 2024-2025 to 2026-2027 would range from HK$7.1 billion to HK$29.7 billion.

Data sources: 2022-2023 Budget speech and The Treasury (various years).

Source: Research Office, Legislative Council Secretariat, Research Brief (Issue 1, 2022/23)

Figure 2 below shows the surge in the fiscal deficit resulting in a rapid decline in the government's fiscal reserves. The current level of fiscal reserves dwindled sharply from 23 months in 2019-2020. It is indeed close to the level in 2003-2004 when Hong Kong was hit by the SARS pandemic. It is estimated to reach its record low in the financial year 2022-23 and will maintain at more or less the current level for the following four years.

**Figure 2 – Fiscal reserves as number of months of government expenditure**




Notes: (*) Revised estimate.
(^) Estimate/forecast.

Data sources: 2022-2023 Budget Speech and The Treasury (various years).

Source: Research Office, Legislative Council Secretariat, Research Brief (Issue 1, 2022/23)

The sharp fall in revenue from land premium contributed partly to the deficit. According to the data from the Lands Department, it was just HK$53.6 billion (about AU$9.93 billion) in 2020/21. The 2021-22 Budget estimated land premium to be HK$97.6 billion (about

AU$18.08 billion) [49] but at the end of the financial year, again according to the Lands Department, it was just HK$94.377 billion (about AU$17.48 billion), with the sale of one single piece of land at the New Central Harbourfront near the Star Ferry terminal on Hong Kong Island contributing HK$50.8 billion (about AU$9.41 billion).[50] While the latest Budget expects an increase in the land premiums, no successful sale has been concluded during the first two months of the new financial year.

Regarding revenue collected via tax, it seems from the table below that salaries tax and stamp duty have coped with the recent situation relatively better. However, the narrow tax base remains a concern; inequality and the absence of distributive justice caused by the system persist.[51]

**Figure 1 Revenue collected by tax type**

| Type of tax | 2017-18 ($m) | 2018-19 ($m) | 2019-20 ($m) | 2020-21 ($m) |
|---|---|---|---|---|
| Profits tax - | | | | |
| Corporations | 133,459.3 | 160,833.2 | 149,427.5 | **129,489.7** |
| Unincorporated businesses | 5,640.9 | 5,786.5 | 6,472.8 | **6,050.0** |
| Salaries tax | 60,838.8 | 60,145.9 | 50,412.4 | **75,027.3** |
| Property tax | 3,447.8 | 3,624.4 | 2,806.5 | **3,957.2** |
| Personal assessment | 5,342.5 | 5,963.1 | 4,999.8 | **6,293.7** |
| **Total earnings & profits tax** | **208,729.3** | **236,353.1** | **214,119.0** | **220,817.9** |
| Estate duty | 31.3 | 88.7 | 53.6 | **7.4** |
| Stamp duty | 95,172.8 | 79,978.7 | 67,198.0 | **89,044.6** |
| Betting duty | 21,959.1 | 22,194.4 | 22,012.2 | **20,877.1** |
| Business registration fees | 2,726.7 | 2,826.7 | 189.6 | **73.0** |
| **Total revenue collected** | **328,619.2** | **341,441.6** | **303,572.4** | **330,820.0** |
| **% change over previous year** | **13.2%** | **3.9%** | **-11.1%** | **9.0%** |

Source: IRD 2020-21 Annual Report

For instance, the poverty situation continues to be worrying while the overheated real estate market has remained an unresolved long-term problem.[52] Poverty is defined with reference to monthly household income. Poor households are households with income below the poverty line which is drawn up for each group of households of the same size, defined as 50% of the median monthly household income (before policy intervention) of that household size group.[53] The Government used to refer to the poverty rate, which represents the ratio of poor population (meaning the number of persons living in the poor

49 Research Office, Legislative Council Secretariat, *Research Brief* (Issue 3, 2021/22): <https://www.legco.gov.hk/research-publications/english/2021rb03-the-2021-2022-budget-20210407-e.pdf>.

50 Lands Department, 'Land Sale Records' (Web Page, 2021) <https://www.landsd.gov.hk/en/resources/land-info-stat/land-sale/land-sale-records.html>.

51 Yan Xu, 'Distributive Justice and Income Taxation – Is Hong Kong Special?' (Conference Paper, Australasian Tax Teachers Association (ATTA) Conference, 19-20 January 2022).

52 See eg, Wang and Chow (n 42) 559-61.

53 'Poverty Situation', *Census and Statistics Department* (Web Page, 2022) <https://www.censtatd.gov.hk/en/scode461.html#section8>.

households) to total population living in domestic households,[54] with intervention of recurrent cash only, including cash-based benefits recurrently provided by the Government to individual households, such as social security benefits and education allowances in cash. From 2019 onwards, it refers to the rate after intervention of all measures including one-off measures and non-cash benefits provided with means tests such as the provision of public rental housing by the Government. Behind this rosier comparison, the public expenditure on relieving poverty has increased.[55]

Generally, public expenditure has been ever increasing, more noticeably in social welfare and health care since 2017-18.[56] Among other social issues, housing has always been one of the biggest concerns. To illustrate, Hong Kong housing prices have had an index between 170 and 190 over the last three and a half years, with July 1997 as the base period with an index of 100, according to a weekly index based on contract prices in transactions of a major property agency group that monitors variations in residential property.

The need for additional resources will intensify, particularly in light of the increasing costs for housing, the ageing population that refers to a shift in the distribution of population towards older ages with an increase in the population's mean and median ages, a decline in the proportion of the population composed of children, and a rise in the proportion of the population composed of elderly, and hence the increasing demand for medical care and social welfare. High expectations are said to have been expressed by the PRC government on the new Chief Executive of Hong Kong and his 'cabinet' in solving social problems including housing.[57] Some of the recent amendments to the IRO as sketched out above have supported this call. The forecast made in 2017 projected an elderly dependency ratio of 529 in mid-2046. The latest forecast shows the ratio at 569 in 2049, as reflected in the table below. This means that it is estimated to have, by 2049, 569 persons aged 65 and over per 1,000 persons who are within working age of 15-64, close to 57%.

According to the government statistics in August 2021,[58] the provisional estimate of the Hong Kong population was just below 7.4 million (7,394,700) at mid-2021, representing a decrease of over 87,000 (87,100) or 1.2% from 7.48 million (7,481,800) at mid-2020. The population decrease comprised a natural decrease (i.e. deaths surpassing births) and net outflow of Hong Kong residents. Over the same period, there was a net outflow of 89,200 other Hong Kong residents. The Hong Kong government attributed this mainly to

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54 Ibid.

55 Ibid.

56 Secretary for Financial Services and the Treasury, '2022-23 Budget – Briefing for Legislative Council' (Report, 25 February 2021) <https://www.budget.gov.hk/2021/eng/pdf/2021_2022_SFST_Briefing_to_LegCo_25022021_en.pdf>.

57 See further Wallis Wang, 'Beijing has high expectations – especially on housing', *The Standard* (Hong Kong, 20 June 2022) 1.

58 Government of Hong Kong SAR, 'Mid-year population for 2021' (Press Release, 12 August 2021) <https://www.info.gov.hk/gia/general/202108/12/P2021081200387.htm>.

the continued impact of COVID-19, stringent border control and quarantine measures in place in Hong Kong and other places around the world, resulting in severe interruption of international travel, such that Hong Kong residents who had left Hong Kong before the pandemic may have chosen to remain outside Hong Kong or cannot return to Hong Kong. Those figures as at the end of 2021 were revised to just over 7.4 million (7,403,100), 23,600 or 0.3%, partly due to a net outflow of just 27,300 residents.[59] Despite the categorical dismissal by the government of the idea, what might have also contributed to the net outflow but not mentioned is the aftermaths of the social unrest in Hong Kong in 2019 leading to another brain-drain from here. Comparison of enrolment figures from the Education Bureau reveals that over 30,000 students withdrew from Hong Kong schools between October 2020 and September 2021.[60] They may just go abroad for further studies but whether they would return, and if so, how many of them would do so, remain uncertain. Indeed, a survey reported by the Hong Kong Institute of Asia-Pacific Studies, Chinese University of Hong Kong, over a course of five years from September 2017 to September 2021 has revealed that there has been an increase from 34% to around 42 to 43% of respondents would leave Hong Kong if there exists an opportunity to do so. Among those who would leave for elsewhere, more than one-third have somehow been preparing or have prepared to do so.[61]

The COVID-19 epidemic and the strategies, controls and measures taken by Hong Kong may just add more uncertainties as to how long it will take for the local economy to recover, the extent of its recovery and hence how all these may impact on the overall fiscal situation of the place. Hong Kong may well have passed the peak of the fifth wave of the pandemic, it has not yet returned to full normality prior to the first experience of the infectious disease in the midst of the rebound of the fifth wave. While it is undeniable that we are living in the 'new normal' and we must learn how to live up to it, it takes time, and sometimes pain, to adapt to the rather fluctuating and evolving situation with all possible variants and mutants, apart from the possible discovery and spread of another highly infectious and life-threatening disease.

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[59] Government of Hong Kong SAR, 'Summary results of 2021 Population Census and Year-end Population Estimate for 2021' (Press Release, 28 February 2022) <https://www.info.gov.hk/gia/general/202202/28/P2022022800462.htm>.

[60] William Yiu, 'More than 30,000 students quit Hong Kong schools, with campuses in high-income areas taking hardest knocks', *South China Morning Post* (online, 3 June 2022) <https://www.scmp.com/news/hong-kong/education/article/3180243/over-30000-students-quit-hong-kong-schools-campuses-high>.

[61] Hong Kong Institute of Asia-Pacific Studies, 'The Chinese University of Hong Kong's survey on Hong Kong as a livable city', (Report [in Chinese], 2021) <http://www.hkiaps.cuhk.edu.hk/wd/ni/20211020-110804_1.pdf>.

### 2 External Forces

#### (a) *The China Factor: Continuing autonomy or increasing integration*

Hong Kong is a special administrative region under the PRC. While it enjoys a high degree of autonomy administratively, Hong Kong has been subject to the (re)exercise of sovereignty by the PRC since July 1997. *Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China* art 5 ('*Basic Law*'), the mini-constitution of the Hong Kong, preserves its prevailing system and way of life for at least 50 years from 1 July 1997 by providing that the PRC's socialist system and policies shall not be practised in Hong Kong during the period. So far as public finance and the tax system are concerned, the *Basic Law* arts 106 to 108 allow independence of Hong Kong subject to certain caveats including avoiding deficits, keeping the budget commensurate with the growth rate of its gross domestic product, as well as taking the low tax policy as reference. Such independence is given despite the fundamentally different tax systems Hong Kong and its sovereign state respectively have, as shown in the simplified tax matrix in the Appendix. On the other hand, the provisions not just provide a 'fiscal firewall' separating Hong Kong's public finances from those of the PRC, they grant constitutional, or quasi-constitutional, status to the 'low tax policy' and restrict public spending not to increase beyond the growth rate of its gross domestic product even without a deficit.[62]

It is now half-way through to the earliest 'expiry' date of the guarantee set at 2047. More recently, the 14th five-year plan of the PRC 2021-2025 seems to lay more emphasis on 'sovereignty', 'national security' and 'integration' with regards to the inter-relationship between the PRC and Hong Kong. In particular, with a specific aim to maintain the long-term prosperity and stability of Hong Kong and Macau, Article LXI of the plan provides that:

> We will fully and accurately implement the guiding principles of 'one country, two systems', 'Hong Kong people governing Hong Kong', 'Macau people governing Macau', and a high degree of autonomy. We will adhere to Hong Kong and Macau being governed in accordance with the law, uphold the constitutional order of the Special Administrative Regions (SARs) specified in the Constitution and the Basic Law. We will put into practice *the central government's overall jurisdiction* of the SARs, and implement the legal system and enforcement mechanisms of the SARs for *safeguarding national security*, and we will defend the *nation's sovereignty, security, and development interests, as well as the overall social stability of the SARs*. We will resolutely prevent and check external forces from interfering in Hong Kong and Macau affairs, support Hong Kong and Macau in consolidating and enhancing their competitive advantages, and *better integrate them into the overall development of the country*. [*Emphasis added*]

These thematic phrases have become more visible and apparent after the social unrest in 2019, leading to, inter alia, the enactment of the National Security Law and the so-called 'improved' electoral system to ensure patriots are administering Hong Kong. The latest election of the Legislative Council has its lowest-ever voter turnout, probably the

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62 Littlewood (n 2) 244-8.

narrowest-ever political spectrum, albeit with the largest-ever number of seats returnable from direct and indirect elections. Most recently, Hong Kong has also seen the highest-ever number of votes from the Election Committee in support of its next Chief Executive but, for the first time ever, in a one-horse race. Another illustration may well be the Hong Kong's choice of approach in combating and tackling COVID-19 that is more aligned with the PRC's strategies, from vaccination campaigns, social distancing requirements to travel restrictions. The Hong Kong government has been unprecedentedly firm despite repeated calls from the business representatives for earlier and wider relaxation of those measures in order to resume normal business activities.

Public law scholars and columnists hold divergent views on the sustainability of the 'one country, two systems' framework beyond 2047, despite what the PRC officials have repeatedly said and reassured.[63] It may be too early to speculate whether such 'integration' would and could, in time, spill over to the tax system in Hong Kong. While Hong Kong may not be another special economic zone for which the PRC provides location-specific tax incentives, on no account, however, should the China factor be overlooked with respect to how the Hong Kong system might have to change in the following decade or so. Indeed, the expectation from the PRC on the Hong Kong government to counter and solve social problems, as well as to integrate with the bigger part, has hinted the latter to likely expand its role in all aspects, economic, social, and people's livelihood, and to provide necessary impetus for its integration in the overall development of the former. As such, the *Basic Law* art 107 which stipulates that Hong Kong 'should follow the principle of keeping expenditure within the limits of revenues in drawing up its budget, and strive to achieve a fiscal balance, avoid deficits and keep the budget commensurate with the growth rate of its gross domestic product' may no longer be appropriate. Rephrasing of the article to allow the financial flexibility to the Hong Kong government to, for instance, widen its tax base or engage in other major and fundamental tax review and reform is clearly within the ambit of the PRC and may not be far from too remote.[64]

(b) *Regional Competition: The Lion City versus the Fragrant Port*

The two rivals, Singapore and Hong Kong, have long engaged in fierce but rather healthy competition for the most dominant 'mid-shore', as distinguished from 'offshore',[65] financial centre serving as the global gateway to Asia. The simplified tax matrix in Table 1 of the Appendix compares and highlights the key differences between these two taxing jurisdictions. Noticeably, Singapore does have estate duty and GST and it taxes, on top of

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63 For example, compare and contrast Alex Lo, 'Hong Kong is already living past 2047', *South China Morning Post* (online, 8 June 2022) <http://www.scmp.com/comment/opinion/article/3180905/hong-kong-already-living-past-2047>; Albert Chen, 『「一國兩制」的可持續性』 "The sustainability of 'One Country, Two Systems'" (in Chinese), *Ming Pao* (online, 20 June 2022) <https://news.mingpao.com/pns/觀點/article/20220620/s00012/1655662922468/陳弘毅-「一國兩制」的可持續性>.

64 Lau (n 46).

65 See eg, Joe Cheung and Chris Burton, 'Is Midshore the new Offshore', *IFC Economic Report* (Spring/Summer 2019) 41.

its source base, on a remittance basis, namely offshore profits of Singaporean resident companies in some circumstances. It has been, on the other hand, proactive in increasing its attractiveness for activities such as fund management and wealth planning. In 2020, Singapore leapfrogged Hong Kong, just marginally, for the first time in a global jurisdiction ranking survey, which asked 620 corporate services executives to rate the importance of various financial centres.[66] On the other hand, the Hong Kong government has responded with a series of favourable tax policies to further promote the place as a wealth management centre and family office hubs.[67] Would the 'success' of Singapore despite having such other taxes as GST and estate duty and a broader tax base including taxing remittances provide insights to how Hong Kong could reshape its tax system to meet challenges ahead?[68]

While the recent disruption since 2019 of the local economy might have made Hong Kong slightly more unfavourable, the tie and connection between the PRC and Hong Kong are something that Singapore does not, will not and cannot, have. Despite the social unrest and the COVID-19, PRC money has been flowing into the Hong Kong Stock Exchange, an example of which is a report of such investment through the Shanghai-Hong Kong and Shenzhen-Hong Kong connect programmes.[69] A survey conducted by Hong Kong's Private Wealth Management Association ('PWMA') and KPMG China has revealed that the contribution to Hong Kong's estimated private wealth from PRC individuals would increase from just 35% in 2019 to 51% by 2026.[70] Would the increased integration with the PRC offer Hong Kong a larger edge, allowing room even for some fundamental tax reform to modernise the system instead of competing with providing more tax incentives alone?

(c) *International Tax Arena: Cooperation or isolation*

Given its source-based tax system, international tax for a long time had not attracted much attention in Hong Kong despite the existence of a legislative provision for the making of double taxation agreements ('DTAs')[71] and the unprecedented arrangement with the PRC to prevent double taxation of income in 1998, which was subsequently replaced by a comprehensive agreement in 2007.

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66 'Is Singapore nudging ahead of Hong Kong as Asia's preferred financial hub?', *Vistra Insights* (Web Page, 2 November 2020) <https://www.vistra.com/insights/singapore-nudging-ahead-hong-kong-asias-preferred-financial-hub>.

67 See further, Financial Secretary, Hong Kong SAR, *Budget Speech 2020-21* [61]-[62]; *Budget Speech 2021-22* [86]-[88]; *Budget Speech 2022-23* [82]. See 'Past budgets' (n 48).

68 See further Mariani (n 5) 26-9.

69 Yiyang Wei and Denise Jia, 'Chinese Mainland Cash Floods Into Hong Kong Stock Market', *Caixin Global* (online, 20 January 2021) <https://www.caixinglobal.com/2021-01-20/chinese-mainland-cash-floods-into-hong-kong-stock-market-101652920.html>.

70 PWMA and KPMG, *Hong Kong Private Wealth Management Report 2021* <https://www.pwma.org.hk/wp-content/uploads/2021/10/Hong-Kong-Private-Wealth-Management-Report-2021-English.pdf>.

71 *IRO* (n 9) s 49.

Hong Kong now has 45 DTAs with its major trading partners, [72] in addition to several limited agreements for the avoidance of double taxation of shipping income and airline income. Generally, a DTA provides certainty to investors on the taxing rights of the contracting parties, helps investors to better assess their potential tax liabilities on economic activities, and provides an added incentive for overseas companies to do business in Hong Kong, and likewise, for Hong Kong companies to do business overseas.[73] The year 2010 was the watershed year for the treaty network of Hong Kong. Hong Kong was at that time at the edge of being 'blacklisted' by the OECD as a tax haven and during that year a dozen such DTAs were signed. This achievement represents the product of rounds of negotiations and hard work, implementing what the then Financial Secretary announced in the 2009-10 Budget to align Hong Kong's exchange of tax information arrangements with international standards. The expanded network enables Hong Kong to serve as a safe harbour for investors more effectively without carrying the stigma of 'tax haven'. Other than the exchange of information article in DTAs, Hong Kong has seven other disrete Tax Information Exchange Agreements to date, with the first of its kind being with the US, followed by Denmark, Faroes, Greenland, Iceland, Norway and Sweden. Further, Table 4 in the Appendix lists out other legislative changes over the last decade have also highlighted Hong Kong as one of the international tax rule-takers in enhancing international tax cooperation, specifically with regards to exchange of tax information and related matters.[74]

Lately, the Two Pillars under BEPS 2.0 of the OECD pose another round of challenges to the Hong Kong tax system.[75] Essentially, Pillar One deals with tax challenges arising from digitalisation and the increasingly digitalised economy. It seeks to, among other things, expand the taxing rights of market/user jurisdictions where there is an "active and sustained participation of a business in the economy of that jurisdiction through activities in, or remotely directed at, that jurisdiction". To follow suit may mean necessary amendments to the Hong Kong charging provision on profits tax which currently requires, inter alia, carrying on a trade or business in Hong Kong. Further or alternatively, it may take the form of additions to the existing list of dutiable commodities, which comprises liquor, tobacco, hydrocarbon oil and methyl alcohol,[76] or the introduction of a new tax akin to GST. Pillar Two, intends to subject multinational enterprises ('MNEs') to a minimum 15% corporate tax rate globally. According to the OECD, Hong Kong has an effective corporate tax rate below this minimum rate while, for comparison, PRC and

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72 'Comprehensive Double Taxation Agreements concluded' (Web Page, 8 November 2022) <https://www.ird.gov.hk/eng/tax/dta_inc.htm>. See further Julien Chaisse and Xueliang Ji, 'Rethinking Hong Kong's Tax Agreements: Challenges of Transparency, Harmonisation and Global Tax Reform' (2021) 51 *Hong Kong Law Journal* 405.

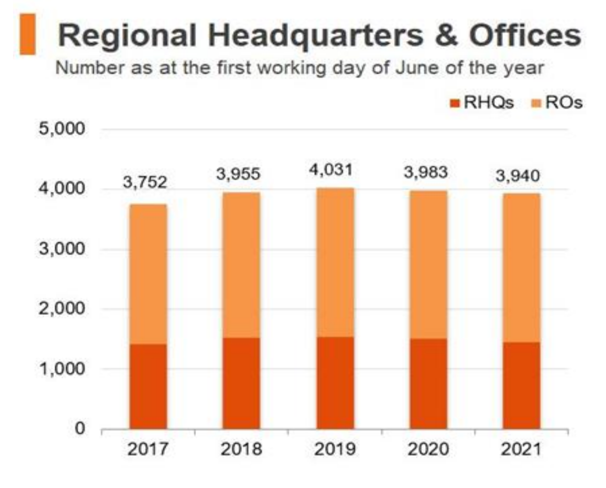
73 'Double Taxation Relief', *IRD* (Web Page, 2017) <https://www.ird.gov.hk/eng/pol/dta.htm>.

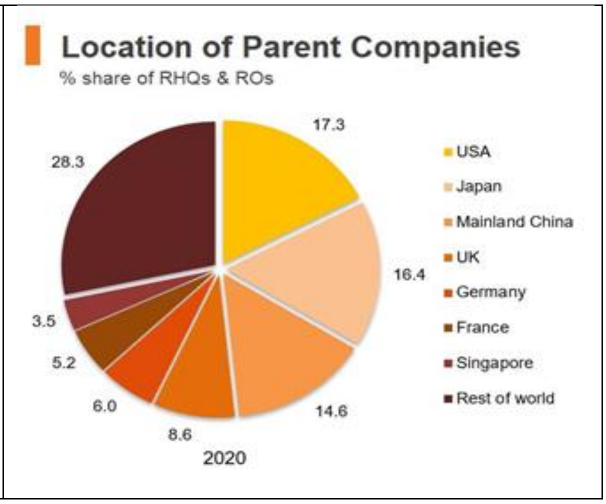
74 See further Jingyi Wang, 'Global Development of Information Exchange: Rule-maker versus Rule-taker in International Tax Law' (2019) 49 *Hong Kong Law Journal* 951.

75 See Christina Allen, 'Jurisdictional Taxing Rights under Model Conventions' (Conference Paper, ATTA Conference, 19-20 January 2022) for a historical account and a summary of both BEPS and BEPS 2.0.

76 *Dutiable Commodities Ordinance* (Hong Kong) cap 109.

Singapore have theirs over 20% and 15% respectively.[77] It is understood that the Hong Kong government plans to implement, inter alia, the global minimum effective tax rate and considers introducing a domestic minimum top-up tax with regard to MNEs with global turnover of €750 million euros (about AU$1,177 million) to ensure that their effective tax rates reach the global minimum effective tax rate of 15% so as to safeguard Hong Kong's taxing rights.




Source: HKTDC Research

More than two decades post-1997, Hong Kong remains a popular gateway for regional headquarters or offices of MNEs, as the figures above show. On the other hand, the European Union ('EU') in October 2021 announced, again, the inclusion of Hong Kong in its watchlist on tax co-operation as it considered that the non-taxation of certain foreign sourced passive income in Hong Kong might lead to situations of "double non-taxation". In response, the Hong Kong government has committed to amend the *IRO* to target corporations, particularly those with no substantial economic activities in Hong Kong, that make use of passive income to evade tax across the borders.

While Hong Kong's attitude to remain a norm-taker in international tax rules seems evident, to what extent its continuously playing this role would impact on the MNE's choice of the place as their regional hubs is less than certain. What may seem even more uncertain is the PRC's approach towards the Two Pillars. The PRC has risen from a norm-taker to a norm-shaker in the international arena, especially in the shaping of BEPS 1.0, but its stance towards BEPS 2.0 seems to have been ambivalent, especially with regards to Pillar Two.[78] With the rise of the PRC as one of the world-leading powers, we have also seen, from time to time, a propagandistic war of words in the media between its spokesmen and the West's over all sorts of issues, political, social and economic. Would such divergence of views on a number of other matters spill over into the debate about international tax policy or there would be more convergence on tax matters because of

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77 *Corporate Tax Statistics* (OECD, 3rd ed, 2021).

78 Jingyan Li, 'China's Rising (and the United States' Declining) Influence in Global Tax Governance? Some Observations' (2021) 75 *Bulletin for International Taxation* 1.

commonly shared economic interests? How would the PRC's role in the playing out in the next steps of BEPS 2.0 and beyond affect the positioning of Hong Kong?

## III CONCLUSION: 'HAVE NOT THY CLOAK TO MAKE WHEN IT BEGINS TO RAIN'

The simple and low-rate tax system in Hong Kong has a remarkable track record of standing against the tide at various difficult times. It clearly 'ain't broke'. Nevertheless, it has long been considered outdated and inequitable. The last decade or so has seen the continuation of the rather reactive and piece-meal approach in legislative amendments. Such changes have made the tax codes grow significantly in volume and, in a way, complicated the system. On the other hand, no initiative to broaden the narrow tax base has succeeded in modernising the system and keeping it in pace with the changing socio-economic conditions in Hong Kong which have become drastically different from what they were underlying the original design of the system. Internal issues such as an ageing population, increasing costs of housing and demand for medical care and social welfare will only intensify in the years ahead, pressing for further increases in public expenditure and subjecting the system to a stress test. The recent socio-political events in Hong Kong, magnified by the socio-economic impact caused by the pandemic, have added fuel to the fire, draining the level of fiscal reserve with uncertainty over how long it will take to recover.

The external factors pose more questions than they answer. The PRC's balance in its approach and attitude towards Hong Kong in its broader sense of integration and national security as a sovereign state on the one hand, while seeing Hong Kong as a major gateway for global investment on the other hand, cannot be neglected. Its tug of war with the West, in particular the US, in the political and economic arenas may influence how it stands with respect to global tax governance, which in turn may have an impact on the positioning and (re)action of Hong Kong in the international trend of tax cooperation. The sustainable challenge from, if not success of, Singapore as a long-time economic rival in the region, will have to be borne in mind and, in some ways, may be worth appropriate referencing. This article argues that all these forces combined, internal and external, justify the need for a comprehensive review of and, where appropriate, wholesale changes to the tax system in Hong Kong, some of which may be more pressing timing-wise than the others.

Options have been raised over the years, from reviving and reforming the suspended estate duty[79] to rejuvenation of the discussion on the GST[80] and the vacancy tax withdrawn, from a capital gains tax with Hong Kong characteristics[81] to reimagining territoriality or even putting it to its end and expanding the tax schedules,[82] just to

79 See eg, Andrew Halkyard and Wilson Chow, 'The Death of Estate Duty? The Case for Retention and Reform' (2004) 8 *Asia-Pacific Journal of Taxation* 48.

80 See eg, Adrian Sawyer, 'New Zealand's Successful Experience Introducing GST: Informative Guidance for Hong Kong' (2013) 43 *Hong Kong Law Journal* 161.

81 See eg, Wang and Chow (n 42); Butt and Ho (n 5).

82 See Mariani (n 5) 25-31.

reiterate a few. Experience tells that any proposal to alter the fundamentals of the Hong Kong tax system will unavoidably attract arguments against it, more often than not, from the business and professional sectors. However, the recent approach adopted by the Hong Kong government in combating and controlling the impact of COVID-19, seemingly in alignment with the PRC strategies, has tipped the balance more towards maintaining public health and not overloading public hospitals as paramount even at the price of less expeditious economic recovery, contrary to the usual voices from the business and professional sectors. Could this be an indicator that we may be entering into an era under the 'new normal' when a larger scale of review and reform of the Hong Kong tax system can take off?

How would the general public perceive and respond to any fundamental changes to the Hong Kong tax system? The ordinary people in Hong Kong can tolerate the opulent paying much less tax than the latter would elsewhere because they mostly pay hardly any. The public view was overwhelmingly negative towards GST when it was proposed. However, researchers have also shown that Hong Kong people would be more receptive to tax reform that would address the unfairness in the tax system and/or improve their living conditions[83] and that they would agree to pay higher taxes if that would result in better public services.[84] Indeed, no strong public sentiment against the increase in *ad valorem* stamp duty and the introduction of Special Stamp Duty and Buyers Stamp Duty was evident. Those measures aim at stabilising property prices with available exceptions favourable to Hong Kong permanent residents who are genuinely acquiring their only property for self-use.

In no circumstances will tax reform be as straightforward as one would like to see. Any proposal, standalone or a combination of options, requires careful design and analysis, gauging expert and public opinion from all stakeholders. All these steps take time and effort. Accordingly, prompt action trumps. Continued and extended delay is not, however, recommended. While the Hong Kong tax system 'ain't broke', it would be better to 'have not thy cloak to make when it begins to rain'.

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83 Wang and Chow (n 42) 564. See further Richard Cullen and Richard Simmons, 'Tax Reform and Democratic Reform in Hong Kong: What do the People Think?' [2008] *British Tax Review* 667.

84 Wang and Chow (n 42) 564-65.

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## APPENDIX

**Table – A simplified tax matrix**

| Country / Features | HKSAR | PRC | Singapore |
|---|---|---|---|
| Level of Tax | 1 | 2 | 1 |
| Jurisdiction to Tax | Territorial source | Residence and source | Territorial source [and on remittance] |
| Tax Rate | Relatively low [except stamp duty on land property transaction] | Medium | Low to medium |
| Income Tax | Similar to a schedular system [except personal assessment] | Income tax on individuals and enterprises | Income tax on individuals and companies |
| Tax on Capital | No | Yes; as income | No |
| Indirect Taxes | No | Yes | Yes |
| Tax Incentives | Not many | Many | Many |