Annex D

A Broader-Based Tax System for Hong Kong?

Consultation Document

Advisory Committee on New Broad-based Taxes

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Contents

A BROADER-BASED TAX SYSTEM FOR HONG KONG?

Advisory Committee on New Broad-based Taxes

Background

In the 2000-01 Budget, the Financial Secretary drew attention to the Government's operating deficits for the previous two financial years and the projected deficits for the forthcoming three years. He cautioned that if they continued, Hong Kong would encounter serious fiscal problems. The sustained health of Hong Kong's public finances needed to be addressed and recurrent revenue, being the most significant component of the overall fiscal system, was of particular concern.

2. Whether the operating deficits were cyclical (and would self-correct with an upswing in the economic cycle) or of a more serious structural nature has yet to be determined. Regardless of their nature, Hong Kong can ill-afford the luxury of waiting for a crystallisation of events prior to devising remedial measures for implementation when required. Having a portfolio of well thought-out, feasible strategies ready for implementation to hold economic instability at bay is essential.

3. A two-pronged approach has been adopted. The first prong was the establishment of a *Task Force on Review of Public Finances* to identify whether the operating deficit was cyclical or structural in nature. It is expected that the Task Force's findings will be available by end 2001. Concurrently, the second prong was the establishment of the *Advisory Committee on New Broad-based Taxes*. Under the principle of maintaining a low and simple taxation regime and preserving Hong Kong's competitiveness, the *Advisory Committee* is to consider the suitability of new types of broad-based taxes for introduction in Hong Kong. It is expected to advise on the practical implementation of any new taxes recommended. The *Advisory Committee* is drawn from a wide spectrum of society, including academics, professionals, business and community leaders. A list of its membership is at Annex A and its Terms of Reference at Annex B.

Hallmarks of a Good Tax System

4. The *Advisory Committee* has been meeting regularly since June 2000 to consider the options to improve Hong Kong's tax system. It has surveyed the practices and experiences of developed tax jurisdictions and evaluated the lessons learned, taking into consideration Hong Kong's unique position. The initial tasks included identifying the internationally recognised tenets of good tax system design, testing the Hong Kong system against the international benchmarks to assess areas that merit improvements and problem areas that require rectification. The identified benchmarks provided the foundations against which the present tax system was evaluated and against which the *Advisory Committee's* considerations for enhancing revenue yields were weighed. The widely accepted principles are summarised below.

Neutrality

5. Good taxation systems fairly distribute the tax burden whilst minimising the disincentive effects. They are economically neutral and equitable as between forms of commerce so that the driving force for decisions is the maximisation of economic gain rather than minimisation of tax. Neutrality, or horizontal equity, is preserved when individuals and businesses with the same ability-to-pay are taxed equally. The neutrality of a tax is maximised when its impact on economic decisions is minimised.

Fairness

6. 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.

Effectiveness

7. 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 strike a balance that is proportionate to the risks.

Efficiency

8. 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 and adversely impact on the community's standards of living. 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.

Certainty and simplicity

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

Flexibility

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

International competitiveness

11. 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 overseas investment for its continued economic growth. The fundamentals of the tax system must remain simple and efficient to maintain an attractive investment environment for Hong Kong.

Revenue stability

12. 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.

Establishing Benchmarks

13. Having established benchmarks against which Hong Kong's tax system could be objectively judged, the *Advisory Committee* surveyed developed overseas tax jurisdictions to ascertain the scope of the taxes they impose and the relative contributions of respective taxes to total revenue. The Organisation for Economic Co-operation and Development (OECD) member countries were selected for the study because of their developed economies and the availability of reliable tax statistics in a standardised format.

Overview of Hong Kong Taxes

14. Hong Kong's sources of revenue are shown in Table A.

Table A - Sources of Hong Kong Revenue				
Revenue Source	**Revenue Yield** ($ million)		***Percentage of Total Revenue*** (%)	
	1999-2000	2000-01	1999-2000	2000-01
Direct Taxes [1]				
Profits tax	37,699	42,969	16.18	19.09
Salaries tax	24,831	26,303	10.66	11.69
Personal assessment	3,216	3,455	1.38	1.54
Property tax	1,168	1,143	0.50	0.51
	66,914	73,870	28.72	32.83
Indirect Taxes [2]				
Stamp duties	12,116	10,911	5.20	4.85
Betting duty	11,938	12,630	5.12	5.61
Duties	7,377	7,293	3.17	3.24
General rates	7,132	14,428	3.06	6.41
Motor vehicle taxes	2,613	3,025	1.12	1.34
Estate duty	1,272	1,503	0.55	0.67
Air passenger departure tax	499	537	0.21	0.24
Hotel accommodation tax	182	223	0.08	0.10
Cross-Harbour Tunnel passage tax	97	0	0.04	0.00
	43,226	50,550	18.55	22.46
Total Tax Revenue	110,140	124,420	47.27	55.29
Non-Tax Revenue				
Land sales	34,810	29,531	14.94	13.12
Properties & investments	23,016	26,542	9.88	11.79
Fees & charges	10,896	10,973	4.68	4.88
Utilities	3,326	3,297	1.43	1.46
Other income	50,807	30,297	21.80	13.46
Total Non-Tax Revenue	122,855	100,640	52.73	44.71
Total Revenue	**232,995**	**225,060**	**100.00**	**100.00**

[1] Direct taxes are taxes levied on the person who ultimately bears the burden of these. The term is usually used in connection with taxes charged on income and profits.

[2] Indirect taxes are primarily taxes levied on goods and services and not on income or profits.

The Tax Base

15. One of the areas for improvement for the Hong Kong tax system, as often alleged by local experts, is that the tax base is too narrow. The *Advisory Committee's* brief to propose new broad-based taxes was a direct response to this perceived aspect of our system. With the assistance of a consultant with international connections and experience, the *Advisory Committee* analysed the tax base in detail to establish whether it is narrow and if so, what options are available to reform the system.

16. The key findings[3] of the study on tax base are that –

(a) using the measure of total tax revenue as a percentage of GDP, Hong Kong's tax levels are significantly lower than the Asia-Pacific and overall OECD averages;

(b) Hong Kong derives 27% of its tax revenue from personal income - equal to the OECD average but 4% lower than the Asia-Pacific benchmark;

(c) Hong Kong has a noticeably heavy reliance on taxation from corporate profits. As a percentage (32%) of tax revenue, Hong Kong's reliance on corporate profits tax is three and half times that of the OECD average (9%) and slightly higher than that of the Asia-Pacific average (29%);

(d) taxation from property (rates, stamp duties on real property and shares and estate duty) in Hong Kong is above the international benchmarks as a percentage of GDP, and significantly higher than each of the benchmarks as a percentage of total taxation (24%, against 5% for the OECD benchmark and 10% for the Asia-Pacific benchmark);

(e) Hong Kong has a very low reliance on taxation from goods and services, and is the only developed economy that does not have any form of general consumption tax. The OECD countries on average raise 18% of tax revenue from general consumption taxes, and 12% from specific goods and services taxes, while on average the Asia-Pacific benchmark countries raise 12% from general consumption taxes and 16% from specific goods and services taxes. The overseas trend is towards a greater reliance on consumption taxes and less reliance on taxes on income and property;

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[3] An executive summary of the tax base study is at Annex C and the full report is downloadable from the website www.info.gov.hk/fb/ac/index.htm.

(f) Hong Kong is more reliant on taxation from property, personal income and corporate profits than the OECD or Asia-Pacific averages, but its tax levels are below the averages of these groups. It has an outstandingly low reliance on taxes from goods and services. Considering the limited number of taxes levied, Hong Kong's tax base is narrow in comparison to other developed jurisdictions;

(g) separately, because of the limited scope of the liability to some of the taxes levied, the composition of Hong Kong's tax base is narrow; and

(h) Hong Kong derives a significant proportion of its total revenue (approaching half) from non-taxation sources – substantially above international 'norms'. This revenue is derived substantially from land sales and earnings from the investment of accumulated Budget surpluses. Hong Kong's revenue base, with its increasing reliance on non-tax revenue sources, is heading in the opposite direction to the overseas trend.

17. In the circumstances, the study made recommendations to broaden the tax base. Details can be found in the consultant's report.

Sources of Additional Revenue

18. Having noted that Hong Kong's tax base is narrow, the *Advisory Committee* explored options for broadening it. It drew on the positions prevailing overseas and took into account Hong Kong's particular situation. Two main directions were explored -

(a) raising the revenue productivity of certain key existing taxes by extending the scope of their coverage, increasing tax rates, and reducing personal allowances and concessions; and

(b) introducing new taxes.

Increasing Revenue Productivity of Existing Taxes

19. A number of options for increasing the productivity of current taxes were considered. A synopsis of the *Advisory Committee's* deliberations on each option is set out in Tables I – IV.

Table I - 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 are taxed at the same rates of tax, 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 because of the increased rates.
Effectiveness	Increasing salaries tax rates 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 administration or collection costs are incurred by either taxpayers or the Government.
Certainty and simplicity	Under Hong Kong's tax system, tax rates are both simple to understand and certain in their application.
Flexibility	Tax rates are unaffected by changes in technology and commercial developments.
International competitiveness	The international trend is towards reducing personal income taxes as one means of attracting and retaining skilled employees in an economy. Increasing tax rates may adversely impact on Hong Kong's ability to attract the calibre of employees required for its long-term development.
Revenue yield	Every one percentage point increase in salaries tax rates (including the standard rate) would yield an estimated $2.2 billion in additional revenue, assuming an unchanged tax base.
Overall assessment	Increasing tax rates is revenue productive. It fails to address the issues of the narrowness of the tax base and vulnerability to cyclical volatility. All of the additional revenue will be paid by existing taxpayers.

Table II - 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. As there are only two rates of tax (one for corporations and the other for unincorporated businesses) neutrality is preserved.
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 is a very effective way of enhancing revenue yields. Taxpayers cannot avoid paying the increased tax. Income presently not subject to tax (interest, dividends, offshore income and capital gains) remain 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 administrative or collection costs for either taxpayers or the Government.
Certainty and simplicity	Under Hong Kong's tax system, tax rates are both simple to understand and certain in their application.
Flexibility	Tax rates are unaffected by changes in technology and commercial developments.
International competitiveness	The international trend is reducing corporate tax rates as a means of attracting new business. Increasing tax rates may adversely impact on Hong Kong's long-term development.
Revenue yield	Every one percentage point increase in profits tax rates would yield an estimated $2.6 billion in additional revenue, assuming an unchanged tax base.
Overall assessment	Increasing tax rates is revenue productive. It fails to address the underlying problem of the narrowness of the tax base and vulnerability to cyclical volatility. All of the additional revenue will come from existing taxpayers.

Table III - Increase Stamp Duties on Property

Relevant Factors	**Considerations**
Broadness	Increasing stamp duties payable on property transfers cannot broaden the tax base.
Neutrality	The increased stamp duty rates will apply to all transfers of Hong Kong properties.
Fairness	The burden of the additional tax remains with those who purchase property located in Hong Kong.
Effectiveness	Increasing stamp duties on property transfers is an effective way of enhancing revenue yields. Taxpayers cannot avoid paying the increased tax.
Efficiency	Increasing stamp duty rates on property transfers is an efficient way of collecting additional revenue. Neither taxpayers nor the Government incur additional costs.
Certainty and simplicity	Stamp duties on property transfers are simple and certain in their application.
Flexibility	The liability for stamp duty on property transfers is largely unaffected by changes in technology or commercial developments.
International competitiveness	The international trend is moving away from transaction taxes such as stamp duties. Increased stamp duties may adversely affect the property market.
Revenue yield	Using 2000-01 turnover figures, increasing the stamp duty rates by 20% would yield $1 billion per annum.
Overall assessment	Increasing the stamp duty rates on property transfers does not provide the capacity to produce significant additional revenue on a stand-alone basis. If a significant increase in revenue is intended, that will impact adversely on international competitiveness and the property market.

Table IV - Reduction in Allowances and Deductions under Salaries Tax

Relevant Factors	**Considerations**
Broadness	Reductions in 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 all taxpayers in the same income and family circumstances have their allowances reduced by the same amounts.
Fairness	Tax base is broadened as some salaries-earners currently paying no salaries tax are drawn into the tax net. Most of the additional revenue comes from existing taxpayers.
Effectiveness	Reducing personal allowances 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 allowances are simple and certain in their application.
Flexibility	Reductions in personal allowances are unaffected by changes in technology and commercial developments.
International competitiveness	The flow-on effect of increased effective tax rates for higher-income individuals may act as a disincentive to skilled employees relocating to Hong Kong.
Revenue yield	Across the board reductions in allowances of 10%, 25% and 50% would respectively yield additional revenue of $2 billion, $6 billion and $14 billion. A total abolition of allowances would yield additional revenue of $40 billion.
Overall assessment	Hong Kong's personal allowances are high by international standards. In recent years, they have increased faster than inflation. Notwithstanding that decreasing personal allowances does broaden the tax base, a disproportionate amount of the additional revenue will come from existing taxpayers. In the absence of a comprehensive social security system, personal allowances are used as a conduit for providing financial assistance to taxpayers with increased levels of family responsibilities and low incomes.

Introduce New Taxes

20. The revenue potential of a number of new taxes was considered. These included taxes on specific categories of consumption (such as mobile telephones, signboards, etc), a general consumption tax, poll tax, capital gains taxes, social security contributions levied on employers and employees, land and sea departure taxes, taxes on Hong Kong-sourced interest, taxing taxpayers' world-wide income and taxes on corporate dividends received by individuals. Of these proposals, the *Advisory Committee* noted the practical implementation difficulties of some options and the low revenue-productivity of others. The *Advisory Committee* also took account of international trends in taxation and wider government policies. A synopsis of the issues for each of the potential new taxes considered is set out in Tables V - XIII.

Table V - 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 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	Hong Kong residents may be encouraged to invest offshore in order to avoid capital gains taxes on their investment gains. 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.
Overall assessment	A capital gains tax broadens the tax base and would yield some additional revenue. Since the tax is directly influenced by the state of the property and stock markets, revenue yields are susceptible to cyclical volatility. On the other hand, the tax could adversely affect the property and stock markets.

Table VI - 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 the source basis 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 income received on a specified level of savings is predominantly determined by market interest rates.
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, overall it is an inefficient tax.
Certainty and simplicity	For individuals, taxing interest on a withholding tax basis 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 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. The tax yield from taxing interest received from business may be in the order of $1 billion annually.
Overall assessment	The ease with which the tax can be avoided militates against its effectiveness as a major source of revenue. The potential adverse effects on the monetary system far outweigh the possible revenue yield.

Table VII - 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 source basis of taxation, it would only apply to dividends paid by Hong Kong companies. Dividends from foreign companies would not be taxed.
Fairness	The tax is imposed on the dividend received by the taxpayer. If the underlying profits from which the dividend was declared are Hong Kong-sourced, they have already been taxed under profits tax. A situation of double taxation of the same income arises.
Effectiveness	If companies elect to re-invest profits to promote growth in 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 for company profits and dividends, a dividend imputation system would be necessary.
Revenue yield	The corporate tax rate is 16% and the top personal tax rate is 17%. With the 15% standard tax rate (for individuals) being less than the corporate tax rate, individual taxpayers chargeable at the standard rate would have their tax liabilities reduced whilst taxpayers with lower overall levels of income (but subject to the 17% marginal tax rate) would incur higher tax liabilities. Under a dividend imputation system, the net level of additional revenue generated through taxing dividends would not be significant.
Overall assessment	It would be inappropriate for Hong Kong to impose a "double taxation" regime if it decided to tax dividends. With dividend imputation, the considerable complexity introduced into the tax system is not matched by a complementary increase in tax yields.

Table VIII - 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 even if 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.
Overall assessment	Taxing foreign-sourced income would technically broaden the tax base. Practically, it will only generate additional tax revenue from offshore income that has escaped tax in the jurisdiction of source.

Table IX - Land and Sea Departures Tax

Relevant Factors	**Considerations**
Broadness	A tax on all land and sea departures from Hong Kong would be very broadly-based.
Neutrality	Persons wishing to depart 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 charge. All outbound travellers from Hong Kong would then be subject to a charge.
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. The liability is 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 departure (the current rate for Macau and Mainland departures by sea) it would yield some $900 million a year in revenue.
Overall assessment	An expanded departure tax is broadly-based and will widen the tax base. However, with increasing inter-connection between the Mainland and Hong Kong, the tax could be seen as interfering with the exchange and communication between the two economies. It may also have adverse effects on the local tourist industry. On the other hand, if a consumption tax were to be introduced in Hong Kong, an expanded departure tax could help alleviate the impact of Hong Kong consumers' spending north of the border.

Table X - Payroll and Social Security Taxes

Relevant Factors	Considerations
Broadness	A tax paid by both employees and employers on payrolls is reasonably broadly-based. Unemployed persons and retired persons would not pay the tax.
Neutrality	They apply to all payrolls and employees' wages.
Fairness	The taxes are levied on employers and/or employees as a percentage of each employee's wages. No personal allowances apply and all employed persons contribute. Persons who do not pay income taxes still make social security contributions.
Effectiveness	The taxes, because of their reasonably wide bases, are capable of yielding sustainable revenue on an ongoing basis.
Efficiency	The liability of each employee and the employer is calculated in conjunction with the preparation of the employees' wages.
Certainty and simplicity	Legislation can be complex and may cause problems for employers initially. Once established, ongoing administration is relatively simple.
Flexibility	The taxes are capable of adapting to varying employment patterns.
International competitiveness	Most employers and employees have just commenced making contributions under the Mandatory Provident Fund legislation. 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 1% of any levy imposed would generate $5.8 billion annually.
Overall assessment	The taxes are broadly-based and are capable of growing with the economy. Compulsory payroll or social security contributions will increase employment costs in Hong Kong. This is likely to prejudice Hong Kong's competitiveness.

Table XI - 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 have proven to be very costly to administer and subject to very high levels of evasion.
Certainty and simplicity	The principle of a poll tax is very simple and certain. It is well understood by persons subject to it.
Flexibility	It 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. Hong Kong has 5.3 million persons aged 21 years or over. A poll tax of $200 per person would yield $1 billion annually.
Overall assessment	Poll taxes provide a very broad tax base because every adult is liable for the tax. Poll taxes have never been successfully implemented in any overseas jurisdiction. In densely populated places with highly mobile populations (such as Hong Kong) the policing of poll taxes would be a difficult issue.

Table XII - General Consumption Tax

Relevant Factors	Considerations
Broadness	Most expenditure on private consumption is subject to the tax. Its scope is very broad.
Neutrality	General consumption taxes apply to virtually every aspect of private consumption and are therefore largely 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	Consumption taxes, being very broadly-based, are capable of yielding sustainable revenue on an ongoing basis.
Efficiency	Broadly-based consumption taxes have relatively low administration and compliance costs. With broad bases, they are relatively difficult to avoid. There is however the possibility of a shift to consumption over the border.
Certainty and simplicity	Broadly-based consumption taxes with limited exemptions are certain in application and easily complied with.
Flexibility	Taxes on private consumption are reasonably flexible and can adapt to changes in business practices and technology.
International competitiveness	A broadly-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	A broadly-based consumption tax of 3% is estimated to yield in excess of $18 billion annually in additional tax revenue.
Overall assessment	A broadly-based, reasonably simple tax on private consumption levied at low rates is revenue productive, has a lower sensitivity to economic downturn and minimal economic distortion for the economy as a whole. All OECD members levy some form of consumption tax. A detailed note on goods and services tax (GST) is at Annex D. As GST taxes virtually all personal consumption, everyone pays the tax as they consume. The burden on different income groups will depend on the detailed design of the tax but in general those who consume more will pay more. At low rates GST is mildly regressive but, universally, compensations are in place to lessen or eliminate its adverse impact on the lowest income group (e.g. CSSA payments can be increased to compensate in full the GST impact).

21. Hong Kong already has a limited number of excise-type taxes on specific items, e.g. cigarettes and alcohol. In theory, all items with relatively inelastic demand have the potential of being taxed and therefore the options are unlimited. The *Advisory Committee* has considered two options which have been put to it by members of the community so far.

Table XIII - Tax on Mobile Telephones and Signboards

Relevant Factors	**Considerations**
Broadness	A narrowly-based tax that only applies to specific categories of expenditure is in itself not broadly-based.
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. A tax on mobile phone usage is relatively more broad-based given the high penetration rate.
Effectiveness	Difficult to avoid or evade the tax.
Efficiency	Low costs of collection and administration.
Certainty and simplicity	Liability for the tax and its 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, non-prohibitive rates will not yield significant revenue. For illustration, a flat-rate $10 monthly charge on each mobile phone user will yield around $460 million per annum and a $1,000 annual tax for signboard owners will yield $200 million.
Overall assessment	Neither tax would be capable of generating significant levels of revenue on a stand-alone basis.

Toward a Broader Base Tax System

22. As foreshadowed in paragraph 3, it is uncertain at this stage if the successive years of operating deficits represent a structural or a cyclical problem. In view of the task given to it, the *Advisory Committee* considers that it is in fact opportune for Hong Kong to reassess its tax system, noting that we are vulnerable to the downsides of a narrow tax base.

23. The *Task Force on Review of Public Finances* is expected to establish if the Government of the Hong Kong Special Administrative Region is experiencing a structural fiscal deficit, and if so the scale of the problem. The *Advisory Committee* recognises that awaiting the completion of the work of the *Task Force* before progressing its work is not a preferred approach as it delays the problem-solving process. As it has turned out, the *Advisory Committee's* current finding that Hong Kong's tax base is narrow has led it to consider options for broadening the tax base. On this basis, the *Advisory Committee* considers that the 13 measures identified in this document to raise additional revenue and/or to broaden the tax base should be further explored.

24. Before finalising its recommendations to the Financial Secretary, the *Advisory Committee* invites the community to contribute to the discussion on ways and means to broaden the tax base of Hong Kong. At this stage, the *Advisory Committee* has not endorsed any option and sincerely solicits the views of the public with an open mind.

Parameters of Comments

25. It is recognised that measures outside the purview of the *Advisory Committee*, e.g. reducing government expenditure, may solve the potential fiscal problem (although it does not address the problem of a narrow tax base). Nevertheless, the *Advisory Committee* must make recommendations on a broader tax system for Hong Kong as prescribed by its terms of reference (at Annex B). All submissions should therefore have as their focus, the development of a broader tax system for Hong Kong that retains its longstanding tenets of a low rate, simple taxation regime and preservation of Hong Kong's competitiveness. Comments and proposals are invited on any aspect of broadly-based taxes that may be suitable for implementation. In addition, and without in any way restricting the scope of comments on all relevant issues, views from the public with full justifications are also invited on the following specific questions –

1. Should Hong Kong seek to improve the stability of its tax revenues by broadening its present tax base?

2. Should tax rates (including the standard tax rate) on incomes derived by individuals from salaries, properties and businesses be increased?

3. Should the tax rates charged on profits earned by corporations be increased?

4. Should personal allowances and concessionary deductions under salaries tax be abolished?

5. If personal allowances and concessionary deductions are not abolished, should they be reduced? If so, in percentage terms, how much should the reduction be?

6. Should interest income, capital gains, dividends and offshore income received by Hong Kong residents be taxed?

7. Should a tax on land and sea departure be introduced? If so, what is the acceptable level of the tax?

8. Should payroll taxes and social security contributions be levied on –
(a) employers; and
(b) employees?

9. If payroll taxes and social security contributions should be paid, what is the maximum acceptable rate of contributions for –
(a) employers; and
(b) employees?

10. In line with the worldwide trend to increasingly tax consumption rather than income, should some form of consumption taxes be introduced?

11. If so, should specific excise-type taxes be considered vis-a-vis a tax on general consumption?

12. If excise-type taxes are preferred, are taxes on mobile phone and signboards acceptable options?

13. Should excise-type taxes be imposed on other specific items? If so, on which items and at what rates?

14. Should a broadly-based consumption tax levied at a single, low rate be introduced?

15. If a broad-based consumption tax should be introduced, what is an acceptable tax rate? What factors should be considered in designing the tax?

16. Should a combination of measures be adopted? If so, what are the possibilities? What options should be ruled out?

26. Relevant considerations for all comments will include recurrent revenue productivity, revenue productivity that is less sensitive to economic cycles, the burden placed on the economy, the impact (if any) on the development of electronic commerce, cost-effectiveness in administration and compliance, and equity.

Timeframe for Submissions

27. Submissions from the all interested parties should reach the *Advisory Committee* before 6 October 2001.

Getting Your Message to the Committee

28. Written submissions may be made by mail or e-mail. The *Advisory Committee* may be contacted as follows -

Mail: Advisory Committee on New Broad-based Taxes
4th Floor, Main Wing
Central Government Offices
Lower Albert Road
Central
Hong Kong

E-mail: consultation@fb.gov.hk

Telephone Enquiries: 2810 2526

Annex A

Advisory Committee on New Broad-based Taxes
Membership

Chairman

Mr Moses CHENG Mo-chi, JP

Members

Mr Marshall H BYRES

Professor Leonard K CHENG

Professor Nelson CHOW Wing-sun

Mrs LEE WONG Pui-ling, Angelina, JP

Miss LUI Wai-yu, Paddy

Mr Tim T L LUI, JP

Mr Roger LUK Koon-hoo, JP

Mr Michael OLESNICKY

Mr Michael TIEN Puk-sun, BBS, JP

Ms TING Yuk-chee, Christina, BBS, JP

Dr Michael TSUI Fuk-sun

Mr WONG Ying-wai, Wilfred

Miss Denise YUE, GBS, JP, Secretary for the Treasury

Mrs Alice LAU, JP, Acting Commissioner of Inland Revenue

Mr K Y TANG, JP, Government Economist

Annex B

Advisory Committee on New Broad-based Taxes
Terms of Reference

Under the principle of maintaining a low and simple taxation regime and preserving Hong Kong's competitiveness,

(a) to consider what types of broad-based taxes (including consumption-related taxes) may be suitable for introduction in Hong Kong, taking into account the following considerations:

+ revenue productivity on a recurrent basis
+ revenue productivity less sensitive to economic cycles
+ the burden on the economy
+ the impact of the development of electronic commerce
+ cost-effective to administer
+ simple to comply with
+ equitable

(b) in the light of the findings at (a) above, to advise on the implementation of the identified specific broad-based taxes

(c) to solicit views from the Legislative Council, the community at large and interested parties

(d) to submit to the Financial Secretary a progress report by November 2000 and the final report by the end of 2001.

Annex C

Executive Summary of the Tax Base Study

1 Executive Summary

This is a study by KPMG into the nature of Hong Kong's tax base with particular reference to whether that tax base is narrow and/or is shrinking. The study compares Hong Kong's tax base with that of other developed jurisdictions, and identifies options for reform to broaden the tax base in the context of the deliberations of the Advisory Committee on New Broad-based Taxes.

The reform options to broaden the tax base are discussed in the context of three broad revenue scenarios, which KPMG has been requested to consider, i.e.

(i) where the additional revenue to be raised is in the region of 1% to 2% of GDP;

(ii) where the additional revenue to be raised is in the region of under 1% of GDP; and

(iii) where there is no need to raise additional revenue but options could be considered to broaden the tax base.

1.1 International comparison - is Hong Kong's tax base 'narrow' ?

KPMG was asked to assess the nature of the tax base of Hong Kong in comparison with other developed countries. To examine whether or not Hong Kong's tax base is "narrow", the study (at the macro level) compares the sources of Hong Kong's tax revenue with selected countries, and then compares these source components. The purpose is to determine the neutrality, incidence, reliability and nature of Hong Kong's tax base.

At the macro level, the study uses two "averages" for international benchmark comparative purposes. These are:

- the average of OECD member countries; and
- the average of Asia Pacific members of OECD (Australia, Canada, Japan, Korea, Mexico, USA and New Zealand) plus Hong Kong and Singapore.

In its closer study of the component features, a smaller number of jurisdictions were used – Australia, Canada, New Zealand, Korea, Ireland and Singapore. The authors explain these choices for comparison.

A tax base will be "narrow" if it is not sufficiently broad to protect the revenue from distortions and/or discriminatory effects of taxation on one form of economic activity as opposed to another; and/or if there is inadequate revenue for the purposes required. A government may be limited in its ability to raise revenue to reflect growth in the economy because the "taxed" sector is too small and is unable to meet the additional demands on it.

Key international comparisons revealed by the study are:

- Hong Kong is the lowest taxation jurisdiction of the comparative group, when total tax revenue as a percentage of GDP is examined. Its nearest comparisons are Singapore and Mexico. On this measure, its tax levels are significantly lower than the Asia Pacific and OECD averages.
- Hong Kong is more reliant on taxation from property, personal income and corporate profits than the OECD or Asia Pacific averages, but its tax levels are below the averages of these groups. It has an outstandingly low reliance on taxes from goods and services.
- Hong Kong's reliance on tax revenue from income and property is considerably higher than the equivalent proportion of revenue on either comparison.
- Hong Kong derives 27% of its tax revenue from personal income - equal to the OECD average but 4% lower than the Asia Pacific benchmark.
- Hong Kong has a noticeably heavy reliance on taxation from corporate income ("profits tax"). As a percentage (32%) of tax revenue, Hong Kong's reliance on corporate income tax is three and half times that of the OECD average (9%) but closer to that of the Asia-Pacific average (29%).
- Taxation from property (rates, stamp duties on real property and shares and estate duty) in Hong Kong is above the international benchmarks as a percentage of GDP, and significantly higher than each of the benchmarks as a percentage of total taxation (24%, against 5% for the OECD benchmark and 10% for the Asia-Pacific benchmark).
- Hong Kong has a very low reliance on taxation from goods and services, and virtually no reliance on general consumption taxes. The OECD countries on average raise 18% of tax revenue from general consumption taxes, and 12% from specific goods and services taxes, while on average the Asia-Pacific benchmark countries raise 12% from general consumption taxes and 16% from specific goods and services taxes.
- Hong Kong derives a significant proportion of its total revenue (approaching half) from non-taxation sources – substantially above international 'norms'. This revenue is derived substantially from land sales and earnings from the investment of accumulated Budget surpluses.

Hong Kong is a low tax jurisdiction, with a narrow tax base that is heavily reliant upon a limited range of taxes. It is therefore neither as neutral nor as reliable as the taxation systems in the comparison jurisdictions.

The study also noted that:

- Hong Kong, at 16%, is at the lowest end of the corporate tax rate range, against an average of 30% and a high (Canada) of 45%; and
- Hong Kong, at 17%, is also at the lowest end of the range of top marginal tax rates on individual income.

However, the average Hong Kong wage or salary earner is not a taxpayer at all – personal allowances have the effect of reducing their tax to nil. The effective average tax rate in the comparative jurisdictions is 20%. Because only a minority of potential taxpayers in Hong Kong are in fact taxpayers, Hong Kong is dependent on a small proportion of taxpayers for most of this tax type. A typical Hong Kong family (2 adults – 1 working, 2 dependent children) would pay a much higher level of, and a broader range of taxes in, other representative jurisdictions.

International trends

While personal income tax remains the largest source of taxation revenue in the OECD, the international trend is towards lower reliance on this form of taxation. To the extent Hong Kong levies those taxes, it has been broadly consistent with the other trends noted, which were:

- Corporate income taxation has remained relatively steady as a proportion of taxation revenue for the past 20 years in the OECD.
- Social security and payroll taxes have increased in proportion.
- Tax on property’s share has gradually fallen in significance in the past 25 years.

General consumption taxes have risen significantly over the past 25 years – the only major source of taxation revenue to show continuing strong growth in the 1990s. As Hong Kong does not have this type of tax, it has been unable to follow this trend.

1.2 Tax reform options for Hong Kong

Benchmarked against other developed jurisdictions, Hong Kong has a narrow tax base, and the composition and trend of its taxation base is inconsistent with international practice. Hong Kong’s revenue is becoming increasely dependent on non-tax revenue, and its revenue base is becoming less robust, less balanced and less stable.

The options to broaden the tax base are discussed in the context of the three broad revenue scenarios, i.e.

(i) where the additional revenue to be raised is in the region of 1% to 2% of GDP;

(ii) where the additional revenue to be raised is in the region of under 1% of GDP; and

(iii) where there is no need to raise additional revenue but options could be considered to broaden the tax base.

Options discussed in the report for broadening the tax base are:

Reduce personal allowances. Hong Kong's personal income tax system includes comparatively generous allowances that have the effect of exempting many wage and salary earners from this tax base. Fewer than 40% of wage and salary earners actually pay salaries tax. A reduction in basic allowances [other than special concessionary allowances for elderly care, home loan interest and donations to charity] of 10% would raise $2 billion. A reduction of around 75% would be necessary to raise the revenue required in scenario (i), a smaller reduction of 50% could meet the requirements of scenario (ii).

Reducing personal allowances has only a marginal base broadening effect, as even a 50% reduction (scenario (ii)) raises 90% of its additional revenue from the existing salaries tax base of taxpayers. In other words, the existing tax base is simply contributing more revenue and would fail the "neutrality" test for options.

Expand the existing tax base. Hong Kong could seek to tax capital gains, as most developed jurisdictions do. However, such taxes are notoriously susceptible to economic swings, in particular stock and property market movements. In the short-term, if capital losses were taken into account, net tax revenue would be limited.

Hong Kong could reinstate a tax on interest. Because Hong Kong would only be able to tax interest earned in Hong Kong, this option would create an incentive for investors to seek interest earnings from outside of Hong Kong.

Dividends could be taxed. It is doubtful that such a tax would raise much, if any additional tax revenue.

Tax worldwide income. Overseas experience tends to indicate that taxing worldwide income adds complexity to the taxation system for business and yields very small tax revenue.

Hong Kong could *strengthen* the existing taxation of fringe benefits by either taxing benefits at their full value (eg, accommodation and holiday warrants) or *widen* the definition to include benefits that are not readily convertible into cash such as company cars, club memberships and non-business travel). This would broaden the tax base, but revenue benefits might be limited.

Hong Kong already has a departure tax for air departures, and this could be *expanded* to include land and sea departures. The revenue implications are modest, but it could be considered as part of a wider package of new tax measures [and is suggested to complement a GST].

All of these measures would deliver only very modest (if any) broadening of Hong Kong's tax base and could not meet the revenue requirements of scenarios (i) or (ii). These options fail the "revenue adequacy" aspect.

Introduce new taxes. There is no limit to the imagination on new taxes that could be introduced (eg, taxes on television sets or on mobile phone usage). But a broadly based indirect tax would be less discriminatory.

Social security or payroll taxes. These taxes would be an additional cost to employing labour or would add extra complexity to the salaries tax system. They are also inconsistent with other government policies, like the Mandatory Provident Fund (MPF) schemes.

Broad-based tax on general consumption. A single level sales tax or a multi-level consumption tax [Goods and Services Tax (GST) or Value Added Tax (VAT)] could be considered. The latter is the common international practice. A 3% GST in Hong Kong would yield an estimated $18 billion which is 1.5% of GDP. [A rate lower than 3% is not suggested based on international experience and the efficiency principle.]

The 3% GST is capable of meeting all revenue scenarios [with an excess of revenue to be used for other tax reductions or abolition], is supported by international benchmarks and recent tax reform experience, and meets the fundamental criteria of broadening the tax base.

The authors discuss in the report the advantages and disadvantages of such a tax, and find it would be the most appropriate to meet the objectives of the study.

The report presents a range of options that could be adopted in conjunction with the GST to form a reform package that would provide a broader tax base under each scenario.

Scenario 1 introduces a broad-based GST of 3%. The revenue raised meets the 1% to 2% of GDP required. Minimal if any excess revenue would be available. With the exception of expanding the departure tax to cover land and sea, no further tax measures are encompassed.

Scenario 2 introduces the 3% GST and provides excess revenue of at least $6 billion per year. Offsets available for the additional revenue are reduction of salaries tax rates by 3 percentage points, profits tax by 2 percentage points, reductions in rates, excises or other minor taxes, increase of personal allowances by 40%, abolition of stamp duty on securities or property, hotel and accommodation tax and estate duty, and/or expansion of government payments and tax rebates as ‘compensation’ for the GST. After these base broadening and offsetting adjustments, the additional revenue raised is approximately 1% of GDP.

Scenario 3 is the same as Scenario 2, but because revenue neutrality is the goal, reductions in the tax rates, abolitions of taxes, or government payments and tax rebates can be 3 times the revenue value, i.e. $18 billion of offsets compared to $6 billion. For example, all salaries tax rates could be reduced by 8 percentage points [eliminating the two bottom rates], profits tax rate could be reduced by 7 percentage points, property rates could be abolished [although not recommended] and stamp duty on both shares and property could be abolished as well as some other tax reduction measures.

1.3 Conclusion and recommendations

- Hong Kong's tax base is narrow in comparison to other developed jurisdictions.
- Hong Kong's tax base in narrow in composition.
- Hong Kong is the only developed economy that does not have any form of general consumption tax. The overseas trend is towards a greater reliance on consumption taxes and less reliance on taxes on income and property.
- Hong Kong's tax base is heading in the opposite direction to the overseas trend.

Hong Kong needs to broaden its tax base. The most obvious areas to be addressed are taxes on personal income and/or general consumption.

The most preferred tax measures need to provide a sustainable, robust and growing tax base.

- A new broad-based consumption tax, even with a low rate of 3%, is the most appropriate option to consider. It would broaden the tax base, consistent with overseas trends and benchmarks; address any of the revenue scenarios without jeopardising Hong Kong's low-tax status and international competitiveness; and provide a sustainable tax base into the future. It is the only option that provides a comprehensive solution to all of the issues covered by this tax study as set out in the study brief.
- Without the inclusion of a GST, it is almost impossible to develop an options package that can both address the three revenue Scenarios and meaningfully broaden the tax base, while at the same time being consistent with good tax design principles.
- Because a 3% GST will raise more revenue than that contemplated in Scenarios (ii) and (iii), the study identified options for the Advisory Committee that can offset any excess revenue [while still being consistent with the overarching objective of tax base broadening]. For the 1% to 2% of GDP revenue Scenario (i), the 3% GST alone and without major offset will suffice.

The Advisory Committee should consider seriously the option of recommending the introduction of a low rate broad-based consumption tax.

(The full report of the tax base study is downloadable from the website www.info.gov.hk/fb/ac/index.htm.)

Annex D

What is a Goods and Services Tax

BACKGROUND

Modern taxes on general consumption are mainly referred to as a goods and services tax (GST) in the Asia-Pacific region or a value-added tax (VAT) in Europe. GST and VAT are the same tax under different banners. Because of their underlying nature, they are only imposed on private consumption. Within the OECD, the United States is the only member country without a federal level GST-type tax on consumer expenditure, although it has a wide range of state or local taxes on consumption. In Asia-Pacific, the major economies that levy GST include Australia, New Zealand, Canada, Japan, Singapore, Taiwan, Philippines and Thailand.

ESSENTIALS OF GST

2. The two main features of a GST are that it applies to virtually all consumption of goods and services and that it is a tax paid by the final consumer. GST is levied on all consumption using the multi-level approach. Notwithstanding GST is ultimately paid by the final consumer, it is collected at every stage of production and distribution chain because each vendor accounts for the tax on the value that has been added to the goods and services. Every party charges GST on its sales and claims credits for all tax paid on its purchases. Although intermediate purchasers of goods and services pay GST, the GST paid is refunded under a tax credit mechanism and the total burden passed to the final consumer.

3. The following table sets out a simple example to illustrate the application of a GST at the various stages of production and distribution of a can of preserved vegetables. For simplicity only, a GST rate of 10% has been assumed -

	Purchase			**Sale**			**GST**
	Price Paid (a)	GST (b)	Total (c)	Price Charged (d)	GST (e)	Total (f)	GST Paid (e) minus (b)
Gardener				10	1	11	1
Cannery	10	1	11	40	4	44	3
Wholesaler	40	4	44	60	6	66	2
Retailer	60	6	66	90	9	99	3
Consumer	90	**9**	99				
Total GST		**9**					**9**

4. GST is based on the concept of "taxable supplies". Every person who makes taxable supplies which, in aggregate, exceed a specified sum must be registered for GST. Exempt items and zero-rated items (see paragraph 9) are not taxable supplies. Suppliers whose taxable supplies do not exceed the registration threshold are not required to register. GST tax credits can only be claimed by registered persons.

5. With a GST, part of the tax burden is shifted away from income and on to spending. GST's comprehensive nature means that everyone is affected and everyone pays. The relative transparency of GST results in the tax being reasonably immune from evasion and the broadness of its coverage results in persons not required to pay tax on their income having to pay GST when purchasing goods and services.

ADMINISTRATION AND COMPLIANCE

6. GST is a self-assessment tax and taxpayers must voluntarily comply with the legislation. There is a close correlation between the costs of compliance and the underlying simplicity of the tax. Where multiple tax rates and numerous exemptions exist, compliance is burdensome and more costly to business. A complex GST system increases administrative costs and is incompatible with a low GST rate regime.

CONSIDERATIONS FAVOURING A GST

7. Assessed against the *Advisory Committee's* Terms of Reference, a GST is less sensitive to adverse movements in economic cycles as compared with earnings and profits taxes. With a broad coverage and a single rate, it is administratively cost-effective. Experiences in other jurisdictions indicate that when registration thresholds are high, the administrative and compliance costs are not significant. GST is arguably an equitable tax as one pays it only when one consumes.

IMF RECOMMENDATION FOR A GST

8. The Fiscal Affairs Department of the International Monetary Fund (IMF) visited Hong Kong in 2000 to assess the feasibility of implementing a GST in Hong Kong. It concluded that GST is feasible and recommended a GST that would –

- contain few zero ratings, exemptions and special concessions;
- have a low single rate in the range of 3-5 percent; and
- have a high registration threshold to minimise the number of businesses required to register.

9. The key features of the IMF's design recommendations for zero-rated items, exemptions from GST and special concession provisions follow accepted practices adopted elsewhere. They are –

- zero-rated items
  - exports (including international transportation)
  - financial services (other than services consumed domestically for which explicit fees are charged)

- exempt items
  - residential rents
  - sales of residential property (other than newly constructed residential properties)

- small business concession
  - high GST registration threshold for small businesses
  - optional registration for GST available for small businesses (businesses whose annual turnovers fall below the registration threshold)

- tourist refund scheme
  - GST refunds available to tourists for goods purchased in Hong Kong and taken overseas when they depart (goods exported from Hong Kong).

A copy of the Executive Summary of the IMF's report is attached as the Appendix. The full report is available from the *Advisory Committee's* website at www.info.gov.hk/fb/ac/index.htm.

Appendix to Annex D

Executive Summary of the IMF's Report

Hong Kong SAR has one of the lowest overall tax burdens in the world and its tax base is remarkably narrow by any standard. Indeed, it is the only major territory in the Asian and Pacific region that does not have some form of a broad-based tax on consumption. However, none of these facts, in and of itself, constitutes a sufficient basis for introducing a new tax in the territory, broad-based or otherwise. Therefore, the mission welcomes the fact that the impetus for considering a broad-based consumption tax in Hong Kong SAR has arisen not based on any of these facts, but in the context of assessing the necessity of meeting possibly rising revenue needs that are of a structural nature with minimum distortions, and obtaining a more cyclically stable tax base than the present one.

The focus of the present report is not on whether Hong Kong SAR should or should not introduce a broad-based consumption tax—that decision will presumably be made by the authorities after the release of the findings, expected by end-2001, of the recently formed task force charged with the responsibility of looking into the existence of any structural budget deficits in the territory. The report's focus is, instead, on issues that are largely technical in nature. Specifically, it addresses policy issues related to the design, and administrative issues related to the implementation, of a broad-based consumption tax in Hong Kong SAR—should an eventual decision be taken to introduce it.

Given sufficient preparation time and the necessary administrative resources, almost any country—let alone a territory of Hong Kong SAR's level of economic development—can introduce a broad-based consumption tax. Nevertheless, introducing such a tax in Hong Kong SAR does pose formidable administrative challenges. (It may also pose political challenges, about which the mission does not have the competence to render an informed assessment.) Most notably, effective controls over cross-border flows of goods are currently lacking on account of Hong Kong SAR's status as a free port; and key revenue departments (i.e., the Customs and Excise Department (CED) and the Inland Revenue Department (IRD)) have no experience in administering broad-based consumption taxes. Overcoming these challenges would require the political will to reorient the mode and focus of the operations of both the CED and the IRD in a fundamental way, as well as careful and advance planning to execute such a change.

In considering broad-based consumption taxation, it is the mission's understanding that the authorities have in mind a goods and services tax (GST), otherwise known as a value-added tax, of the credit-invoice type—this being the overwhelmingly dominant practice around the world and that Hong Kong SAR has little desire to deviate from the international norm. Furthermore, in keeping with the authorities' commitment to safeguard Hong Kong SAR's competitiveness in part by keeping its tax system simple and tax burden low, the mission takes as given that the prospective GST in the territory—if introduced—would: (1) contain few exemptions, zero ratings, and special concessions; and (2) have a low single rate, presumably in the range of 3–5 percent (a rate below 3 percent could raise questions about the cost-effectiveness of introducing a GST at all). It is worth underscoring that administrative and compliance costs could rise significantly if the design of the GST were to deviate materially from these two attributes.

Policy issues

Issues of GST design are by now quite familiar, as a large number of countries have already implemented it with minor variations. Nevertheless, the mission has singled out four issues for the authorities' special attention, on account of their particular relevance to Hong Kong SAR's circumstances.

- **Destination vs. origin principle.** Almost all countries that have a GST implement it on the basis of the destination principle (i.e., imports are taxed but exports are zero-rated). Clearly, applying such a principle requires carrying out border tax adjustments and, therefore, effective border controls—which Hong Kong SAR does not, as noted earlier, currently have. An alternative would be to implement the GST on an origin basis, taxing exports but exempting imports. While not requiring border tax adjustments, the origin principle has some major disadvantages, most notably exports will bear the GST burden, which could hardly bode well for maintaining Hong Kong SAR's competitiveness (in view of Hong Kong SAR's linked exchange rate). Other problems associated with the origin principle include import and export valuation, as well as transfer pricing issues. On balance, the mission is of the view that a destination-based GST would be in the best long-run interest of the territory, and efforts should be directed to securing effective border controls.
- **Treatment of financial services.** Financial services pose some of the most difficult problems for a GST, because they are often rendered with no explicit charges. Since such services play an important role in Hong Kong SAR's economy and face a highly competitive environment in the region, care should be given to how they are to be treated under the GST. The mission advises that Hong Kong SAR should consider adopting one of two possible approaches. It could follow Singapore's approach, which taxes most financial services for which explicit fees are charged (except those exported), and exempts all others. To reduce cascading when financial services are purchased by taxable businesses as inputs, financial institutions—notwithstanding the fact that most of their outputs are exempt—are nevertheless allowed to recover a substantial proportion of the GST they paid on their purchases. As an alternative, Hong Kong SAR could take Singapore's approach one step further and allow financial institutions to recover their input tax fully, thus eliminating cascading completely. The mission has estimated that the revenue consequence of taking the latter approach, relative to Singapore's, is of only marginal significance. Either approach is conceptually superior, and administratively simpler to adopt, than the European Union's (EU) approach of exemption with no recovery of input tax allowed.
- **Treatment of immovable properties.** The importance of the real estate sector in Hong Kong SAR's economy also necessitates a careful consideration of its GST treatment. The approach favored by the mission can be stated in fairly simple terms. The sale and use of commercial properties, whether new or existing, should be fully taxable. This will not impose a burden on taxable businesses, since the GST so paid by them on such transactions is recoverable. Rental payments on residential properties should be exempt to avoid creating a distortion between rental and owner-occupied housing. However, the sale of new residential properties supplied by the private market should be taxed—which tax could be considered as imposed on the stream of future housing services provided by the properties. The above approach is one that is broadly followed by most countries in the region, but stands in contrast to the EU's approach, which largely exempts the sale and use of immovable properties, commercial or residential.

- **Treatment of small businesses.** Given the great number of small businesses in Hong Kong SAR, the success of introducing a GST in the territory hinges crucially on setting a small business exemption threshold specified in terms of annual turnover. Businesses whose annual turnover is below the threshold are not required—but could optionally elect—to be registered. This approach, which is almost a universal practice, reduces substantially the administrative and compliance costs of the GST at relatively minor revenue costs. This is so because small businesses, though large in number, collectively contribute relatively little to an economy's total value-added. Moreover, those who are exempt because of the threshold still pay tax on their purchases. Industry survey data on the distribution profile of business establishments by annual turnover indicate that the appropriate threshold in Hong Kong SAR would most likely be between HK$1 million and HK$5 million. More detailed data are required, however, to set the exact level of the threshold.

The mission has calculated that, based on available national income accounts data and CPI basket weights, a broad-based GST would have a base of about 38 percent of Hong Kong SAR's GDP and produce only a moderate price impact—provided that the GST rate is low. These estimates are, however, largely indicative in nature; they should, therefore, be used with caution.

Administrative issues

The typical timeframe for introducing a GST in a developed economy is around two years from the date a decision to implement the tax is taken. For Hong Kong SAR, however, given its present limitations with customs and tax administrations, as noted earlier, the necessary timeframe could stretch to three years. Since the decision on the GST is still far into the future, the present report does not address the details of GST implementation; rather, it focuses on contingency planning for both the CED and the IRD—identifying tasks that each of these departments can usefully do now in anticipation of a possible eventual affirmative GST decision. The mission suggests that the authorities consider requesting further technical assistance from the Fund, if and when such a need arises after the decision to introduce the GST is made.

- **Planning focus for the CED.** An essential first step for the CED to establish an acceptable border control environment in Hong Kong SAR would be to implement with some urgency a number of recommendations put forward by a recently completed consultancy study on customs cargo clearance requirements and services. These recommendations have to do with ensuring that the CED has timely information on the movements of goods into and out of the territory through early lodging requirements of cargo manifests, and securing better physical control of public cargo working areas, especially with respect to river trading vessels. While this step alone is not sufficient to support the effective collection of GST at the borders, it would provide a strong platform for the CED to effect further necessary changes with the advent of the GST.

- **Planning focus for the IRD.** The contingency tasks that the IRD should perform are more varied, including: (1) developing and maintaining a database—including a review of the adequacy of the present system of taxpayer identification numbers—that would capture more complete information on active businesses than is available now to better ascertain the potential GST taxpayer population and set the exemption threshold, and to facilitate information exchange between the IRD and the CED; (2) accelerating the shift to a full self-assessment system; (3) developing shorter and more targeted audits, upgrading the skills of field inspection staff, and promoting a culture of field checks at business premises that the IRD does not currently have; (4) maintaining a strong focus on improving business record-keeping standards and practices; and (5) enhancing the consultation process between the IRD and relevant private-sector business and professional groups to identify and resolve existing and/or potential tax issues in a cooperative environment. Undertaking these tasks in a timely manner would place the IRD in a better position than it is now to begin preparation for the GST's introduction.