No Debt High Growth Low Tax

HONG KONG'S ECONOMIC MIRACLE EXPLAINED

Andrew Purves

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Foreword

Andrew has for many years, held the view that much of the unequal outcome of the capitalist system is due to an inefficient and misdirected system of taxation, which gives a big advantage to property owners, while keeping wages artificially low. This has encouraged him to study economics and the complexities of our tax system.

He became fascinated by the success of Hong Kong (where he spent his early years), and Singapore, and recently visited both Cities to try to better understand the reasons for their success. He also took the opportunity to examine the way that the very successful Hong Kong Mass Transit Railway was funded and explains the process.

I consider this result of his studies to be a well researched and easily read case for the merits of a simple and easily understood tax regime.

I commend his efforts.

Sir William Purves, CBE, DSO, GBM
Group Chairman, HSBC Holdings
1986-1998

Contents

'… without a knowledge of [the law of rent], it is impossible to understand the effect of the progress of wealth on profits and wages, or to trace satisfactorily the influence of taxation on different classes of the community'[1]

'ATHENIAN: There was also another advantage possessed by the men of that day, which greatly lightened the task of passing laws.

'MEGILUS: What advantage?

'ATHENIAN: The legislators of that day, when they equalised property, escaped the great accusation which generally arises in legislation, if a person attempts to disturb the possession of land, or to abolish debts, because he sees that without this reform there can never be any real equality. Now, in general, when the legislator attempts to make a new settlement of such matters, every one meets him with the cry, that "he is not to disturb vested interests"- declaring with imprecations that he is introducing agrarian laws and cancelling of debts, until a man is at his wits end; whereas no one could quarrel with the Dorians for distributing the land – there was nothing to hinder them; and as for debts, they had none which were considerable or of old standing.'[2]

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[1] David Ricardo, *On the Principles of Political Economy and Taxation*, 1817, Preface.

[2] Plato, *The Laws*, Book 3, translated by Benjamin Jowett.

1

Introduction

SINCE I was a boy, I have been acutely aware of differences in wealth and opportunity available around the world. Comparing what was available to me, with what I could observe almost from my bedroom window, it seemed obvious that something was wrong with a system that allowed such inequality. That feeling stayed with me as I grew up. Alongside a conventional career in business, I continued to study and ponder this question.

Having been convinced of the efficiency and justice inherent in Land Value Taxation (LVT) in my late twenties, and having begun teaching Economics with Justice[1] some ten years later, the great unanswered question always arose amongst our students: 'Is there somewhere where this is put into practice?'

We continue to struggle to find such a place. The fact is, there are elements of LVT incorporated in several jurisdictions around the world, including the USA, Australia and South Africa, and for a short time LVT was reintroduced as an important form of taxation in Denmark in the 1960s, having first been established in the nineteenth century. Denmark continues to operate a two pronged property tax, with separate valuations for land and improvements (usually buildings). But the fact remains, that there is nowhere where the majority of a nation's public revenue, is raised from the value of land. There is one place however, where a substantial part of public revenue is raised from the land – Hong Kong. The curious thing is, that very few people are aware of it, least of all those people who reside there and live with the consequences. It also has to be said, that the particular form of raising such revenue in Hong Kong is neither a complete system, having

[1] Course taught at School of Economic Science, London (http://www.economicswithjustice.co.uk).

been introduced over the years in an ad hoc manner, nor one which advocates of LVT would recommend. In addition, some of the features and loopholes created by this blind approach in Hong Kong, has in some ways contributed to higher levels of inequality contrary to the predicted outcome.

So, in teaching it has been difficult to use the Hong Kong case as an example. One of the major obstacles has been the lack of evidence and documentation to explain how the revenue is raised. My initial searches, and scouring of text books indicated very little awareness of the unique arrangements pertaining in Hong Kong. Only latterly have I discovered the work of Alice Poon,[1] and a paper by Richard Cullen,[2] both of whom refer to the work of Henry George on LVT in the context of Hong Kong, so I am relieved to discover that I am not alone in my attempt to explain the case.

I grew up in Hong Kong in the '60s, and returned to the island regularly over the following decades, so witnessing at first hand the extraordinary growth of the economy there during the second half of the 20th century. I have taken a keen interest in its history and development since the return to Chinese sovereignty in 1997. It seemed, therefore, that I was well placed, to undertake some research. I am very grateful to my father, who worked there for over thirty years and who made many introductions, as well as to a number of random connections put my way by many people.

This book is an attempt to describe how public revenue is raised in Hong Kong, both through taxation and by other means. The aim is then to compare these methods with those used in the UK, and analyse the main differences.

Before doing so, we need to look at the unique land holding arrangements of Hong Kong, which is the subject of Chapter 2, where I will explore the abstract benefits which accrue to a society organised in this way when it comes to delivering certain public services, particularly transport, and in the case of Hong Kong its underground railway (MTR). In Chapters 3 and 4, I will

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[1] Alice Poon, *Land and the Ruling Class in Hong Kong*, Enrich Professional Publishing, 2nd edition, 2011.

[2] 'Far East Tax Policy Lessons: Good and Bad Stories from Hong Kong', *Osgoode Hall Law Journal*.

explore taxation, and other forms of raising revenue before returning to a case study of the method of financing the MTR in Hong Kong in Chapter 5.

In Chapter 6, I will look at the situation in Singapore, which bears some resemblance to Hong Kong. I had intended to include a chapter on China, of which Hong Kong is now a Special Administrative Region (SAR), but found it difficult to obtain detailed information in English, so I have added a postscript.

I will not dwell on the logic and merit of the Land Value Tax (LVT), as this has been done by many and various people over the last 150 years, often with great authority and eloquence, for example Henry George,[1] Winston Churchill,[2] and more recently Mark Braund.[3] Sufficient to say, LVT is levied on the value of the site only, ignoring the value of any buildings. Thus the land value is determined by what any willing buyer is prepared to pay for the use of a particular site. It is a market-determined value, based on such factors as natural endowment (soil fertility, presence of minerals etc) and location (proximity to social amenities like transport, schools, parks, hospitals etc). In an urban setting, such as Hong Kong, location is by far the most important determinant of value. It is created by the presence and activity of the surrounding community. The purchaser of a particular plot is putting a price on the benefits conferred by society on that site thereby hoping to recoup his investment. The value of any piece of land will fluctuate as a community grows and prospers or stagnates, and declines.

As these fluctuations are the result of both public investment and the presence of a community rather than the enterprise of the occupant of the site, it is only fair that the benefit should accrue to society, and any decline also be borne by society.

This can be achieved by regularly undertaking a revaluation of all land, and levying an annual charge to the owner in proportion to the resulting value. There would be a separate valuation of any improvements on the site, should the relevant government choose

[1] Henry George, *Progress and Poverty.*

[2] Winston Churchill, *The People's Rights.*

[3] Mark Braund, *The Possibility of Progress.*

to raise revenue from the activity undertaken by the owner of the site. The outcome of any business carried out at the site would be down to his or her enterprise, and therefore not necessarily subject to taxation.

The introduction of a full LVT in any economy would give rise to a more just and equitable distribution of wealth in that society. Given that the introduction of a new method of tax will impose new burdens on a number of individuals, it may be necessary to make transitional arrangements for a short period, and it would be essential to cancel or shift the burden from other taxes. At the heart of arguments in favour of LVT is not only that it would create a more level playing field, but that it is economically more efficient, and would allow more real wealth creation. As *The Ecomomist* wrote recently:

> Taxing land and property is one of the most efficient and least distorting ways for governments to raise money. A pure land tax, one without regard to how land is used or what is built on it, is the best sort. Since the amount of land is fixed, taxing it cannot distort supply in the way that taxing work or saving might discourage effort or thrift. Instead, a land tax encourages efficient land use.[1]

The motive for writing this book is to demonstrate the many advantages that have accrued to Hong Kong as a result of raising a substantial part of its public revenue from this land value, a surplus generated by location, or what the Classical Economists termed Economic Rent. Further weight is given to the argument by Adam Smith:

> Both ground-rents and the ordinary rent of land are a species of revenue which the owner, in many cases, enjoys without any care or attention of his own. Though a part of this revenue should be taken from him in order to defray the expenses of the state, no discouragement will thereby be given to any sort of industry. The annual produce of the land and labour of the society, the real wealth of the great body of the people, might be the same after such a tax as before. Ground rents and the ordinary rent of land are, therefore, perhaps, the species of revenue which can best bear to have a peculiar tax upon them.[2]

[1] 'Free Exchange/Levying the Land', *The Economist*, June 29th 2013.

Change is always difficult, but the sooner we recognise that most western-style economies have gone down an economically inefficient blind alley of taxation – by collecting public revenue from production and consumption – the sooner our economies will enjoy further real growth. Another benefit may be that manpower might begin to replace machine power in the creation of goods, as labour, shorn of the additional cost of taxation would become more attractive to employers. This might reduce unemployment, as well as reintroducing craftsmanship to the production of ordinary goods, and begin to unwind the massive investment in machines for otherwise quite simple tasks; it may also reduce our reliance on fossil fuels to power the machines.

Opponents will argue that shifting tax in this way (from production and consumption) to land value will only cause firms at the higher value locations to raise their prices to cover the cost of the tax. This is to miss the point on two fronts: first, given that the landlord usually demands the highest possible rent at any particular location, if he is efficient and accurate in his assessment of the rent available, he will not be in a position to increase the rent any further. Second, the activity at each location must be the one which creates the highest surplus value in order to pay the rent, or the LVT due. This is commensurate with achieving the economic efficiency mentioned above. The follow-on effect will be that the lower value locations will pay a lower LVT, or at the margin, no tax at all – thus encouraging more land to come into use at the margin.

Given the regressive nature of taxes on production and consumption (where a higher burden – proportionally – is placed on those with a lower income), such a change may also lead to a reduction in the manifest inequality that surrounds us.

[2] Adam Smith, *The Wealth of Nations*, Book 5, Chapter 2.

2

Landholding in Hong Kong

I WILL TAKE as my starting point the date at which Hong Kong became a British territory in 1841, except to note that China, as a nation, has a long tradition of land held under various forms of lease from the Emperor. By contrast, China gave up sovereignty of the island of Hong Kong (and later, in 1860, the piece of land known as the Kowloon peninsula up to what became 'Boundary Street') in perpetuity, by signing the Treaty of Nanjing.[1]

The opium trade with China, carried on under monopoly conditions by the East India Company was an essential part of the triangular trade between Britain, India and China. China, understandably, took exception to the drain of resources – both of its people suffering from the addiction, and its wealth – and periodically raided – or burnt the opium warehouses in Canton (now Ghangzhou). After one such episode, Britain responded, and inflicted a heavy military defeat on China.

Keen to remove their stocks from Chinese territory, in case of future attack the British merchant adventurers in China determined to establish a new trading base on the almost uninhabited island of Hong Kong at the entrance to the Pearl river delta, which formed a perfect deep water harbour giving shelter to their ships at times of tropical storm. Lord Palmerston, Foreign Secretary at the time, described Hong Kong to Queen Victoria as a 'barren rock', but it was not unusual for the government of the

[1] The original Convention of Chuenpee ceded the island of Hong Kong only to the UK in January 1841. This was confirmed in August 1842 after consultation with London in the Treaty of Nanjing. In October 1860, the Kowloon peninsula was also ceded to the UK, through the Convention of Beijing, being the land south of Boundary Street. Finally in July 1898 at the second Convention of Beijing, the 99-year lease for the New Territories was signed, including the land of Kowloon north of Boundary Street.

day to play catch up with policy once the agenda had been set by the buccaneers on the front line.

Captain Charles Elliott was the Crown representative faced with the decision about how to accommodate the traders, and their warehouses while dispatches were sent to London to confirm the acceptance of Hong Kong as bounty after the short war. He could not sell land he was not sure would later be owned by the British Government, so decided to auction leases, which could later be converted into freeholds. As it turned out, the British Government liked the idea of the new colony 'paying its way', so stuck with the original plan of granting land for use, under lease, at fixed rents. Having lost the American colonies at the end of the previous century, the British Government was wary of demanding taxes from its colonies, and wisely took the view that local revenue should pay for local services. This logic, in turn, meant that Britain would not be sending money to Hong Kong to pay for the defence of the new colony, thus creating the need for a local revenue source.

Famously, the only piece of freehold land in Hong Kong was given to the Anglican Church, on which now stands St John's Cathedral.

Generally, leases were granted for a total of 75 years, or in some cases 99 years at fixed rents. Later, the majority of the leases on Hong Kong island were converted into 999-year leases, again at fixed rents. This practice was endorsed by the Land Commission Report, which confirmed that the majority of the original 75-year leases in Hong Kong and Kowloon, had been extended to 999-year leases. Examining the logic of conversion, it stated:

> It may be urged that the parties should be kept to the strict performance of their engagements with the Crown, and that where land has risen in value the landlord should be entitled to the unearned increment, at least proportionably with the tenant.
>
> In modern days it has been strenuously urged that the landlord, even if a private individual, has no right to this unearned increment. In case the Crown insists upon its rights, however, the Crown will, at the expiration of 75 years, take not only the unearned increment, but the whole value of the improvements effected by the tenants.

> The Crown in dealing with Crown Lands is not like some private persons selfishly seeking to drive a hard bargain at the expense of the individual, but to dispose of its lands in the best interests of the whole community.[1]

The question, as ever, is what is in the best interests of the whole community. Should the private investor be incentivised to such an extent that the unearned increment remains always in his hands, so that he can continue to invest in industry to create jobs? Or is it in the better interests of the whole community that the unearned increment is socialised, or collected for the public benefit through taxation, year after year? This way, enterprise is rewarded fully, while the unearned increment is available for public investment.

In this instance, the report sided with the private investors, and the Commissioners went on to assert:

> The Commissioners feel sure that the same reasons which decided Earl Grey to sanction the extension of the Town Lots from 75 to 999 years would apply equally to the extension of the Leases of all other lots from 75 to 999 years.

Hong Kong continued to grow as a trading post throughout the nineteenth century, and by the 1890s it was clear more land would be needed to sustain the colony. As a result, a lease was granted by China for a much larger tract of land, including the island of Lantau, known as the New Territories in 1898. This is all the land beyond Boundary Street, running up to the current border between the Hong Kong Special Administrative Region (HKSAR) and China.

The Land Commission, having confirmed the status quo, it might have been assumed this would be how leases in the New Territories would be handled, notwithstanding the fact that the head lease from China was only for 99 years. In the event, the colonial Government, began granting leases for 75 years, some of which were extendable for a further 75 years.

However, it was Joseph Chamberlain, who as Secretary of the Colonies, on 23rd May 1898 wrote to the local Governor:

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[1] Land Commission Report, 1886-7.

> Leases for 999 years are practically equivalent to a freehold tenure and the grant of such leases deprives the Government of all control over the land of the Colony, and of all the advantage of any future enhanced value of the land ..., no further leases for 999 years should be granted, at any rate without previous reference to me in each case.[1]

This was a significant intervention, and it is possible that Chamberlain, as a Liberal member of parliament had been influenced by the ideas of Henry George. It was, after all, the great Liberal reforming administration of Campbell Bannerman in 1906 which attempted to introduce a Land Value Tax in the UK, to which I will refer a little later. Chamberlain, although a Liberal, served with the Unionist Government under Lord Salisbury, and was a noted Imperialist.

By prohibiting any further conversions of 75-year leases to 999 years, Chamberlain bequeathed to the people of Hong Kong a perpetual source of public revenue. It is worth quoting Nissim at length on this topic:

> The new instructions from London showed a good appreciation of the benefits of a properly managed leasehold system. They also set the tone for how leaseholds should be treated on expiry of their leases. The author of these instructions could not have possibly conceived of the significance all this would have in the treatment of land under the Sino-British Joint Declaration of 1984, where the precepts of 1898 still hold good.
>
> The reduction of the lease term to 75 years aroused great protest but the only immediate concession that Chamberlain agreed was to make them 75 year leases renewable for one further term.[2]

At the time, there were more Chinese living in the area of the New Territories, particularly farmers serving the needs of the growing population. Various accommodations were reached with them to compensate for the loss of their land, or to ensure they could continue to live within the area of the new lease – and some of those rights continue to exist today.

To jump forward a little in the history, by the early 1970s some

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[1] Roger Nissim, *Land Administration and Practice in Hong Kong*, Hong Kong University Press, 2nd revised edition, 2008.

[2] *Op. cit.*, Chapter 2, final two paragraphs.

of these leases in the New Territories were due for renewal. Some of the leases were not renewable and new premiums were demanded from those wishing to remain in possession. As for the renewable leases, the question arose as to what to do, as clearly a new lease of 75 years was not possible, given that the head lease was due to revert to China in 1997. China by now was reasserting its position in the hierarchy of nations, and given the ideological differences of the time, the head lease was unlikely to be renewed. Instead, the leases were rolled over by the colonial administration, in return for the payment of an annual 'Crown Rent' enshrined in the Government Leases Ordinance (Cap. 40). As much as anything else, the uncertainty surrounding continued use of land, and the potential disincentive to invest and develop land forced the pace in negotiation with China to agree a way forward beyond 1997. This practice was endorsed by the Joint Declaration between Britain and China in 1984, and has continued up to the present, albeit the Crown Rent became Government Rent on the handover in 1997. Government Rent is currently set at 3% per annum, of the assessed value, such leases being revalued every year. It was also agreed in the joint declaration that non-renewable leases could be extended, without a new premium, but with the application of the same annual rent at 3% of the rateable value.

Thus the Government Rent on leases that had not been renewed, but rolled over, carry a variable charge. This contrasts with the rent charged on the original or longer leases, not yet expired, where the rent remains as fixed at the time of issue of the lease. I will explore the impact of such arrangements later in the chapter.

This accident of history, whereby an arrangement has been made, which in other jurisdictions where land is held under lease would not have been made, is typical of the way practice in relation to land ownership has developed in Hong Kong.

Roger Nissim, who has written the definitive work on land administration in Hong Kong describes the arrangement thus:

> ... what has now been established in Hong Kong is a land tenure system which is, in effect, a perpetual leasehold.[1]

[1] *Ibid.*