Contents

Page

BACKGROUND

- Review of Public Finances 1

DELIBERATION AND CONSULTATION

- Towards a Broader-based Tax System 2
- Hong Kong's Tax Base 4
- Public Consultation 7
- Public Response 8
- Tax Base Broadening Options 8
  - *Increasing Revenue Productivity of the Existing Taxes* 8
  - *Introducing Broad-based New Taxes* 14
- Green Taxes 24

RECOMMENDATION

- Goods and Services Tax 25
- Rates on Tenements 26
- Personal Allowances 26
- Land and Sea Departure Tax 26

CONCLUSION 27

ANNEXES *

Annex A - Terms of Reference of the Advisory Committee

Annex B - Membership List of the Advisory Committee

Annex C - Report on Tax Base Study

Annex D - Consultation Document : A Broader-based Tax System for Hong Kong?

Annex E - Summary of Response to Questions Posed in the Consultation Document

Annex F - A Goods and Services Tax for Hong Kong

Annex G - IMF's Report on a Goods and Services Tax for Hong Kong

BACKGROUND

Review of Public Finances

In March 2000, the Government reported an operating deficit for the second successive financial year and projected that deficits would continue for at least another three financial years. The then Financial Secretary cautioned that if operating deficits were to continue into the longer term, Hong Kong would encounter serious fiscal problems. The sustainability of Hong Kong's public finances needed to be addressed. In particular, the productivity and stability of recurrent revenue was of specific concern.

2. Whether the operating deficits were cyclical in nature and would self-correct with an upswing in the economic cycle, or of a more serious structural nature, was not yet known. However, regardless of their character, the opinion was that Hong Kong could ill-afford to wait for the crystallisation of events through the passage of time prior to devising remedial measures for implementation. To safeguard against the risk of future fiscal instability, it was essential that a store of well thought-out, feasible strategies be available for early implementation if required.

3. The Government initiated a two-pronged approach to address the problem. The first prong involved the establishment of a *Task Force on Review of Public Finances* to identify whether the operating deficits were cyclical or structural in nature. Concurrently, the second prong entailed the establishment of the *Advisory Committee on New Broad-based Taxes.* Given the primary requirement of maintaining a low rate, simple taxation regime and preserving Hong Kong's competitiveness internationally, the *Advisory Committee* was tasked with considering the suitability of new types of broad-based taxes for introduction in Hong Kong. It was also expected to advise on the high-level practical implementation aspects of any new taxes recommended. The Terms of Reference
Annex A and membership of the *Advisory Committee* are at Annex A and Annex B
Annex B respectively.

DELIBERATION AND CONSULTATION

Towards a Broader-based Tax System

4. The *Advisory Committee* has met regularly since June 2000. Its first task was to identify the internationally recognised tenets of good tax regimes. Good taxation systems fairly distribute the tax burden whilst minimising the disincentive effects. Eight widely accepted principles of good tax system design were identified. They are **neutrality, fairness, effectiveness, efficiency, certainty and simplicity, flexibility, international competitiveness and revenue stability**. It was against these principles that the present overall mix of Hong Kong taxes was assessed. A description and analysis of these principles is set out below –

(a) **Neutrality**

Good taxation systems are economically neutral. Neutrality, or horizontal equity, is preserved when individuals and businesses with the same ability-to-pay are taxed equally. When a tax system's impact on economic decisions is minimised, neutrality is maximised and the tax burden is fairly distributed between the various forms of economic activity.

(b) **Fairness**

Good taxation systems are equitable vertically. They preserve equity by taxing in proportion to taxpayers' abilities to pay. On the other hand, narrow tax bases are regarded as being inconsistent with equity because the overall tax burden is borne by relatively few taxpayers. Tax jurisdictions must also be cognizant of the need to attract and retain high-value-adding individuals and businesses, as well as providing the incentive to work harder and maximise returns.

(c) **Effectiveness**

Good taxation systems must be revenue-productive. They should produce the amount of tax revenue required in a timely manner. Revenue yields should be sustainable over time and be insulated as far as reasonably possible from adverse economic cycles. Enforcement measures for minimising tax evasion and avoidance must be proportional to the revenue at risk.

(d) **Efficiency**

Good taxation systems must be operationally efficient to minimise compliance costs for taxpayers and administration costs for government. Taxes affect economic efficiency. Inefficient tax systems force up costs. The broader the tax base and the more comprehensive the tax system, the greater is the efficiency of the economy at any given tax level. Lower overall tax burdens are less distorting to economic activity.

(e) **Certainty and simplicity**

Good taxation systems are transparent, predictable and intelligible. The rules are clear, simple to understand and based upon unambiguous principles embodied in tax legislation. With uniformity and consistency in the application of the law, taxpayers are able to reliably anticipate the tax consequences of their economic activities.

(f) **Flexibility**

Good taxation systems are dynamic. They must be flexible and capable of adapting to technological changes, commercial developments and other changes of the economy.

(g) **International competitiveness**

Good taxation systems do not ignore international trends in taxation. Hong Kong's tax system must complement its overall competitiveness. Neither the structure nor the rates should be detrimental to international or regional competitiveness. Hong Kong depends heavily upon investment from overseas for its continued economic growth. Its tax system must remain simple and efficient in order to maintain an attractive investment environment for Hong Kong.

(h) **Revenue stability**

Good taxation systems promote stability in revenues. Economic activity is cyclical and not all taxes are equally immune from downturns in economic cycles. A taxation system that is less sensitive to economic cycles enhances the overall fiscal system.

5. The *Advisory Committee* also surveyed the Organisation for Economic Co-operation and Development (OECD) member countries' tax regimes to ascertain the nature and scope of taxes imposed and the relative contribution of each tax to total tax revenue. The OECD countries were chosen for comparison because of the high level of economic development within them and the availability of reliable taxation statistics published in a standardised format. A small number of non-OECD jurisdictions for which reliable statistical data were available were also incorporated into the study. All of the economies surveyed are regarded as being mature taxation jurisdictions.

6. The internationally recognised hallmarks of good tax systems, the diversity of taxes levied in other jurisdictions, their revenue mixes and revenue yields were taken together by the *Advisory Committee* to provide the foundation stone for the benchmarking of Hong Kong's tax system. In addition, the *Advisory Committee* took into account Hong Kong's particular circumstances in assessing the strengths and weaknesses of its tax system against the international benchmarks.

Hong Kong's Tax Base

7. Leading local tax professionals have been suggesting for some time that Hong Kong's tax base is narrow. With the assistance of a consultant with international experience and expertise, the *Advisory Committee* carried out a detailed analysis of Hong Kong's tax base. The purpose of the tax base study was to assess the narrowness or otherwise of Hong Kong's tax base by reference to those in other developed taxation jurisdictions. The study compared Hong Kong's sources of tax revenue with those in the selected jurisdictions to determine the nature, neutrality, incidence and reliability of the Hong Kong tax base. A copy of
Annex C the study report is at Annex C.

8. The key rationale for the comparison with the world's most developed economies was that if Hong Kong's tax system needed to be reformed, the experiences of the overseas jurisdictions in recent years would provide valuable points of reference. More importantly, given globalisation and competitiveness considerations, Hong Kong had to have regard to international trends and benchmarks when contemplating changes to its tax system. At the time the tax base study was undertaken, 1998 was the latest year for which OECD tax revenue statistics had been published. To maintain the consistency of the comparison, Hong Kong's tax revenues for 1997-98 were used in the study.

9. The key findings of the tax base study are that –

(a) in terms of total tax revenue as a percentage of GDP, Hong Kong is the lowest-taxed jurisdiction in the comparison group. Hong Kong's tax levels are significantly lower than the averages of the Asia-Pacific region and the overall OECD benchmark;

(b) Hong Kong has a heavy reliance on the taxation of corporate profits, which provides 32% of tax revenue. This compares with only 9% for the OECD and 29% for the Asia-Pacific region benchmark, notwithstanding that these jurisdictions generally have higher profits tax rates;

(c) taxation in Hong Kong from property generally (i.e. rates, estate duty and stamp duty on landed property and shares) is above international benchmarks – 24% of tax revenue as compared to 5% and 10% for the OECD and Asia-Pacific benchmarks respectively;

(d) Hong Kong has a low reliance on taxes from goods (principally duties on cigarettes, alcohol and hydrocarbon fuels) at under 6% of tax revenue and virtually no taxes on general consumption. In the OECD, on average, 18% of tax revenue comes from general consumption and 12% of tax revenue comes from taxes on specific goods and services. Within the benchmarked Asia-Pacific region, general consumption and specific goods and services taxes respectively provide 12% and 16% of tax revenue; and

(e) in recent years, Hong Kong has derived around half of its total government revenue from sources other than taxation. In 1999-2000 and 2000-01, 53% and 45% respectively of total government revenue came from non-tax revenue sources. In the main, this revenue has come from land sales and earnings from the investment of the accumulated fiscal reserves. This level of non-tax revenue is substantially above international norms.

10. The study also noted that while personal taxation remains the largest source of taxation revenue in the OECD, the international trend is towards a lower reliance on this source of revenue. The quid pro quo for lower personal income taxes has been the significantly increased use of general consumption taxes as a source of revenue over the last 25 years. More particularly, general consumption taxes are the only major source of taxation revenue to show steady growth in the past decade.

11. Based on the tax base study, the *Advisory Committee* has determined that Hong Kong –

(a) is a low tax jurisdiction that has a narrow tax base whose limited width is contracting - as an example, only 1.2 million out of 3.2 million employees are paying salaries tax;

(b) has a tax base that is narrow in composition because it is heavily reliant upon a limited range of taxes – for instance, income taxes (i.e. profits tax and salaries tax) contributed nearly 56% of total tax revenue in 2001-02;

(c) is the only developed tax jurisdiction that does not tax general consumption; and

(d) has in the past, and contrary to international norms, often relied on non-tax revenue.

12. Based on its findings that the tax base is narrow, the *Advisory Committee* considers that Hong Kong's current tax system suffers from five notable defects –

(a) it has lower revenue productivity during periods of economic downturn compared with tax systems that are broad-based;

(b) its taxed sectors are small, constraining the ability to raise tax revenue to reflect the changes of the economy;

(c) its narrowness exacerbates economic distortions;

(d) it, in the main, taxes income but not private consumption expenditure; and

(e) it is slow to adjust to changing population demographics.

13. The *Advisory Committee* has concluded that for Hong Kong to remedy the defects, it needs a tax system with a broader base. A broad-based tax system is one that does not overly rely on a limited range of economic activities for its tax revenues because tax revenues are sourced from the economy as a whole rather than from segments of it. In contrast to the defects inherent in narrow tax bases, the principal advantages of broad tax bases are that the tax system overall becomes –

(a) more robust, less susceptible to avoidance and evasion and better able to adapt to the structural changes in the economy over time;

(b) more stable because of the reduced reliance on revenue collections from a limited number of earnings-related taxes, especially during the downward phases of economic cycles;

(c) more balanced because of a wider coverage of economic activity for deriving tax revenue;

(d) more capable of increasing the growth of revenue yields at a rate that reflects the growth in the economy; and

(e) more capable of maintaining revenue yields notwithstanding the changing demographics of the population, as in the case of a reduced contribution to direct taxes from the taxpaying public due to an ageing population.

14. The *Advisory Committee* also believes that from a socio-economic perspective, broadening the tax base has the additional benefit of enhancing civic awareness within the community in general. While this is not the *raison d'être* for broadening the tax base, a broader tax base may have a subsidiary benefit of enhancing the community's sense of responsibility and contribution to society. It will help develop a greater awareness of the implications of the provision of services on the Government's revenue requirements. This, in turn, will contribute to an enhancement of civic responsibility.

Public Consultation

15. The *Advisory Committee* is required by its Terms of Reference to solicit views from the Legislative Council, interested parties and the community as a whole on the options for broadening the tax base. Therefore, it launched a public consultation on 6 August 2001, which ran for two months and ended on 6 October 2001.

Annex D

16. The *Advisory Committee* issued a Consultation Document entitled "*A Broader-Based Tax System for Hong Kong?*" (at Annex D) to solicit views from the public. The Consultation Document invited the public to address the *Advisory Committee* on any issues falling within its Terms of Reference. Relevant issues included enhancing revenue productivity, reducing the sensitivity of revenue yields to adverse economic cycles, the burden that new or increased taxes placed on the economy, the impact (if any) on the development of electronic commerce, the cost-effectiveness of tax administration and compliance, and equity. In the Consultation Document, the *Advisory Committee* explored 13 options for raising additional revenue. Its deliberations took two directions –

(a) raising additional revenue from the existing tax base; and

(b) introducing new taxes.

In addition, the public's views were sought on 16 questions that reflected the specific revenue raising options considered by the *Advisory Committee.*

Public Response

17. The consultation drew, in all, 267 responses from a cross-section of the general public, political, business and professional organisations. They comprised seven verbal responses received in the course of two radio phone-in programmes, 106 written responses and 154 e-mail responses. In addition, at the invitation of the Legislative Council Panel on Financial Affairs, representatives of the *Advisory Committee* attended its meeting on 26 September 2001. Representatives of the *Advisory Committee* also accepted similar invitations to attend meetings received from various District Councils, chambers of commerce, professional bodies and community organisations. The *Advisory Committee* also monitored feedback and opinions expressed through the mass media during the consultation period.

18. Not unexpectedly, neither the options for increasing the tax burden of existing taxpayers nor those for generally extending the circumference of the tax net to bring within its enlarged ambit a significant number of persons who hitherto have paid neither direct nor indirect taxes, proved to be popular. While most respondents recognised the merits of broadening the tax base, some expressed a preference for drawing down on the fiscal reserves and trimming government expenditure. Taken overall, the consultation reinforced the expected public opinion - that there is probably "never a right time" for increasing existing taxes. New taxes are, likewise, never going to be "popular". Nevertheless, the consultation has shed a useful level of light on specific areas of public concern in connection with the design issues for individual taxes that could be addressed if a decision is taken to go forward in that direction. A summary of the responses to the specific questions posed in the
Annex E Consultation Document is at Annex E.

Tax Base Broadening Options

19. The *Advisory Committee* has initially assessed 13 revenue options against the established principles of good tax systems. The *Advisory Committee* considered that it would have been inappropriate for it to have restricted its considerations solely to new taxes. To ensure that its review was comprehensive, the potential for increasing the revenue productivity of Hong Kong's existing taxes was also explored.

Increasing Revenue Productivity of the Existing Taxes

20. Initially, four options for increasing the revenue productivity of existing taxes were considered. Among them, three have the capacity to generate significant levels of additional revenue in a very efficient manner from a tax administration point of view The fourth option, of increasing the stamp duty on landed property transfers, is dependent upon landed property prices and transaction levels in the private sector. It lacks certainty in terms of revenue productivity. In addition, based on the views received during the public consultation, the *Advisory Committee* has also considered a fifth option to increase the revenue productivity of an existing tax. A brief description of each option and the *Advisory Committee's* assessment of each by reference to the evaluation criteria is provided below –

Option 1: Increase Salaries Tax Rates

Relevant Factors	Considerations
Broadness	Increasing salaries tax rates does not broaden the tax base.
Neutrality	The increased tax rates will apply to all persons currently subject to salaries tax. To the extent that all taxpayers with the same incomes are taxed at the same rates, the measure preserves neutrality.
Fairness	The burden of paying the additional tax will fall only on those persons currently in the tax net. Persons presently outside the tax net and not paying tax will not become liable to tax simply because of the increased rates.
Effectiveness	Increasing salaries tax rates within reasonable limits is a very effective way of enhancing revenue yields from the existing tax base. Taxpayers within the tax net cannot avoid paying the increased tax but income presently not subject to tax remains outside the tax net.
Efficiency	Increasing salaries tax rates is a very efficient way of collecting additional revenue. Once the legislation has been enacted, no additional collection or compliance costs are incurred by either the Government or taxpayers.
Certainty and simplicity	Hong Kong's salaries tax rates are both simple to understand and certain in their application.
Flexibility	Tax rates are unaffected by changes in technology or commercial developments.
International competitiveness	The international trend is towards reducing personal income taxes as a means of attracting and retaining skilled employees in an economy. A substantial increase in tax rates may adversely impact on Hong Kong's ability to retain existing talents and attract new employees of the calibre required for its long-term development.
Revenue yield	Each single percentage point increase in salaries tax rates (including the standard rate) would, at 2000-01 income levels, yield an estimated $2.2 billion in additional annual revenue, assuming an unchanged tax base.

21. The *Advisory Committee* considers that increasing salaries tax rates will not broaden the tax base, noting in particular that the increased tax burden falls entirely on existing taxpayers. The *Advisory Committee* does not advocate a significant increase in salaries tax rates as this would go against the international trend of lowering income taxes.

Option 2: Increase Profits Tax Rates

Relevant Factors	Considerations
Broadness	Increasing profits tax rates does not broaden the tax base.
Neutrality	The increased tax rates will apply to all persons currently subject to profits tax. The measure preserves neutrality.
Fairness	The burden of the additional tax will fall only on those currently within the tax net. Persons outside the net and presently not paying tax will not become liable to tax because of the increased rates.
Effectiveness	Increasing profits tax rates within reasonable limits is a very effective way of enhancing revenue yields. Taxpayers cannot avoid paying the increased tax. Income presently not subject to tax (e.g. interest, dividends, offshore income and capital gains) remains outside the tax net.
Efficiency	Increasing profits tax rates is an efficient way of collecting additional revenue. After enactment of the legislation, there are no additional collection or compliance costs for either the Government or taxpayers.
Certainty and simplicity	Hong Kong's profits tax rates are both simple to understand and certain in their application.
Flexibility	Tax rates are unaffected by changes in technology or commercial developments.
International competitiveness	The international trend is towards reducing corporate tax rates as a means of retaining existing businesses and attracting new businesses. A substantial increase in profits tax rates may adversely impact on Hong Kong's long-term development.
Revenue yield	At profit levels for 2000-01, each single percentage point increase in profits tax rates would yield an estimated $2.6 billion in additional annual revenue, assuming an unchanged tax base.

22. The *Advisory Committee* considers that increasing profits tax rates will not broaden the tax base, noting in particular that the increased tax burden falls entirely on existing taxpayers. The *Advisory Committee* does not advocate a significant increase in profits tax rates as this would go against the international trend of lowering income taxes. Separately, the *Advisory Committee* does not recommend the introduction of a progressive tax rate for profits tax because it will encourage the division of existing businesses into economically less efficient smaller units for the sole purpose of having corporate profits taxed at a lower tax rate.

Option 3: Increase Stamp Duty on Landed Property Transactions

Relevant Factors	Considerations
Broadness	Increasing stamp duties payable on landed property transfers cannot broaden the tax base.
Neutrality	The increased stamp duty rates will apply to all transfers of Hong Kong landed properties.
Fairness	The burden of the additional tax remains with those who purchase landed property located in Hong Kong.
Effectiveness	Increasing stamp duties on landed property transfers is an effective way of enhancing revenue yields. Taxpayers cannot avoid paying the increased tax.
Efficiency	Increasing stamp duty rates on landed property transfers is an efficient way of collecting additional revenue. Neither the Government nor taxpayers incur additional collection or compliance costs.
Certainty and simplicity	Stamp duties on landed property transfers are simple and certain in their application.
Flexibility	The liability for stamp duty on landed property transfers is largely unaffected by changes in technology or commercial developments.
International competitiveness	Increased stamp duties may be a factor that adversely affects international investment in the landed property market.
Revenue yield	Using 2000-01 turnover figures, increasing the stamp duty rates by 20% would yield $1 billion per annum.

23. The *Advisory Committee* considers that increasing the stamp duty on landed property transfers will not broaden the tax base nor provide the capacity to produce significant additional revenue. The *Advisory Committee* does not advocate a significant increase in stamp duty as it will impact adversely upon competitiveness and the already fragile landed property market.

Option 4: Reduction in Personal Allowances and Concessionary Deductions under Salaries Tax

Relevant Factors	Considerations
Broadness	Reductions in personal allowances and concessionary deductions will result in more taxpayers being liable to salaries tax. The salaries tax base will be broadened.
Neutrality	Neutrality is preserved because taxpayers in the same income and family circumstances have their personal allowances reduced by the same amounts.
Fairness	Some salaries-earners currently paying no salaries tax are drawn into the tax net. Most of the additional revenue comes from those existing taxpayers who are not standard rate taxpayers. The tax liabilities of standard rate taxpayers will remain unchanged.
Effectiveness	Reducing personal allowances and concessionary deductions is a very effective way of enhancing revenue yields from personal taxation. Taxpayers cannot avoid paying the increased tax and all taxpayers with incomes above the reduced thresholds contribute.
Efficiency	A large number of new taxpayers are required to lodge returns. Additional administrative resources will be required to process the returns of new taxpayers who will have minimal tax liabilities.
Certainty and simplicity	Reductions in personal allowances and concessionary deductions are simple and certain in their application.
Flexibility	Reductions in personal allowances and concessionary deductions are unaffected by changes in technology or commercial developments.
International competitiveness	The flow-on effect of increased effective tax rates, if significant, for higher-income individuals may act as a disincentive to retaining skilled employees and attracting new skilled employees to relocate to Hong Kong.
Revenue yield	At 2000-01 income levels, across the board reductions in personal allowances of 10%, 25% and 50% would respectively yield additional annual revenue of \$2 billion, \$6 billion and \$14 billion. A total abolition of personal allowances would yield additional revenue of \$40 billion.

24. The *Advisory Committee* notes that reducing the personal allowances and concessionary deductions will broaden the tax base. However, those taxpayers brought back into the tax net will contribute only 2.9% of the additional revenue yield (assuming a 20% reduction of personal allowances). The balance of 97.1% would come from existing taxpayers through increased tax liabilities because the amount of each individual's reduction in personal allowances bears tax at that individual's top marginal tax rate. Standard rate taxpayers are not granted personal allowances and will be unaffected by any reduction in personal allowances.

25. Hong Kong's personal allowances and concessionary deductions are high by international standards. The *Advisory Committee* considers that a moderate reduction of the personal allowances and concessionary deductions would have the effect of broadening the tax base and result in more individuals becoming liable to salaries tax.

Option 5: Increase Rates on Tenements

26. In the *Advisory Committee's* Consultation Document, increasing rates charged on tenements was not listed as a revenue option. However, during the public consultation, it was put to the *Advisory Committee* that rates, being a broad-based tax, may be used to enhance revenue productivity. The key attractions are that rates are already broad-based with the tax burden generally shared among most households equitably and that they do not raise compliance and administrative costs. The *Advisory Committee* therefore evaluated this option.

Relevant Factors	**Considerations**
Broadness	Rates on tenements are broadly-based because they apply to almost all residential and non-residential landed properties located in Hong Kong. The principal exemptions from rates are government premises, agricultural land and buildings, religious property, military land and traditional New Territories village houses.
Neutrality	Virtually all Hong Kong landed properties are subject to rates at a standard, fixed percentage. Rates are neutral in their application.
Fairness	Rates are levied on the rental value of a landed property. Rates are equitable in their impact because generally persons occupy accommodation commensurate with their ability to pay.
Effectiveness	Increasing rates is an effective way of enhancing revenue yields. Landed property owners and (either directly or indirectly) tenants cannot avoid paying the increased property rates.
Efficiency	Increasing rates is a very efficient way of collecting additional revenue. Once the legislation has been enacted, there are no additional administration or collection costs for either ratespayers or the Government.
Certainty and simplicity	Increases in rates are simple and certain in their application.
Flexibility	Increases in rates are unaffected by changes in technology or commercial developments.
International competitiveness	A significant increase in the levels of rates for commercial and residential landed properties may act as a disincentive to businesses and skilled employees relocating to Hong Kong and to the retention of existing businesses and skilled employees.
Revenue yield	At 2000-01 levels, each single percentage point increase in rates would yield almost $2.9 billion in additional revenue annually.

27. Rates are a tax on property. The *Advisory Committee* has noted that Hong Kong's reliance on such a tax type is already higher than either the OECD or Asia-Pacific averages. Nevertheless, rates do provide a broadly-based stable source of revenue that is relatively less affected by cyclical movements in business profits and, to a significantly lesser degree, personal incomes. Rates are very much broader-based than either profits tax or salaries tax because they are payable in respect of all rateable properties without regard to levels of business profits or entitlements to personal allowances. The mechanism to increase rates is simple and an increase in the level of rates generates meaningful additional revenue. The *Advisory Committee* considers that a moderate increase in rates may be used, especially as a short-term measure, to generate additional revenue.

Introducing Broad-based New Taxes

28. The *Advisory Committee* has considered the revenue potential of a number of new taxes. These included taxes on specific categories of consumption, a general consumption tax, poll tax, capital gains taxes, payroll tax or social security contributions levied on employers and/or employees, land and sea departure taxes and taxing certain categories of income that, hitherto, were not subject to salaries tax or profits tax.

Option 6: Capital Gains Tax

Relevant Factors	Considerations
Broadness	A capital gains tax would be a new tax in Hong Kong. It would broaden the tax base.
Neutrality	The neutrality of the tax depends on its scope. A tax imposed only on landed property and/or stock transactions would lack neutrality.
Fairness	The tax is imposed on capital gains that have been realised.
Effectiveness	Capital gains taxes are noted for their susceptibility to adverse economic cycles. Revenue yields are volatile.
Efficiency	There are many complex aspects to the administration of capital gains taxes. Capital gains taxes are relatively inefficient taxes for governments and taxpayers alike.
Certainty and simplicity	To be effective, capital gains tax legislation is invariably complex. It lacks the relative simplicity that is inherent in Hong Kong's existing taxation legislation.
Flexibility	Capital gains tax legislation all too often lacks flexibility. Overseas experience is that legislation requires amendment on a regular basis to maintain the integrity of the tax.
International competitiveness	Under our existing sourced-based system of taxation, Hong Kong residents may be encouraged to invest offshore in order to avoid capital gains taxes on their investment gains. Capital gains taxes dampen investment and are not conducive to capital formation. The introduction of a capital gains tax may also have a detrimental effect on Hong Kong as a destination for regional share listings and as a regional financial centre.
Revenue yield	The revenue yield is dependent upon the scope of the legislation (including provisions relating to deductions for capital losses) and the current state of the economy.

29. The *Advisory Committee* considers that a tax on capital gains in Hong Kong should not be pursued given its limited ability to yield significant revenue and that if implemented, it will compromise Hong Kong's simple tax system. The potential gains are outweighed by the costs.

Option 7: Tax on Interest

Relevant Factors	Considerations
Broadness	A tax on interest would enlarge the categories of income subject to tax. Prima facie, it has the capacity to broaden the tax base.
Neutrality	The tax lacks neutrality as it would only apply to interest on deposits located in Hong Kong. Under our existing source-based system of taxation, interest received from deposits located outside Hong Kong would continue to be free from tax.
Fairness	The tax is imposed on income received by the taxpayer.
Effectiveness	The amount of interest tax revenue received from a specified level of savings within the community is predominantly determined by market interest rates and the types of deposits chosen by investors.
Efficiency	Taxes on domestic interest payments are, in themselves, efficient as the financial institutions can deduct the tax from their interest payments. However, because of the need for small income taxpayers to lodge tax returns solely to obtain a refund of interest withheld at source from their savings accounts and investment accounts, overall it is an inefficient tax.
Certainty and simplicity	The assessment of tax on Hong Kong-sourced interest on a withholding tax basis for individuals is efficient and simple. For companies, the assessment of tax on Hong Kong-sourced interest included in business profits is also efficient and simple.
Flexibility	The tax is relatively inflexible because it does not easily deal with financial returns from derivative products that are in forms other than interest.
International competitiveness	Monetary assets are easily moved offshore to avoid taxes. The loss of deposits may have adverse effects on the financial system and be detrimental to Hong Kong's further development as an international banking centre.
Revenue yield	Because of the potential for individual depositors to move their deposits offshore and the ability of financial institutions to develop offshore banking products, the potential tax yield from individuals is estimated to be negligible. Based on the estimated cost to revenue in 1998-99 arising from the Profits Tax (Interest Income) Order exempting interest received by businesses from profits tax, the tax yield from taxing interest received from business may be in the order of $1 billion annually.

30. The *Advisory Committee* considers that a tax on interest is easily avoided by moving deposits to off-shore locations. The adverse impact on our further development as an international banking centre outweighs any potential gain on revenue, which is not expected to be significant.

Option 8: Tax on Dividends

Relevant Factors	Considerations
Broadness	A tax on dividends would enlarge the categories of income subject to tax. Prima facie, it has the capacity to broaden the tax base.
Neutrality	Under Hong Kong's existing source-based system of taxation, it would only apply to dividends paid by Hong Kong companies. Dividends from foreign companies would not be taxed.
Fairness	The traditional system of double taxation of corporate income[1] impacts on fairness but it has largely been replaced internationally by an imputation system[2] of dividend taxation. Because of the tax credit mechanism under dividend imputation systems, double taxation does not arise and the taxation of dividends on the same basis as all other income is fair.
Effectiveness	If companies elect to re-invest profits to enhance their share prices rather than pay dividends, there is no dividend to tax.
Efficiency	All modern dividend taxation systems include arrangements for the corporate tax paid on the distributed profit to be transferred to the shareholders. This introduces inefficiencies and opens avenues for tax avoidance.
Certainty and simplicity	Comprehensive dividend imputation systems are complex to legislate and difficult to administer.
Flexibility	The tax is relatively flexible because it would be capable of dealing with all distributions of profits to shareholders.
International competitiveness	To maintain international competitiveness, a dividend imputation system would be necessary.
Revenue yield	Under a dividend imputation system, based on cash dividends paid by listed companies in 1999, the net level of additional revenue generated through taxing dividends would not be significant.

31. The *Advisory Committee* considers that given the need to introduce potentially complex dividend imputation systems and the possibility for companies not to distribute dividends (hence no tax to collect), it is not worthwhile to complicate Hong Kong's tax system by introducing a dividends tax.

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1 The profits first being taxed to the company and that portion of profits distributed as dividends subsequently being taxed again in the hands of the individual shareholders.

2 Under dividend imputation systems, the tax paid by companies on that portion of profits distributed to shareholders as dividends is transferred to the shareholders in the form of a tax credit. In the shareholder's hands, the cash dividend received is grossed-up by the amount of the tax credit to obtain the full taxable value of the dividend. The company tax transferred to the shareholder (the imputed tax credit) is deducted from the individual's overall total tax liability.

Option 9: Tax Worldwide Income of Businesses and Individuals

Relevant Factors	Considerations
Broadness	Taxing the worldwide income of taxpayers would extend the scope of income subject to tax. Prima facie, it has the capacity to broaden the tax base.
Neutrality	Taxing foreign-sourced income would make Hong Kong's tax system more neutral because all income, irrespective of its source, would be taxable.
Fairness	Foreign-sourced income will be liable for tax in Hong Kong when tax has not been paid on it in the jurisdiction in which it originates.
Effectiveness	A credit has to be given for any tax paid on foreign-sourced income in its country of origin. As Hong Kong's tax rates are low by international standards, in most cases the amount of the foreign tax credit will be greater than the Hong Kong tax on that income. In these situations, no additional revenue will be raised.
Efficiency	The need to resolve issues such as the tax paid on foreign income in a foreign jurisdiction introduces inefficiencies.
Certainty and simplicity	Legislation to tax foreign-sourced income and allow tax credits is always complex. It may involve issues such as having to negotiate double taxation agreements.
Flexibility	The tax is flexible because the manner of derivation of the income is not an issue.
International competitiveness	To maintain international competitiveness, foreign tax credit legislation and the establishment of comprehensive double taxation agreements with major economic partners would be essential.
Revenue yield	Negligible because of the need to grant credits for foreign taxes paid.

32. The *Advisory Committee* notes that a complex system of tax credits together with double taxation arrangements are major prerequisites for a tax on worldwide income. Given Hong Kong's low tax rates, the revenue gain is unlikely to be significant. On balance, the *Advisory Committee* considers that such a tax should not be pursued.

Option 10: Land and Sea Departure Tax

Relevant Factors	Considerations
Broadness	A tax on all land and sea departures from Hong Kong would be very broad-based.
Neutrality	Persons departing from Hong Kong by land or sea must pay the tax.
Fairness	Persons departing from Hong Kong by air and travelling to Macau or the Mainland by sea already pay a departure tax or charge. All outbound travellers by sea or by land from Hong Kong would then be subject to such payment.
Effectiveness	Difficult to avoid or evade the tax.
Efficiency	Relatively low costs of collection and administration.
Certainty and simplicity	Liability for the tax is certain and easily understood.
Flexibility	Very flexible.
International competitiveness	No material impact on Hong Kong from an international perspective.
Revenue yield	The revenue yield depends on the level of the tax. If set at $18 per land or sea departure (the current rate for Macau and Mainland departures by sea), then based on departures in 2000, it would yield some $1 billion a year.

33. The concept of land and sea departure taxes set at modest levels received quite a measure of support from the public. The *Advisory Committee* finds that there is a reasonable case to consider a land and sea departure tax as it is equitable that all passengers departing from Hong Kong will pay a tax. The downside is the perceived negative impact on economic co-operation with the Mainland and a disincentive to inbound tourism. The *Advisory Committee* considers that if implemented, the tax should be kept at a moderate level to lessen its perceived negative impact.

Option 11: Payroll and Social Security Taxes

Relevant Factors	Considerations
Broadness	The tax is paid by employees and/or employers and is broadly-based.
Neutrality	The tax applies to all payrolls and employees' wages.
Fairness	The tax is levied on employers and/or employees as a percentage of each employee's wages without any personal allowances or concessionary deductions being granted.
Effectiveness	The tax, because of its reasonably broad base, is capable of yielding sustainable revenue on an ongoing basis.
Efficiency	The liability of each employee and/or employer is calculated in conjunction with the preparation of the employee's wages.
Certainty and simplicity	Legislation can be complex and may cause problems for employers initially. Once established, ongoing administration is relatively simple.
Flexibility	The tax is capable of adapting to varying employment patterns.
International competitiveness	Most employers and employees have just commenced making contributions to the Mandatory Provident Fund. Any new tax liability on employment will adversely affect Hong Kong's competitiveness.
Revenue yield	At 1999-2000 income levels of Hong Kong employees, each single percentage point of tax imposed would generate $5.8 billion annually.

34. The option of payroll or social security taxes is viable and sound when assessed against the good tax principles. However, it adds to business costs, especially the cost of employing staff. With the Mandatory Provident Fund System still in its early years of implementation, employers and employees are still absorbing its impact. The *Advisory Committee* considers that implementing any payroll or social security taxes in the foreseeable future may upset the equilibrium of Hong Kong's business and employment costs.

Option 12: Poll Tax

Relevant Factors	Considerations
Broadness	Extremely broadly-based tax because every adult person would be liable to it.
Neutrality	Every resident adult person pays the tax.
Fairness	The tax is levied at a flat rate on all adults without any regard to a person's ability to pay.
Effectiveness	Because the tax is broadly-based, it is capable of yielding sustainable revenue on an ongoing basis.
Efficiency	Elsewhere, poll taxes proved very costly to administer and were subject to high levels of evasion.
Certainty and simplicity	The principle of a poll tax is very simple and certain. It is easily understood by persons subject to it.
Flexibility	The tax is inert to changes in business practices and advances in technology.
International competitiveness	A modest tax rate may not significantly affect competitiveness.
Revenue yield	The revenue yield depends on the level of the tax. In 2000, Hong Kong had 5.3 million persons aged 21 years or over. A poll tax of $200 per person per year would yield $1 billion annually.

35. Poll taxes suffer from a lack of vertical equity. They have not been successfully implemented in any major tax jurisdictions. The *Advisory Committee* does not recommend a poll tax for implementation in Hong Kong.

Option 13: General Consumption Tax

Relevant Factors	Considerations
Broadness	Expenditure on private consumption is subject to the tax. Its scope is very broad.
Neutrality	A general consumption tax applies to all aspects of private consumption and is therefore neutral.
Fairness	Liability to the tax is determined by capacity to spend. Persons with a lower capacity to spend pay less tax. For low income persons the tax is regressive.
Effectiveness	A consumption tax, being very broadly-based, is capable of yielding sustainable revenue on an ongoing basis. Depending on the rate of the tax, there is however the possibility of some shift in consumption expenditure across the border.
Efficiency	A broad-based consumption tax has relatively low administration and compliance costs. With a broad base, it is relatively difficult to avoid.
Certainty and simplicity	A broad-based consumption tax with no or very limited exemptions is certain in application and easily complied with.
Flexibility	A tax on private consumption is reasonably flexible and can adapt to changes in business practices and technology.
International competitiveness	A broad-based tax with a tax rate that is lower than regional or international norms will have no material impact on competitiveness, as Hong Kong is the only developed economy without a general consumption tax.
Revenue yield	Based on private consumption expenditure in 2000, each single percentage point of a consumption tax is estimated to yield around $6 billion annually.

36. The introduction of a general consumption tax or, more specifically, a goods and services tax (GST) has drawn opposition from many quarters of the community but qualified support from some professional organisations. Of all the options surveyed by the *Advisory Committee*, it is the only one that fits the primary criteria of being broadly-based and highly revenue productive even when the tax rate is set at a level which, when compared with other economies, is low.

37. Hong Kong's demographic and labour force trends will have a major impact on Hong Kong's public finances in the future. As the ratio of dependent persons to employed persons increases, future growth in the income tax base will lag behind the growth in the consumption tax base. At the same time, the ageing of the population will place an upward pressure on social security expenditure and medical and health services. The *Advisory Committee* has noted that many other mature taxation jurisdictions have all implemented GST (or a variant of it) to reform their tax system in the face of ageing populations. With changing

demographics, increasing community expectations for government services and the adverse effects on direct tax revenues of cyclical downturns in the economy, it has become increasingly untenable for governments to continue their heavy reliance on income taxes as the predominant revenue source. As a result, many governments have diversified their tax revenue and become less reliant on income taxes. Taxing private domestic consumption provides an alternative form of revenue that is considerably better shielded from economic and demographic changes within the community.

Option 14: Taxes on Mobile Telephone Services and Signboards

Relevant Factors	Considerations
Broadness	Both are narrowly based taxes as they apply only to specific categories of goods and services. A tax on mobile phone usage is relatively more broad-based given the high penetration rate.
Neutrality	As only persons using mobile telephones or erecting a signboard pay the tax, it is not neutral in its application. Consumer preferences may be directed to other forms of communications or advertising.
Fairness	A tax on signboard usage is narrow and selective in its application.
Effectiveness	Difficult to avoid or evade the taxes.
Efficiency	Low costs of collection and administration.
Certainty and simplicity	Liability for the taxes and their amount is certain and easily understood.
Flexibility	Very flexible.
International competitiveness	No material impact on Hong Kong from an international perspective.
Revenue yield	Depending on the charging method, moderate rates will not yield significant revenue. Based on the situation in 2000, a flat-rate $10 monthly charge on each mobile phone user would yield around $460 million per annum and a $1,000 annual tax for signboard owners would yield $200 million.

38. Excise-type taxes lack the essential neutrality required of good tax systems. A proliferation of excise taxes may complicate the tax system and drive up costs for businesses. On a stand-alone basis, they lack the capability to be substantially revenue-productive unless set at high levels. As for the two excise types of taxes under consideration, on conceptual and revenue productivity grounds, the *Advisory Committee* does not recommend their adoption.

Green Taxes

39. In the course of its public consultation, the *Advisory Committee* received a number of submissions on "green taxes". The term "green taxes" is used to refer to taxes imposed on specific items of consumption on environmental protection grounds. Because of the specific environmental goals that they seek to achieve, the scope of application of the individual "green taxes" can be extremely narrow, e.g. car batteries or car tyres. They may also be very broad, e.g. a tax on electricity consumption.

40. The *Advisory Committee's* Terms of Reference are directed at fiscal issues. It is to consider the types of broad-based taxes that could be introduced to yield stable flows of recurrent revenue over the longer term. The *Advisory Committee* is supportive of environmental protection and is aware of the circumstances in which levying taxes on particular categories of consumption is justifiable on environmental grounds. Nevertheless, to use "green taxes" to pursue environmental protection objectives involves complex considerations beyond fiscal justifications. A specific "green tax" may yield meaningful revenue and have a broad tax base. That said, the *Advisory Committee* is concerned that it does not possess the expertise to advise whether it will hamper or help the environmental protection objective, or whether a non-tax measure could achieve a superior result. The *Advisory Committee* considers it appropriate to leave to the Government and its relevant advisory bodies to deliberate on what "green taxes" would be most useful in furthering the environmental protection cause and how each initiative should be prioritised and targeted. The *Advisory Committee* has therefore not discussed "green taxes" as a tax-base-broadening proposal.

RECOMMENDATION

Goods and Services Tax

41. Hong Kong's tax base is continuing to become narrower. The *Advisory Committee's* opinion is that a GST is the only new tax with the long-term capacity to broaden the tax base which is not incompatible with Hong Kong's external competitiveness. Even at an internationally comparable low rate, it will generate significant revenue. The *Advisory Committee* recommends that a suitable Hong Kong model for a GST would have a single low rate (say 3%), a high registration threshold designed to exclude the majority of small and medium-sized enterprises, and zero rates for exports (including exports by tourists). A suggested structure for a GST, including key design features, that would be suited to Hong
Annex F Kong's circumstances, is provided in Annex F. This model is largely based on a report by the International Monetary Fund's tax experts who were invited to advise on the feasibility of introducing a GST in Hong Kong. The full report of the IMF is
Annex G at Annex G.

42. From an implementation perspective, practical experience in New Zealand, Singapore and Australia was that, if high levels of resources are directed at implementing a GST, a minimum period of 18 months is needed once a decision has been taken to introduce a GST. Given Hong Kong's inexperience with consumption taxes generally, the IMF has advised that the enforcement agencies, e.g. Inland Revenue Department and Customs and Excise Department, may require some two years to gear up for GST implementation. The *Advisory Committee* recognises also that the estimated lead-time for implementation of a GST should also include adequate time for the legislative work, including the drafting of the legislation and deliberation of it by the legislature.

43. The *Advisory Committee* understands that the actual timing of implementation of its GST recommendation (if accepted) remains the prerogative of the Government. Just as there is no good time to discuss new taxes, there will never be a popular time to introduce them. The *Advisory Committee* recommends that a policy decision to implement GST or not should be taken as soon as practicable. This is because if a positive decision is taken, the lengthy legislative and practical preparatory work can commence as soon as possible. The *Advisory Committee* further recommends that the Government have regard to its forecast fiscal situation, economic climate and readiness of the businesses before deciding on the actual implementation date. Taking all of these considerations into account, the *Advisory Committee* believes that the earliest implementation date will be some years, possibly three or four years, into the future.

44. Even with an early decision to proceed with the implementation of a GST, the unavoidable lead-time will result in revenue collections beginning some years into the future. If the Government is facing a structural fiscal problem, it may have to consider implementing interim measures to fill revenue shortfalls. The *Advisory Committee* therefore recommends for consideration three measures that have the capacity to be revenue-productive, are broad in their application and relatively easily implemented. Respectively, they draw upon an already broad-based tax base for additional revenue, enlarge the revenue productivity of the existing pool of potential taxpayers, and bring new classes of persons within the tax net.

Rates on Tenements

45. As stated in paragraph 27 above, rates are a broad-based tax having substantial revenue productivity. The *Advisory Committee* does not recommend increased rates be used as a long-term revenue measure (currently at 5% of rateable value) to cover the fiscal needs of the Government. Given that GST may need a long lead-time before implementation, the *Advisory Committee* considers that a moderate increase in rates, in the interim, is an option should the state of government finances so demand.

Personal Allowances

46. In terms of revenue forgone by the Government, the current high levels of personal allowances under salaries tax are costly. As discussed in paragraph 25, Hong Kong's personal allowances and concessionary deductions are high by international standards. They are also the root cause of the narrow salaries tax base. A reduction in personal allowances has the capacity to bring a large number of new taxpayers into the tax base. The *Advisory Committee* proposes that the existing levels of personal allowances be reduced with a view to broadening the tax base.

Land and Sea Departure Tax

47. As outlined in paragraph 33, the revenue yield of a land and sea departure tax would be modest and broad-based if the tax rate is set at a moderate level. Nevertheless, the *Advisory Committee* considers that such a tax would provide a steady revenue source for the Government. Such a tax would also be equitable, in the sense that all passengers departing from Hong Kong by land or by sea will pay a tax, as is already the case for passengers departing by air.

CONCLUSION

48. The *Advisory Committee* has been tasked with recommending what broad-based taxes could be introduced in Hong Kong by the Government if additional revenue is needed. Of all of the options examined, the *Advisory Committee* considers GST is best suited to the purpose. It therefore recommends that if a need for additional revenue is identified because of structural fiscal deficits, GST should be adopted. If necessary, the *Advisory Committee* further recommends an increase in rates, a reduction in personal allowances under salaries tax and the introduction of a land and sea departure tax, all of which are broad-based revenue options and relatively simple to administer, to bridge the gap pending the implementation of GST.