Annex F

A GOODS AND SERVICES TAX FOR HONG KONG

Background

Goods and services taxes (GST) are also known as value added taxes (VAT) and (sometimes) sales taxes. GST and VAT are the same tax under different banners. They are taxes charged on the consumption (or spending) and not on income earned. Because of their underlying natures, they ultimately impact only on private consumption. Businesses are entitled to a refund (usually by way of a credit against GST collected on sales) for any GST paid in respect of goods and services consumed by the business. The principal feature distinguishing GST from other retail and wholesale sales taxes is that it is imposed on the net value added to the good or service at every stage in the economic life cycle of that good or service. This is in contrast with single level taxes that are imposed once only, at either the manufacturing, production, wholesale distribution or retail sales stage. Furthermore, whilst GST applies to services generally, sales taxes often only apply to a limited range of services.

2. Single-stage sales taxes have now been replaced in most developed jurisdictions. There are a number of forces driving these decisions but one of significance is the cascading effect of single-stage taxes. When they are imposed at a point earlier than the point of sale of the goods or services to the end user, they may have a cascading effect on downstream costs if subsequent profit mark-ups are applied to the cost of the goods and the sales tax paid. This increases costs and reduces international competitiveness. Within the OECD, the United States is the only member without a federal GST-type tax on consumer expenditure. In the Asia Pacific region, the major economies that levy GST include the Mainland, Australia, New Zealand, Japan, Singapore, Taiwan, Indonesia, Philippines and Thailand.

Essentials of GST

3. The two principal features of a broadly-based GST are that the tax applies to virtually all domestic consumption of goods and services and that it is a tax paid by the final consumer. GST is collected at each stage of the chain of production and distribution. Each party accounts for the tax on the value that has been added to the goods and services. Every party charges GST on its outputs (output tax), but can claim credits for all tax paid on the goods and services when received (input tax). Although intermediate purchasers of goods and services pay GST, because of the credit-offset mechanism, the final and total burden of the GST is paid for only by the final consumer. There is no cascading of the tax.

4. GST is based on the concept of "taxable supplies". Every person making taxable supplies exceeding a legislatively specified sum or engaged in certain business must be registered for GST. For those suppliers whose taxable supplies do not exceed the registration threshold, registration is not mandatory but GST input credits can only be claimed if a business is registered. Many jurisdictions allow a system of voluntary registrations for businesses below the statutory thresholds.

5. In most OECD countries, the compulsory registration limits are quite low. In contrast, Singapore's registration limit is set at SGD1 million (approximately equal to HK$4.3 million) turnover per annum. The Singapore model ensures that only large businesses, which have proper accounting systems, are required to register. The rate of GST in Singapore is only 3% and the minor competitive GST advantage gained by small businesses is arguably offset, for larger businesses, by economies of scale. If the registration limit for Hong Kong is set at HK$5 million, it is estimated that 50,700 businesses will need to register for GST based on March 2001 statistics. They represent 25% of all business filing tax returns in 1999-2000 or 8% of all entities with business registration, i.e. including dormant business or shelf companies.

6. Under GST, the tax burden is shifted away from income and savings to spending. GST's comprehensive nature means that everyone is affected and everyone pays. Certain governments have come under enormous pressure from those seeking exceptions to be made for particular industries and certain categories of consumption. This has proved to be of problematic benefit because selective exemptions drive up compliance and administrative costs. In terms of design, GST should be kept simple. By keeping it broadly-based and, where tax is payable, charging it at a single rate, GST provides certainty and minimises costs for business. Furthermore, simplicity results in the tax being relatively watertight because the scope for leakage is reduced. Those taxpayers who are able to successfully reorganise their affairs to reduce or eliminate their income tax liabilities are not able to do likewise when it comes to purchasing goods and services.

GST Rates

7. The rates of GST applied in selected jurisdictions are set out in Appendix A. Within the OECD, there are many differences in national GST systems. Some member states apply reduced rates, exemptions and numerous special arrangements to meet particular policy demands. At the opposite end of the spectrum, New Zealand and Singapore are examples of jurisdictions that have successfully implemented a single rate GST with very few exceptions.

Appendix A

8. Notwithstanding the general rule that GST should be wide-ranging in its application, the international norm is to zero-rate or exempt certain categories of supply. When goods are zero-rated, credits can be claimed for the input taxes because although GST is technically payable at the final consumption stage, its rate is set at 0%. In a simple system, usually only exports (including exports of purchases by tourists) are zero-rated. The zero-rating of exports reflects the fact that the intended tax base of GST is domestic consumption. Other services that are zero-rated, because the consumption technically does not take place in the jurisdiction of supply, include international transportation, services supplied in connection with land and buildings situated outside the jurisdiction concerned, and the like. Singapore has a formula for (effectively) zero-rating a significant part of the costs of financial services. As regards goods bought by tourists for consumption outside the jurisdiction, the GST is invariably paid at the time of purchase and subsequently refunded at the point of international departure upon proof that the goods are being exported.

9. Where goods or services are exempt from GST, no tax is charged by the vendor on the consumption but the vendor cannot claim credits for GST paid at the input stage. Internationally, the treatment of financial services, e.g. normal bank dealings that are not zero-rated, is not yet settled. In many cases though, financial services are exempted from GST because of competition in the international market place.

Administration and Compliance

10. GST is a self-assessment tax. It relies on taxpayers voluntarily complying with the legislation. Experience elsewhere suggests that while compliance costs differ between economic sectors, there is a close correlation between the costs of compliance and the underlying simplicity of the tax. With multiple tax rates and numerous exemptions, compliance becomes burdensome. For larger businesses especially, the compliance burden largely entails a one-off conversion of the accounting and information systems. Cash flow benefits, because businesses collect GST and remit the net proceeds to government only at the end of the tax period, may lessen the burden on an ongoing basis.

11. For taxation authorities, complex GST regimes increase staffing costs. It is estimated that if a simple GST system is implemented in Hong Kong, it is likely to entail administrative costs that are proportional to the key taxes currently levied.

Economic Impact

12. The experience elsewhere is that implementation of a GST tends to impact adversely on the economy in the short term. This is particularly the case in respect of inflation and consumption. Regarding inflation, the commencement of a GST normally causes a one-off upward shift in the inflation rate. This increase, however, is less than the GST rate itself and the actual extent of the increase will depend upon the prevailing economic situation within the economy concerned and the rate of the GST. As regards consumption, the short-term impact has been not dissimilar to that of inflation. It depends on the prevailing economic climate, the GST rate and the reaction of businesses and consumers to the GST. In general, a lower GST rate would be easier for the economy to absorb and help minimise the short-term negative economic effects. Over the longer term, once the GST has been "bedded down", it is generally regarded as not having any lasting negative impact.

Compensations

13. Most jurisdictions that have introduced a GST previously had a range of consumption taxes in place. GST has invariably been introduced as an integral part of a wider package of tax reforms - most notably the replacement of wholesale sales tax and duties. Often the overall objective of implementing a GST was not to increase government revenue per se, but to re-balance the tax system to make it more equitable. The GST revenue generated was applied to replacing revenue forgone from the previous consumption taxes, financing income tax reductions and funding compensatory payments. In the Hong Kong context, the *Advisory Committee* is cognizant of the fact that there is no sales tax to replace. The scope for tax reductions in other areas will depend on the then prevailing fiscal situation.

14. One of the key aspects of GST highlighted by the public consultation is its perceived regressivity. Exemptions from the tax for daily necessities may reduce the regressivity factor and are granted in some jurisdictions. However, there is no universally accepted definition or schedule of what items are necessities. Experience overseas is that granting exemptions for selective items undermine the tax net and exert pressure on the GST rate itself if revenue productivity is to be maintained. A New Zealand study on the distribution of the benefits of exempting basic food from GST concluded that to do so would pass a disproportionate part of the benefit to the better off within the community. Further, economic neutrality is impaired and compliance and administrative costs increased.

15. The Advisory Committee believes that directly targeted compensation arrangements, such as increases in CSSA payments to fully cover the adverse impact of GST on eligible families, should be considered as the preferred option for redressing regressivity rather than arbitrarily excluding selected goods and services from the GST net. A large group of persons exist who are not eligible for CSSA payments but do not earn incomes at levels that attract a liability to salaries tax. The Advisory Committee recommends that if GST is introduced, the Government should also consider suitable compensation arrangements to be targeted at this group of persons.

Appendix A to Annex F

CURRENT RATES OF GST IN SELECTED ECONOMIES

Country	Reduced Rate(s) (%)	Standard Rate(s) (%)	Higher Rate(s) (%)
Australia	-	10	-
Austria	10/12	20	-
Belgium	0/1/6/12	21	-
Canada	0	7/15	-
Czech Republic	5	22	-
Denmark	-	25	-
Finland	8/17	22	-
France	2.1/5.5	20.6	-
Germany	7	16	-
Greece	4/8	18	-
Hungary	0/12	25	-
Iceland	14	24.5	-
Ireland	0/3.3/10/12.5	21	-
Italy	4/10	20	-
Japan	-	5	-
Korea	-	10	-
Luxembourg	3/6/12	15	-
Mexico	0/10	15	-
Netherlands	6	17.5	-
New Zealand	-	12.5	-
Norway	0	23	-
Philippines	-	10	-
Portugal	5/12	17	-
Singapore	0	3	-
Spain	4/7	16	-
Sweden	0/6/12	25	-
Switzerland	2/3	6.5	-
Taiwan	-	5	-
Thailand	-	7	-
Turkey	1/8	15	23/40
United Kingdom	0/2.5/5	17.5	-