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Annex C

HONG KONG GOVERNMENT

Tax Base Study
KPMG Consultancy Study for the Advisory Committee on New Broad-based Taxes

July 2001

This Report is prepared by KPMG Australia, in conjunction with KPMG Hong Kong, for the Advisory Committee on New Broad-based Taxes for the Finance Bureau of the Government of Hong Kong Special Administrative Regime.

The views expressed in the Report are those of the authors only.

The Report is proposed for the purposes of further consultation on public policy discussion and is not intended for any other purpose. No warranties or guarantees are given for reliance by others on the Report, its contents, findings or recommendations.

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KPMG Australia

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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 increasingly 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 is 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.

2 Objective of the Tax Study

This study assesses the nature of the tax base of Hong Kong, in comparison with other developed jurisdictions. Particular reference is to be made to whether Hong Kong's tax base is narrow and/or shrinking. The study identifies options for reform to broaden the tax base in the context of the deliberations of the Advisory Committee on New Broad-based Taxes.

To achieve the objectives of the Study the following Study Tasks are undertaken:

- to assess the nature of the tax base of Hong Kong in comparison with other developed jurisdictions, with particular reference to whether it is narrow compared to international benchmarks;

- to identify, for further consultation, reform options, in the context of recent international experience; to broaden the tax base for 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; and

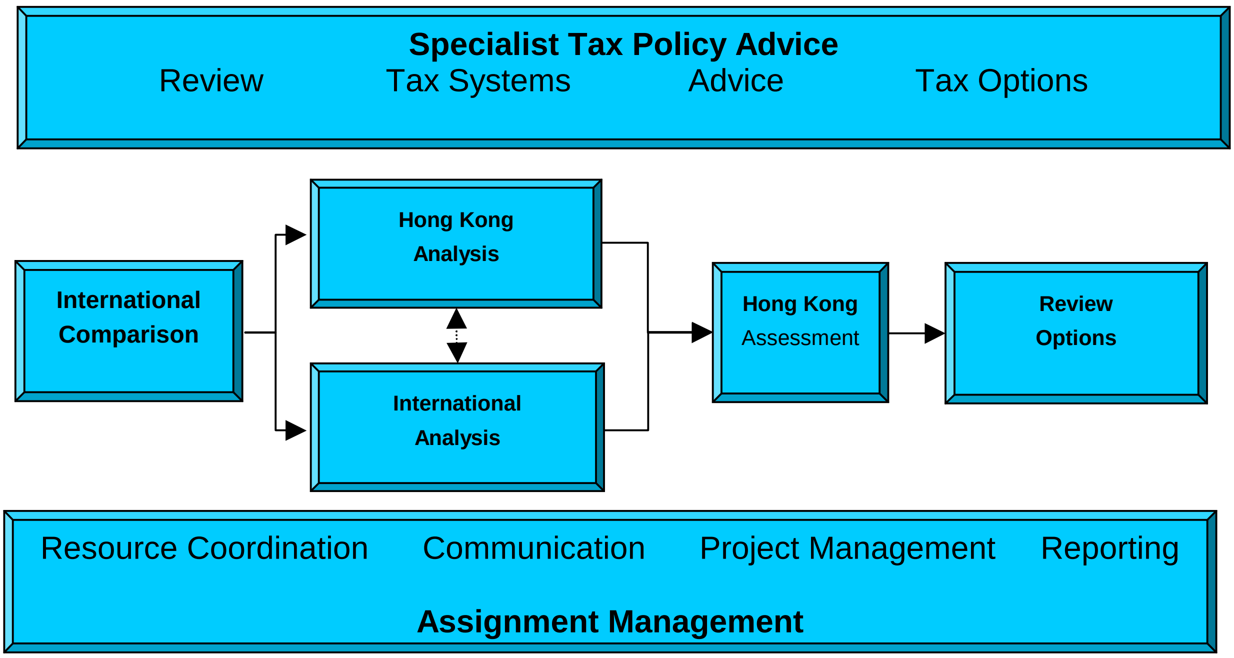
- to present the conclusions and recommendations of the study to the Advisory Committee on New Broad-based Taxes.

3 Approach of the Tax Study

To meet the purpose of the study, as defined in the Objectives in Chapter 2, we have adopted a tailored approach that comprises the following steps:

- Survey of international taxation system characteristics and trends to derive international benchmarks;
- Analysis of the existing Hong Kong taxation system;
- Assessment of the taxation system in Hong Kong as compared to other developed economies, using international benchmarks;
- Review of recent overseas taxation reform experiences;
- Development and consideration of Options for taxation reform in Hong Kong; and
- Summary of conclusions and recommendations for the Advisory Committee's consideration to go forward.

We have depicted this methodology graphically as follows, together with an overview of the procedures we will adopt:



To achieve the Objectives of the Study, we have undertaken the following activities:

Study Tasks	**Approach**	**Reference to Report**
Define what is a "narrow tax base". By comparing Hong Kong tax base to international benchmarks	International comparison to derive international benchmarks Selected economies comparison to derive international benchmarks Test Hong Kong against international benchmarks	Chapter 5
Tax Reform Options	Hong Kong specific tax reform options to address nominated scenarios, that is: (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	Chapter 6
Recommendations to the Advisory Committee on New Broad-based Taxes	Conclusions and Recommendations	Chapter 7

The study has followed the sequence of study brief tasks and assigned a chapter to each task. Before undertaking the study tasks, however, a set of internationally recognised tax principles is introduced in Chapter 4.

These tax principles can then be applied and referenced throughout the study to provide a consistent and coherent framework for assessment, analysis and recommendations.

Each of the study task analysis and assessment chapters above (i.e. 5 and 6) includes a discussion of its purpose and the approach adopted. Within each of these chapters a summary or findings has been included. Chapter 7, Conclusions and Recommendations, summarises the findings from all the prior Chapters and the recommendations that are drawn from those conclusions for the Advisory Committee's consideration.

Notwithstanding the study brief's requirement to consider many issues in the international context, the overwhelming consideration to issues, implications and solutions has been the specific and unique circumstances of the Hong Kong Special Administrative Region.

4 Principles of Tax System design

To make objective assessments about a tax system and to propose options for reform, it is important to establish good tax system design principles. These internationally recognised principles provide sound criteria for this study.

A solid understanding of the foundation upon which good design principles are based is the key to success in implementing the taxation system with the core features that are desirable for Hong Kong. In addition to the three core internationally recognised 'key principles', the 'additional principles' used for consideration during this study have been included to focus the study on principles of utmost concern to the Advisory Committee's terms of reference and Hong Kong's Basic Law.

The design of taxation can reflect a wide range of economic, social, political, cultural and historical factors.

4.1.1 Adam Smith

Adam Smith in his groundbreaking "Wealth of Nations" in 1776 defined four traditional criteria of a good tax system:

- equality (equity);
- economy of collection (efficiency);
- transparency and predictability (certainty); and
- convenience of payment (simplicity).

These criteria have been evolved into the key principles of a tax system design. The third and fourth criteria above, which relate essentially to administrative criteria, have been considered together as one principle below.

4.1.2 OECD

The Organisation for Economic Co-operation and Development ("the OECD") in its recent deliberations on electronic commerce[1], outlined the broad taxation principles that it believed should apply:

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[1] (Source: OECD Committee on Fiscal Affairs discussion paper Electronic Commerce: a Discussion Paper on Taxation Issues (17-Sep-1998)

(a) ***Neutrality*** — Taxation should seek to be neutral and equitable between forms of [electronic commerce and between conventional and electronic forms of] commerce. Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation.

(b) ***Efficiency*** — Compliance costs for taxpayers and administrative costs for the tax authorities should be minimised as far as possible.

(c) ***Certainty and simplicity*** — The tax rules should be clear and simple to understand so that taxpayers can anticipate the tax consequences in advance of a transaction, including knowing when, where and how the tax is to be accounted.

(d) ***Effectiveness and Fairness*** — Taxation should produce the right amount of tax at the right time. The potential for tax evasion and avoidance should be minimised while keeping counter-acting measures proportionate to the risks involved.

(e) ***Flexibility*** — The systems for the taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments.

The OECD principles of neutrality and effectiveness and fairness are often combined into a single principle of equity (vertical and horizontal), while its principle of 'flexibility' (which is of greater significance in an electronic commerce environment) is intertwined with a number of other principles below, most notably 'revenue adequacy'.

4.1.3 Advisory Committee Terms of Reference

The terms of reference of the Advisory Committee on New Broad-based Taxes (Appendix B), state with reference to "maintaining a low and simple taxation regime and preserving Hong Kong's competitiveness … 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; and

- equitable."

These considerations are reflected in the underlying principles to be considered throughout this study.

4.1.4 Balance of competing objectives

Taxation system design goes beyond packaging the most favourable features from other tax systems. A good tax system draws on the principles with the most important Government policy objectives. Ultimately any tax system will be a balance between the competing principles, e.g. equity v efficiency, revenue adequacy v compliance and economic growth.

4.2 Key principles

4.2.1 Equity and Neutrality

Taxation systems should aim to ensure that individuals or businesses in similar circumstances should be taxed in similar ways (horizontal equity or 'neutrality'). The extent to which taxation systems should also be based upon the ability of the taxpayers to pay (vertical equity), must be balanced against the need to provide incentives to retain and attract high value-adding individuals and businesses. A good tax system will fairly distribute the tax burden while also minimising disincentive effects such as discouraging people from working harder and investing available funds in a commercially focussed way. While there is considerable international economic debate about what is 'fair', it is difficult to have a 'fair' tax system if the tax base is 'narrow'.

A 'narrow tax base' (which will be discussed and described in greater detail in the next chapter) is generally characterised by a taxation system in which the incidence of taxation is borne by a limited sector of the economy; narrowness is typified when taxation applies only to a limited number of taxpayers or to a limited range of goods and services.

Neutrality is a key principle to avoid discriminatory or distortionary taxation. The principle that similar circumstances should be taxed in similar ways is important to avoid unfair or arbitrary discrimination between taxpayers. This principle is also important to prevent creating conditions through the taxation system that distort economic activity.

4.2.2 Efficiency

Taxation systems should aim to be efficient. Taxes affect the economic efficiency, and ultimately the living standards of a nation. Efficiency can be assessed by the effort required by governments to raise the required revenue. The lower the cost of administration by the government (for any given revenue), the more efficient the system. The lower the overall burden of taxation the lower the distortions of taxation on economic activity. While the broader the tax base, and the more comprehensive the tax system, the greater the efficiency for any given tax level.

Higher rates of taxation (and associated tax compliance) levied on a limited or narrow tax base provide greater incentives to make arrangements to minimise taxation, either through avoidance schemes or through the diversion of economic activity away from that sector of the economy thus reducing efficiency.

4.2.3 Simplicity and Certainty

Taxation systems should be based upon clear principles, reflected in legislation. Taxpayers should be able to understand simply and comply easily with their taxation obligations. There should be certainty for taxpayers, with uniformity and consistency in the application of the law. The costs of compliance and administration should be minimised where possible. Complexity of tax laws should be minimised or avoided where feasible.

It is possible to have taxation arrangements that meet the criteria of simplicity and certainty, while at the same time having a narrow tax base. For example, taxes levied on a narrow range of luxury goods might also satisfy the simplicity and certainty principles in their administration. However, such a narrow tax base can encourage substitutes or evasion through product re-definition or alteration and thereby undermine this principle. This will be especially so if such an approach becomes a major source of taxation revenue and the ‘incentive’ or opportunity to avoid tax becomes significant.

Transparent (i.e. visibly certain), single rate (i.e. simple), broad base taxes (i.e. certain), with minimal exemptions or concessions (i.e. simple) are generally the most likely to meet the principle of simplicity and certainty.

4.3 Additional principles

4.3.1 International competitiveness

A well-designed tax system, especially for a major trading economy, will have significant regard to its impact on international competitiveness. Exports will not be adversely taxed, while conduit income (that is, income which flows through but does not remain in a jurisdiction) will not be affected. Both the tax base and tax rates will be set with due respect for major competitors and the likely global reactions to taxation measures.

4.3.2 Economic growth

Taxation system design should aim not to retard economic growth and should interfere to the least extent possible with the best economic use of national resources. Taxation arrangements should aim to ensure that the economy is internationally competitive and an attractive investment destination. The taxation system should not impair economic productivity growth. Economic growth will be enhanced by an efficient and simple tax system.

4.3.3 Revenue adequacy/buoyancy

Taxation systems should ensure that adequate revenue is raised to finance government and societal needs. That revenue must not only be adequate, but also essentially be reliable in its expected collection. In addition to this basic requirement, where possible, taxation system design should aim for stability by minimising the impact that fluctuations in the level of activity in the economy will have on revenue.

In a buoyant tax system, the revenue yield will be sustainable and not subject to wide fluctuations, the tax system will be able to accommodate structural changes and the tax revenues will be broadly based and strongly linked to growth in the economy.

In a structural sense, revenue should be adequate to meet the needs of government expenditure, without resorting to borrowing or deficit financing. This means that over an economic cycle, the budget should be able to be at least in sustainable balance. The buoyancy of the tax base is fundamental to government in framing a budget, particularly over the economic cycle.

5 International Comparison – Is Hong Kong's tax base narrow?

5.1 Purpose

An objective of the study is to assess the nature of the tax base of Hong Kong in comparison with other developed jurisdictions, with particular reference to whether it is narrow and/or has a shrinking base.

To achieve this objective, the study brief requires a definition of what is a "narrow tax base". In this respect the study brief observes that a tax base has two aspects – the breadth of scope of the taxes charged and the coverage of actual persons potentially chargeable. In this regard, what is required of this study is:

- A comparison of the different taxes in a number of overseas jurisdictions;
- The development of objective benchmarks, which could be regarded as international "norms"; and
- An assessment of the Hong Kong tax system against these norms to determine whether the tax base is narrow.

This Chapter contains the results of the comparison and analysis described above.

5.2 Approach

5.2.1 International Comparison

To address the three elements enumerated above, the comparison must identify the following:

- What is a "narrow tax base"?
- The elements of the tax systems that are relevant for analysis.
- The overseas jurisdictions for analysis.

Taking into account that the purpose of the international comparison is to objectively to assess whether Hong Kong's tax system is "narrow", both the elements of the overseas jurisdictions' tax systems and the overseas jurisdictions themselves must be relevant to this task.

Accordingly, in undertaking the analysis, the study commences with an identification of what is meant by a "narrow base." Having ascertained the elements of a narrow base, the benchmarks and features that are relevant in assessing the narrowness of a tax base can be identified. Similarly, the jurisdictions that are relevant in ascertaining "international norms" can be determined.

The meaning of a narrow tax base or a narrow taxpayer base and its relevance to the study are discussed in 5.3.1 below. The conclusion as to the meaning of the terms in the context of this study is that a tax base is "narrow" if it lacks sufficient breadth to protect the base upon which taxation is levied because of either a lack of "neutrality" or "buoyancy".

5.2.2 The elements of the tax systems that are relevant for analysis.

Having identified the two elements by which a comparison of taxation systems might be assessed on grounds of "narrowness", this study undertakes the comparison of the tax system of selected jurisdictions in two parts:

- a comparison at the macro level of the tax burden, including the components or sources therein, e.g. income, property, payroll or consumption; and

- a more in-depth comparison of those components, key features and incidence on taxpayers, for a number of the selected jurisdictions' taxation systems.

Macro economic analysis of the taxation burden

In conducting the international comparison, the objective benchmarks or "norms" that are analysed are:

- total taxation revenue as a percentage of GDP. This provides a measure of the level of the tax burden on the economy overall. At the macro level, this is the incidence of taxation paid by the local population in an economy. A comparison can be made to determine whether a particular jurisdiction is heavily or lightly taxed relative to other jurisdictions;

- main headings such as income and profits, social security, payroll, property and goods and services, or components of the taxation base as a percentage of GDP. This provides a measure of the level of taxation of each of the components of the taxation system. A comparison can be made to determine the incidence of the tax components - whether a particular jurisdiction is heavily or lightly taxed in relation to each of the components of its taxation base relative to other jurisdictions;

- main headings or components of taxation revenue as a percentage of total taxation revenue. This provides a measure of the reliance on each of the components of taxation revenue. A comparison can be made to determine how heavily reliant on revenue from particular taxation component/s a particular jurisdiction is, relative to other jurisdictions;

- tax and non-tax revenue as a percentage of GDP and total revenue. This provides a measure of both how reliant a particular jurisdiction is on non-tax revenue as well as how high the Government exactions from the economy is relative to other jurisdictions. It provides information in relation to the importance of the “reliability” factor of the taxation base.

Comparison of the components and features of taxation systems

In carrying out the comparison of some of the selected jurisdictions’ taxation systems, the measures listed below have been used to determine the neutrality, burden, reliability and nature of the tax base:

- the features of the taxation system in relation to taxes on income and profits; social security; payroll and workforce; property; goods and services and other taxes. A comparison of these taxation design features allows an assessment of the breadth of the base for each of the component parts of the taxation mix, relative to other jurisdictions;

- the corporate tax rate provides a measure of the relative incidence of tax on corporate profits relative to other jurisdictions and an indicator of the reliability of the taxation base, when viewed in connection with its relative importance to total revenue collections;

- the number of corporate taxpayers relative to corporate tax collections provides a measure of the relative incidence of tax paid on corporate profits relative to other jurisdictions by a small percentage of taxpayers, which indicates reliability and efficiency of the tax base;

- business profits tax as a percentage of gross operating surplus provides a measure of the incidence of taxation of business profits when compared to the base that is the subject of the base, relative to other jurisdictions;

- top and average marginal tax rates on personal income provides a measure of the relative incidence of tax on individuals relative to other jurisdictions and an indicator of the reliability of the taxation base, when viewed in connection with its relative importance to total revenue collections;

- number of individual persons paying personal income tax relative to the tax collected, provides a measure of the incidence of taxation by taxpayer numbers and an indicator of the reliance or reliability of the tax base on a limited number of taxpayers;

- percentage of taxpayers to persons potentially chargeable and personal tax as a percentage of total compensation of employees. These provide a measure of the breadth of the taxation base in relation to individual incomes both in terms of the number of taxpayers and the total potential base of taxation;

- total consumption taxes as a percentage of total private consumption provides a comparison of the reliability of the taxation base in relation to consumption in terms of the total potential base of taxation.

5.2.3 The overseas jurisdictions for analysis

The OECD plus Singapore are the selected overseas jurisdictions that this study adopts for establishing the macro economic international "norms" against which Hong Kong's taxation system is assessed.

It is important to emphasise that the selection of the group of jurisdictions is not to identify a taxation system that Hong Kong might like to emulate. Rather, the purpose of the comparison is to measure the relative "narrowness" of Hong Kong's taxation system when measured against international benchmarks.

In establishing the international benchmarks at the macro level described above, two averages are also used for comparison. The benchmarks utilise the same data as used in the charts. These averages are the average of OECD member jurisdictions and the Asia Pacific members of the selected jurisdictions. The latter comprises the Asia Pacific members of

OECD (Australia, Canada, Japan, Korea, Mexico, USA and New Zealand) plus Hong Kong and Singapore.

The study has adopted the OECD as the comparative benchmarks because the OECD:

- provides a ready source of comparative data with the requisite integrity.

  Data integrity is critical to this comparative study. Internationally recognised statistical information is used as quoted in the Sources section. With the same information used in the corresponding charts and benchmark tables.

- includes a broad range of taxation systems and breadth of taxation base. Within its members there are both high and low taxing jurisdictions, narrow and broad bases.

- members of the OECD include most developed taxation jurisdictions and economies. With the inclusion of Singapore, the selected jurisdictions utilised in the study as benchmarks for comparison, contain all jurisdictions with which Hong Kong could reasonably seek to make comparisons as to the narrowness or otherwise of the Hong Kong tax base.

The representative comparisons of the components and features of taxation systems that are used for comparison with the Hong Kong tax base, adopts a smaller number of jurisdictions. These selected jurisdictions are Australia, Canada, Ireland, Korea, New Zealand and Singapore.

These jurisdictions have taxation systems that are representative of others that might be used for comparisons in relation to the “narrowness” of a taxation base. They include an appropriate mix of jurisdictions that are comparable from the following benchmarks so as to make the comparison appropriate. They have been selected based on the following criteria:

- developed economies;

- share regional influences;

- most have similar legal and economic structures;.

- many have undergone tax reform programs of relatively recent significance (Study task 11(b) requires reference to be made to recent examples of taxation reform in other jurisdictions); or

- were requested for inclusion by the Advisory Committee.

The selection of the smaller and larger group of jurisdictions provides a suitably broad international framework for analysis. The international comparative analysis serves three purposes:

- to provide information on key features of tax systems in the selected jurisdictions;

- to give some insights of the impact of the taxation system in the selected jurisdictions, and

- to derive objective benchmarks for comparing with Hong Kong.

5.3 International Comparison

5.3.1 What is a "narrow" tax base?

This study is primarily concerned with ascertaining whether Hong Kong's tax base is narrow and, if so, the implications of that "narrowness".

A narrow base is generally regarded as a deficiency in a tax system if it is being assessed against the hallmarks of good design discussed in Chapter 4.

Essentially, a tax base may be "narrow" in the context in which the term is used in the Study Brief because it is not sufficiently broad to:

- Protect the revenue from distortions and discriminatory effects of taxation of one form of economic activity as opposed to another.

  In this regard, consistent with the principles discussed in Chapter 4 we have used the term "neutrality" to connote that the tax system itself does not advantage or disadvantage the production or sale of a particular category of goods or services, or the corporate structure or manner that might be chosen to manufacture, acquire or supply goods and services or any industry or industry sector. The aim is that, as far as the tax system is concerned, business and consumers alike should be indifferent as to what is produced, how it is produced or from whom it is purchased.

In a neutral taxation system, the economy will adjust to produce and operate in a way that is most efficient for the production of goods and services and not be biased to less efficient forms of activity because of the operation of the tax system alone.

- Provide reliability or buoyancy of revenue because the taxation base is not representative of the economy overall or the Government's requirements to fund its expenditure needs. That is, the base is broad enough to ensure revenue adequacy for the purposes required.

  In this regard, the narrowness of a taxation base on the neutrality test described above, can limit the Government's ability to raise revenue commensurate with growth in the economy overall because to do so would unreasonably impact on the ability of the "taxed" sector to deliver goods or services into the market (whether domestic or export) at a competitive price and a return on investment and effort that is "neutral" compared to other activities.

  Further, the taxation base may suffer from "narrowness" because the activities that are within the base do not grow at the same rate as the economy overall or are more volatile than the general economy – thus not securing a reliable source of revenue to the Government over time.

A "narrow" tax base may also be considered a tax base that relies on a few taxpayers (or small percentage of taxpayers) relative to the possible population of payers. This is referred to throughout the study as a "narrow taxpayer base" and is in addition to a limited range (i.e. narrowness) of activities or sources of taxation in the economy.

5.3.2 Key macro economic comparisons

This study adopts the following benchmarks to compare jurisdictions and measure relative "narrowness" of the taxation systems of those jurisdictions.

- total taxation revenue as a percentage of GDP.

- main headings or components of the taxation base as a percentage of GDP;

- main headings or components of taxation revenue as a percentage of total taxation revenue; and
- tax and non-tax revenue as a percentage of GDP and total revenue.

Whilst none of the above elements, on their own, are determinative as to narrowness, the overall analysis provides an indication of the various features of the taxation systems of the jurisdictions that can be used to establish relative benchmarks against which narrowness can be measured. The purpose of each of the measures is described briefly in 5.2.2 above.

The key components above have drawn on internationally used and accepted definitions of different taxes, e.g. they are used by the OECD, IMF and most developed jurisdictions' revenue and statistical government agencies.

5.3.3 Total taxation as a percentage of GDP

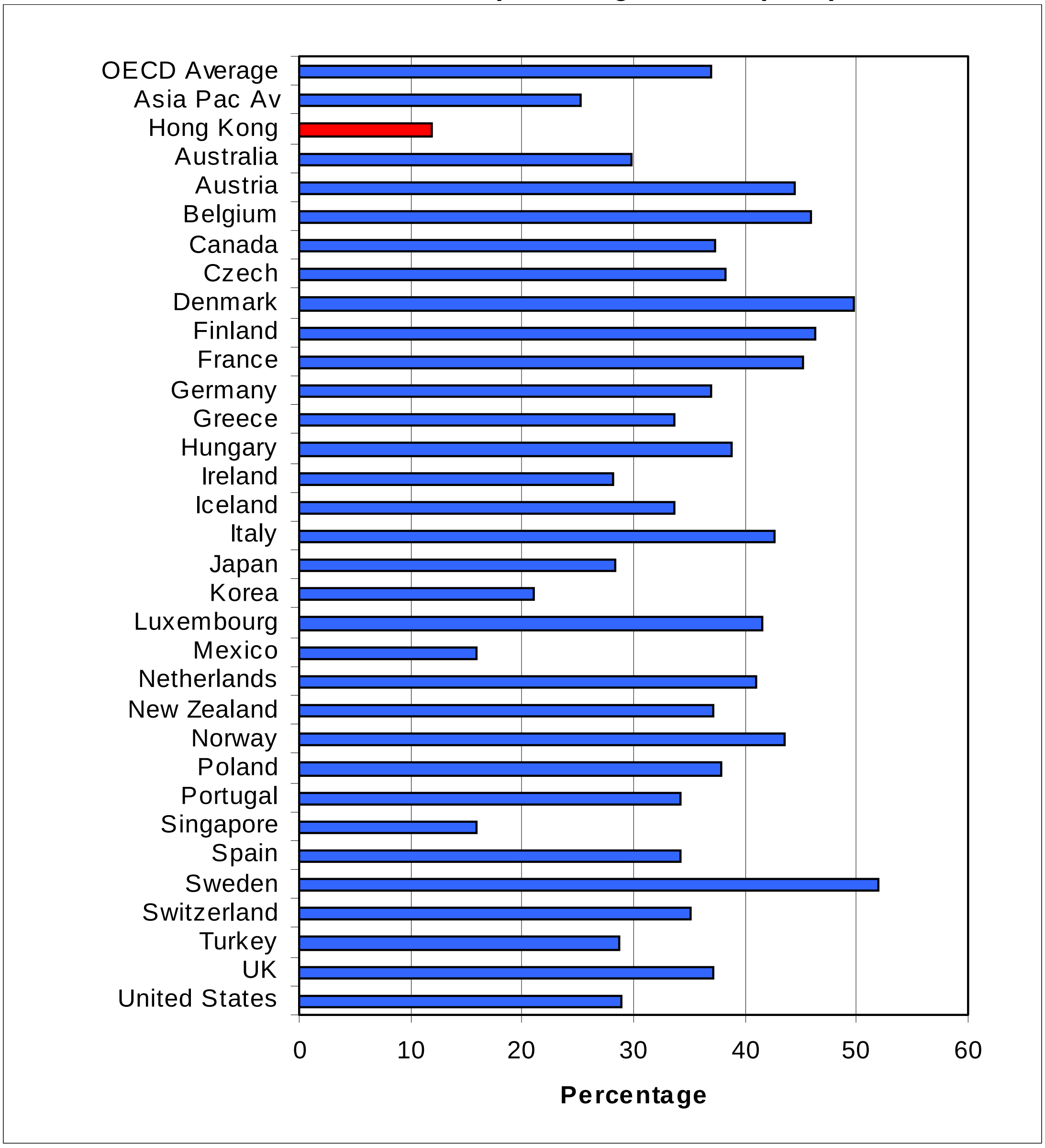
Total taxation revenue as a percentage of GDP is the most commonly used measure of the overall burden of taxation on a nation. At the broadest level, it indicates whether a jurisdiction is heavily or lightly taxed. While on its own it is not a prima facie indicator of breadth of taxation, when examined in conjunction with the composition of the tax base together they can provide a basis of such an assessment.

The following chart sets out the total taxation revenue as a percentage of GDP as well as that for the OECD and Asia Pacific average. On this comparison, Hong Kong can be seen to have the lowest level of taxation of all of the jurisdictions.

The OECD member jurisdictions are, on average, more highly taxed on this measure than the Asia Pacific jurisdictions.

When compared to the smaller group of jurisdictions, Hong Kong is less heavily taxed than Singapore but not significantly so. When compared with Canada, Australia, New Zealand and Ireland, however, the position of Hong Kong as a low taxing jurisdiction is stark with each of those jurisdictions having ratings above the Asia Pacific average. In fact, New Zealand and Canada, on this measure, must be regarded as having relatively high levels of taxation. (See Chart 5.3.3 below).

Chart 5.3.3
Total tax revenue as percentage of GDP (1998)



Source: OECD Revenue statistics (2000), Hong Kong Finance Bureau, Singapore Ministry of Finance. Hong Kong revenue data is for FY97/98 and GDP data is for calendar year 1997.

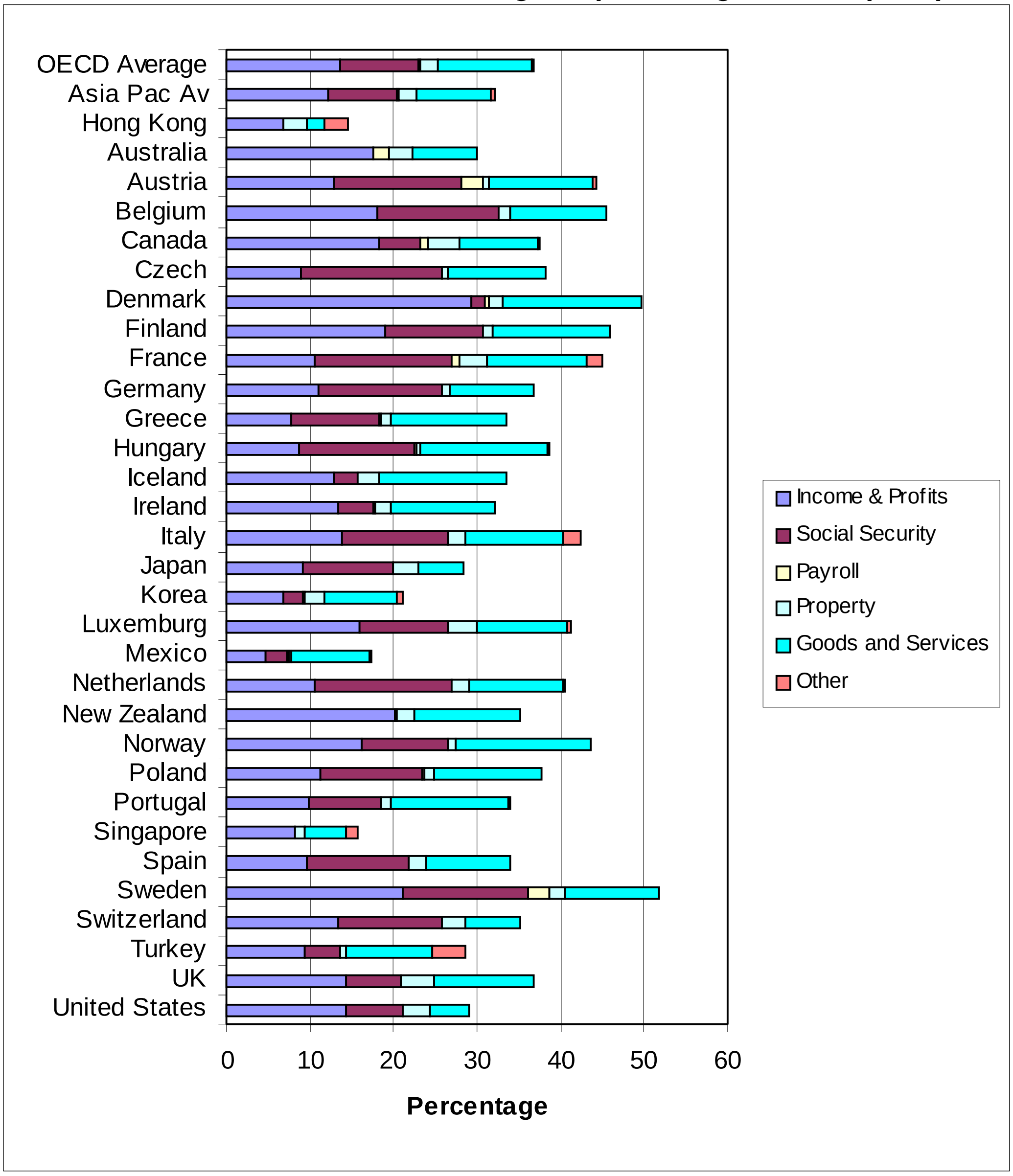
5.3.4 Tax components as a percentage of GDP

The assessment in the previous section is relevant in determining whether, overall, the level of taxation of an economy is high or low.

When each of the main headings of taxation revenue in each of the jurisdictions are examined against GDP, it can be seen that some jurisdictions are relatively high in taxing one base and low in others.

In this regard, in those areas that Hong Kong has an established tax base, i.e. taxes on property, income and profits, Hong Kong's low tax level status demonstrated in the first analysis, is less discernable in relative terms. (This can be seen in Chart 5.3.4 below). The components of the tax base are discussed in more detail in the following section.

Chart 5.3.4
Tax revenue of main headings as percentage of GDP (1998)



Source: OECD Revenue statistics (2000), Hong Kong Finance Bureau, Singapore Ministry of Finance. Note: Mexico & Greece information based on 1997. Hong Kong revenue data is for FY97/98 and GDP data is for calendar year 1997.

5.3.5 Tax components as a percentage of total taxation revenue

The first two bars in Chart 5.3.5 below are benchmarks to compare the component parts of taxation to the total taxation revenue.

If the taxation components of total taxation are examined, an assessment can be made of the relative reliance on taxation types in each jurisdiction.

This is one measure of narrowness of a tax base, in the sense that reliance on a few sources of taxation can be an indication of discriminatory or distortionary impacts of the taxation system. If the level of taxation has to be raised, it requires an increase in the burden on the narrow base, thus making the economic impact less efficient.

In addition if the taxation sources are themselves subject to volatility or do not grow at the overall growth rate, the Government's source of revenue is less secure.

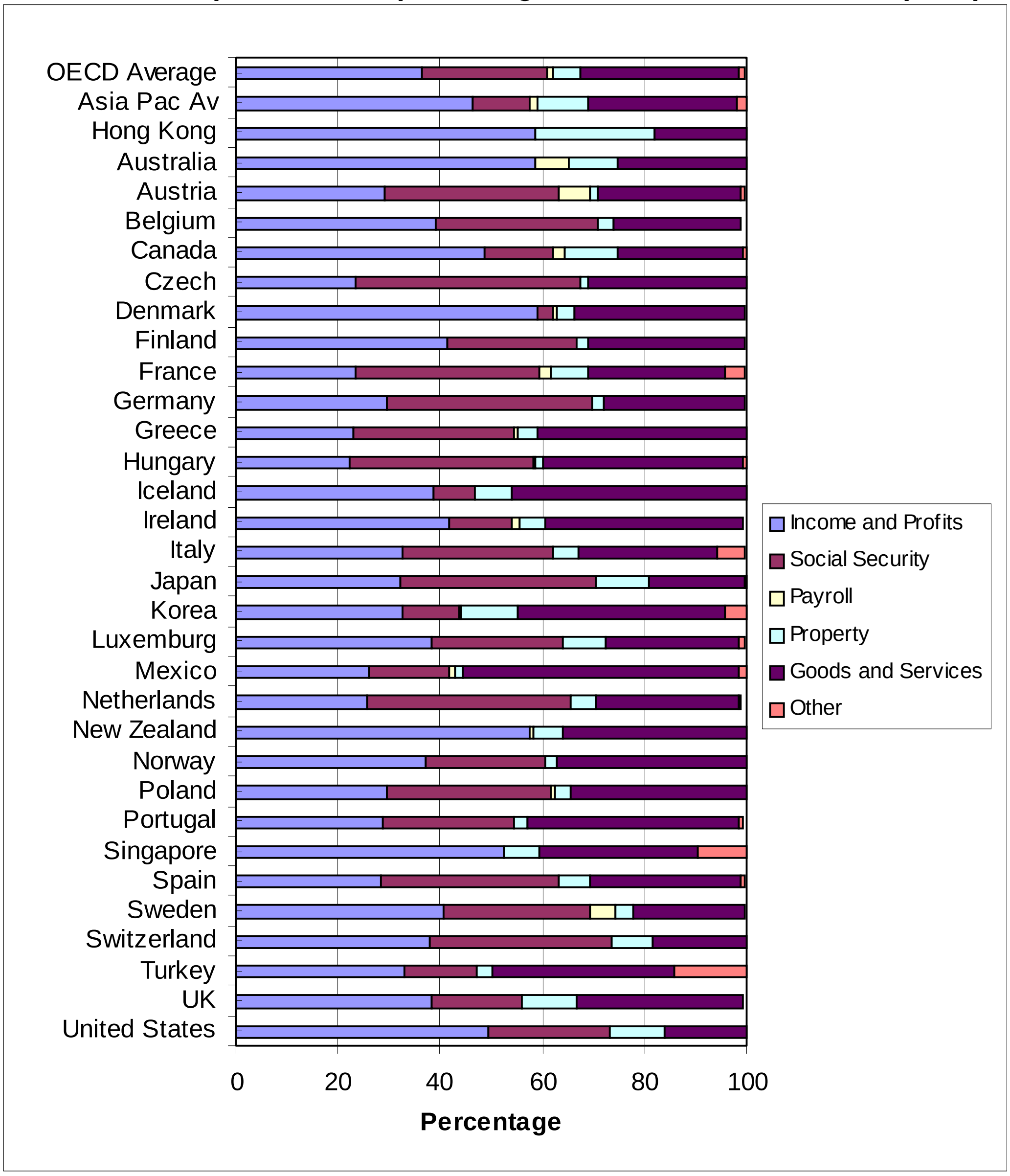
The analysis of the selected jurisdictions as compared to Hong Kong shows that it is more reliant on taxation from property and income and profits than the OECD or Asia Pacific average. In this respect, the base is narrow (on the measure of "neutrality"), because it taxes some economic activities more harshly than others – if compared with other benchmark economies. It is also narrow on the "reliability" measure because the narrow range of economic activities that constitutes the tax base are susceptible to volatility in their own sector of the economy. When compared to other jurisdictions it is evident that Hong Kong has a low reliance on taxes from goods and services.

Analysis of the different components of the tax base highlights a number of significant differences between Hong Kong's tax system and that of other developed jurisdictions. The benchmarks used for assessing Hong Kong include the OECD averages and Asia-Pacific averages (which have been calculated including Australia, Canada, Hong Kong, Japan, Korea, Mexico, New Zealand, Singapore and the USA).

Hong Kong's tax base is heavily reliant on tax revenue derived from income and property and its reliance on these two types of tax revenue is considerably higher than the equivalent proportion of revenue in either the OECD or Asia-Pacific average.

Each of the major components of taxation revenue in Hong Kong and internationally will now be subjected to further comparison.

Chart 5.3.5
Tax components as a percentage of total taxation revenue (1998)



Source: OECD Revenue statistics (2000), Hong Kong Finance Bureau, Singapore Ministry of Finance. Note: Mexico & Greece information based on 1997. Hong Kong revenue data is for FY97/98 and GDP data is for calendar year 1997.

5.3.6 Tax on personal income

Personal income tax covers all taxation paid on income (including capital gains and business profits where taxable) earned by individuals. In Hong Kong, the taxation of personal income is performed through "salaries tax", "property tax", "profits tax" on unincorporated businesses and "personal assessment." Consistent with Hong Kong's low tax level status, it has a low ratio of personal income tax to GDP (around one third of the OECD average). However, the composition of tax revenue from personal income compared to other taxation sources is almost identical to the OECD average. (Refer to Table 5.3.6 and Chart 5.3.6 below).

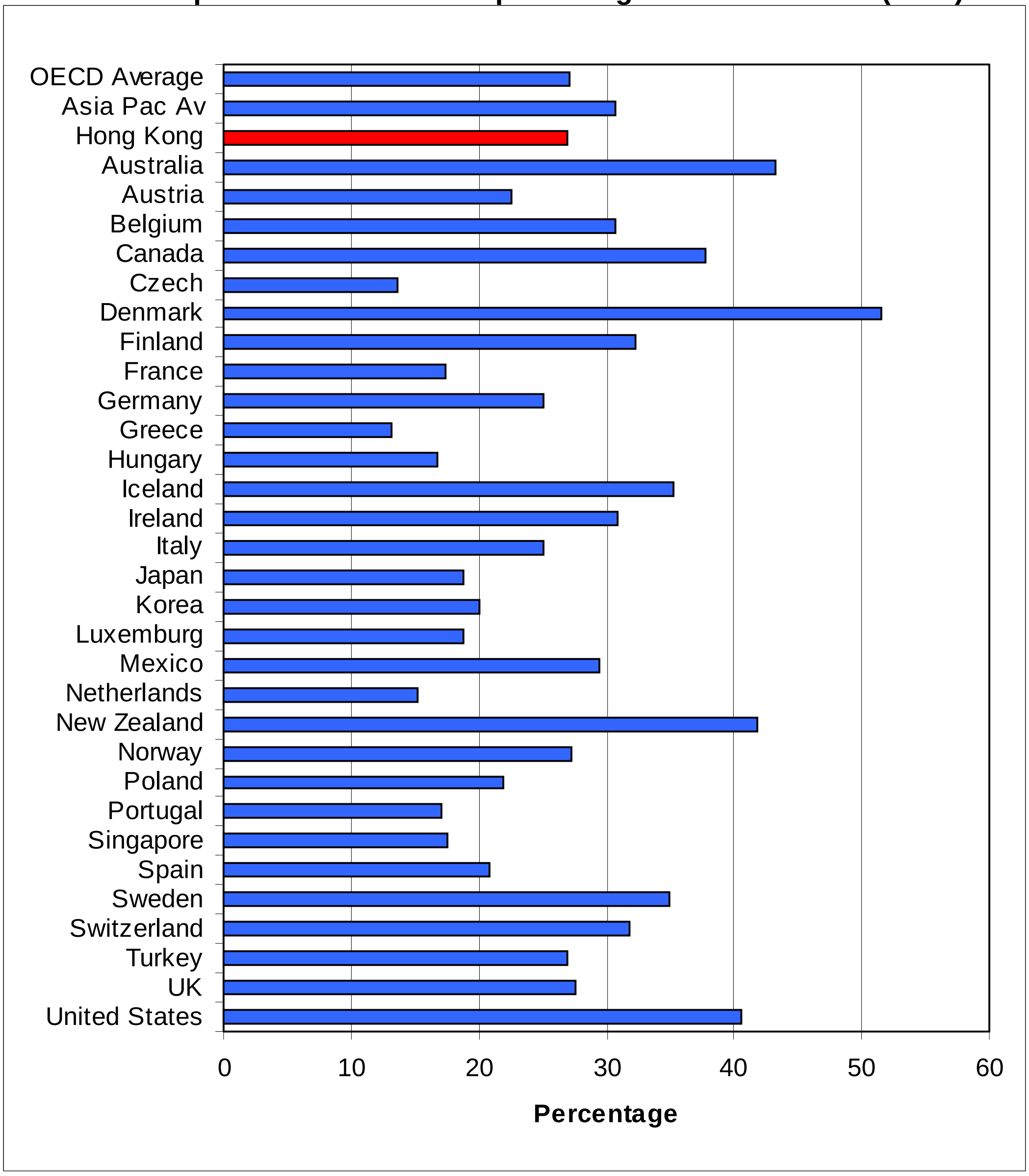
Table 5.3.6
Personal Income Tax Benchmarks

	Hong Kong	**OECD Benchmark**	**Asia Pacific Benchmark**
% of Tax Revenue	27%	27%	31%
% of GDP	3%	10%	8%

Source: OECD Revenue Statistics (2000), Hong Kong Finance Bureau. Hong Kong revenue data is for FY97/98 and GDP data is for calendar year 1998.

While the "average" measure as a percentage of total revenue is not illustrative of a narrow base, the fact that personal income is lowly taxed on the international benchmark is illustrative of a possible narrowness in the base – a feature that is demonstrated later when a more detailed comparison is undertaken.

Chart 5.3.6
Taxes on personal income as a percentage of total taxation (1998)



Source: OECD Revenue statistics (2000), Hong Kong Finance Bureau, Singapore Department of Statistics. Notes: Greece information based on 1997 figures, Mexico information based on figures from taxes on Income, Profits and Capital Gains unallocated between individuals and corporate. Hong Kong revenue data is for FY97/98 and GDP data is for calendar year 1997.

5.3.7 Tax on corporate income

The taxation of corporate income is defined as the tax paid by incorporated entities. It mainly covers tax on corporate profits and earnings. In Hong Kong, this tax is called "profits tax" for incorporated businesses. Hong Kong has an extraordinarily heavy reliance on taxation from corporate income as evidenced in the corporate income tax benchmarks below. This is highly affected by cyclical economic fluctuations and is subject to increasing global tax rate competition.

In this respect, the reliance on taxation from corporate income represents a narrow feature of the Hong Kong taxation system relative to international benchmarks (on both the neutrality and reliability measures).

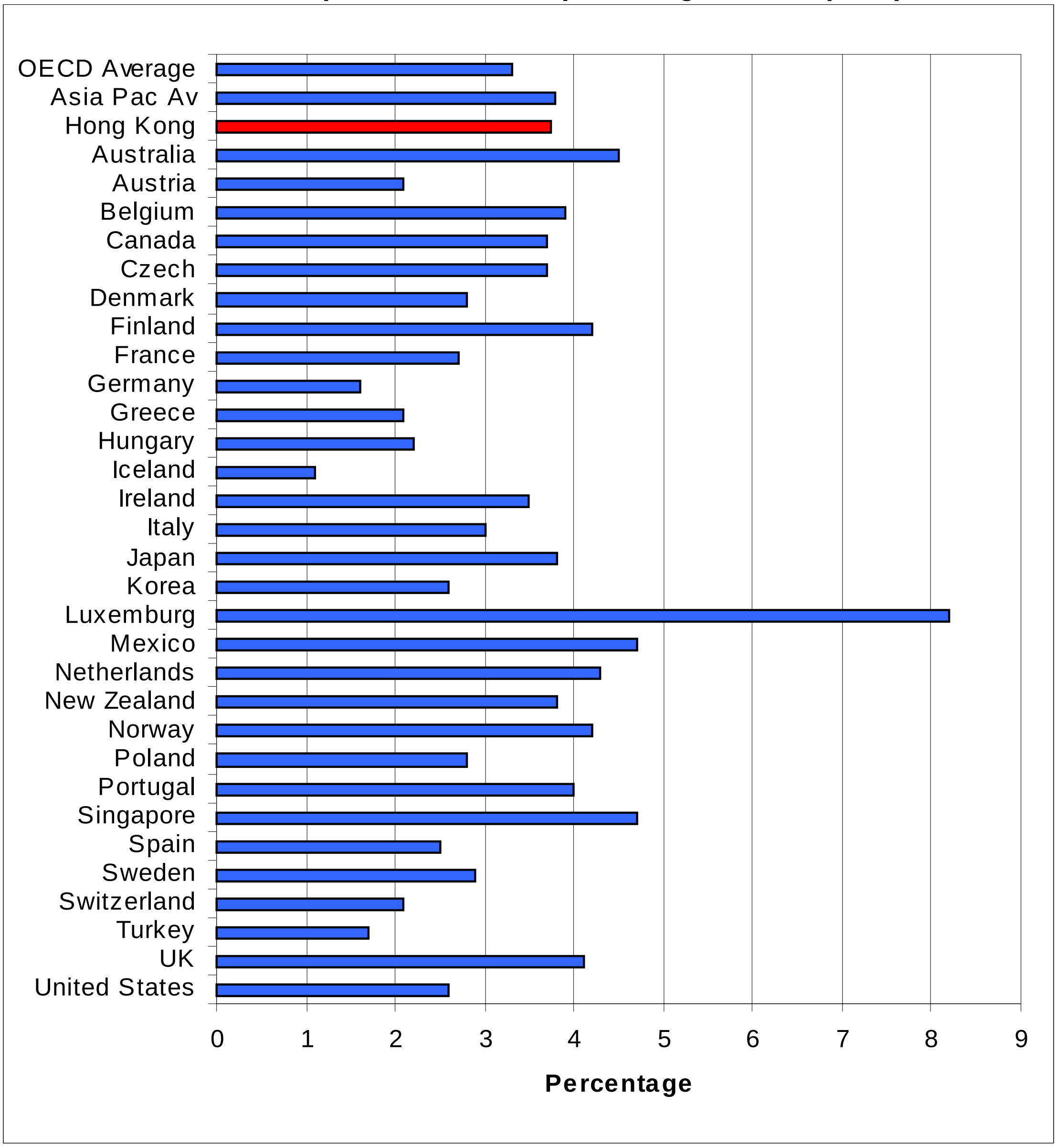
While Hong Kong's corporate income taxation to GDP ratio is only slightly higher than the OECD average, as a percentage of taxation revenue, it is three and a half times more than the OECD average, although it is close to the Asia-Pacific averages.

Table 5.3.7
Corporate Income Tax Benchmarks

	Hong Kong	**OECD Benchmark**	**Asia Pacific Benchmark**
% of Tax Revenue	32%	9%	29%
% of GDP	4%	3%	4%

Source: OECD Revenue Statistics (2000), Hong Kong Finance Bureau. Hong Kong revenue data is for FY97/98 and GDP data is for calendar year 1997.

Chart 5.3.7
Taxes on corporate income as percentage of GDP (1998)



Source: OECD Revenue Statistics (2000), Hong Kong Finance Bureau, Singapore Department of Statistics. Note: Mexico & Greece information based on 1997. Hong Kong revenue data is for FY97/98 and GDP data is for calendar year 1997.

5.3.8 Tax on property

Taxation revenue from property (defined by the OECD as recurrent taxation from the use, ownership or transfer of property, but excluding taxes on income or capital gains derived from property) includes both tax on immovable property and financial property, such as shares. In Hong Kong, this form of taxation is raised through rates, stamp duties (on real property and shares) and estate duty. Table 5.3.8 below shows the international benchmarks:

Table 5.3.8
Tax on Property Benchmarks

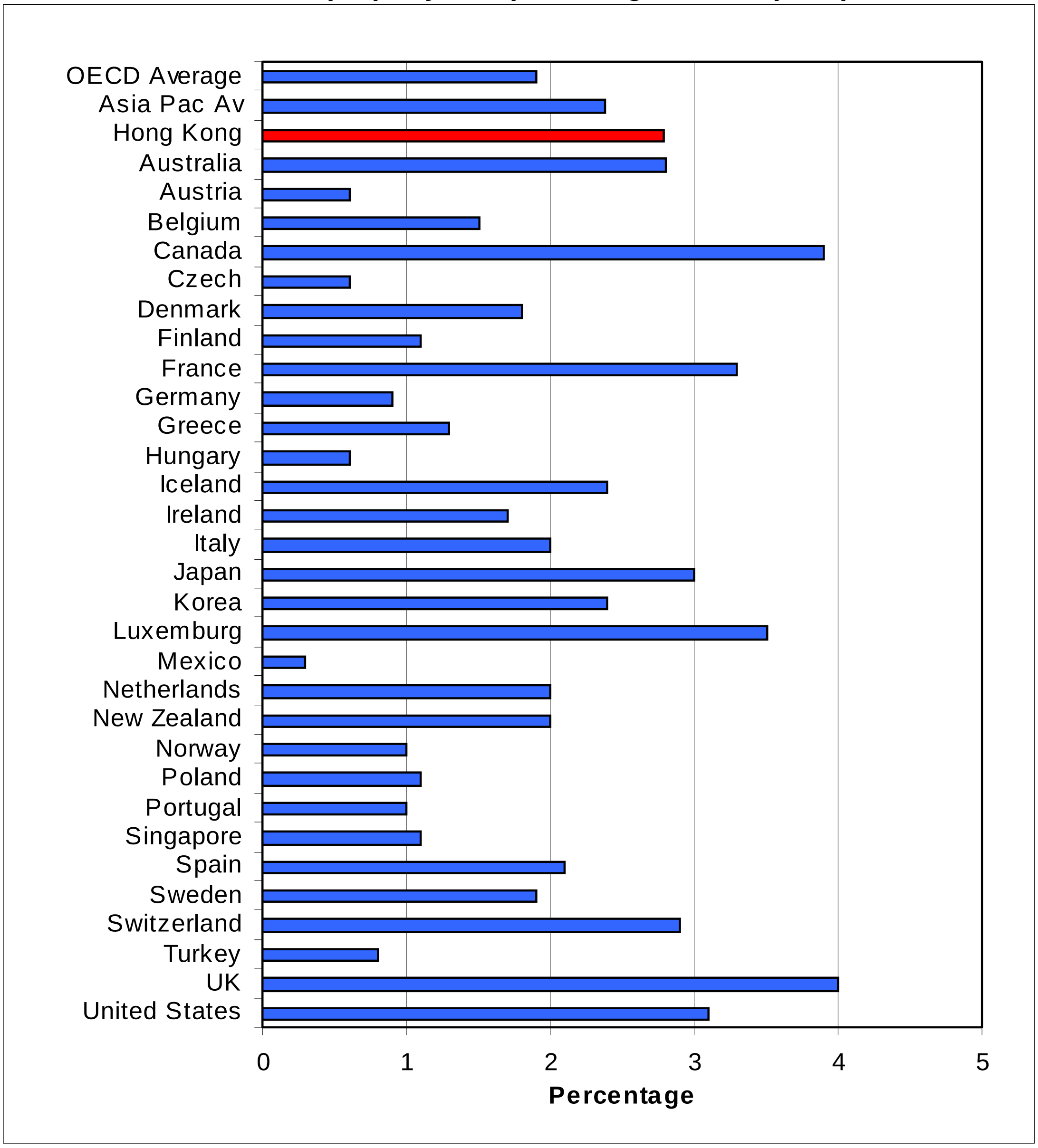
	Hong Kong	OECD Benchmark	Asia Pacific Benchmark
% of Tax Revenue	24%	5%	10%
% of GDP	3%	2%	2%

Source: OECD Revenue Statistics (2000), Hong Kong Finance Bureau. Hong Kong revenue data is for FY97/98 and GDP data is for calendar year 1997.

Taxation from property in Hong Kong is above the international benchmarks as a percentage of GDP, and significantly higher than either of the benchmarks as a percentage of total taxation revenue. (Chart 5.3.8 shows the international comparison with other jurisdictions).

Hong Kong's tax base clearly has a heavy reliance on taxes from property. As a consequence it taxes the consumption or use of property more heavily than alternatives, creating discrimination and distorting efficient resource allocation – that is it is narrow on the neutrality ground. In addition, the tax base will vary according to the volatility in property values, which makes the base narrow on reliability / buoyancy grounds. In this respect, the base is "narrow" by international comparison on both the neutrality and reliability measures.

Chart 5.3.8
Taxes on property as a percentage of GDP (1998)



Source: OECD Revenue Statistics (2000), Hong Kong Finance Bureau, Singapore Ministry of Finance. Note: Mexico & Greece information based on 1997. Hong Kong revenue data is for FY97/98 and GDP data is for calendar year 1997.

5.3.9 Taxes on payroll and social security

Hong Kong does not levy tax on payrolls nor require social security contributions to general government.

Taxation of payrolls is not common amongst the developed jurisdictions with only 12 of the 29 OECD jurisdictions applying this type of taxation (although Australia and Canada that will be looked at in more detail in Chapter 5.4 have major payroll taxes). The effect of paying a payroll tax or a social security contribution for an employer is similar.

Social security contributions are usually linked in one form or another to the funding of retirement incomes. Some jurisdictions do not require social security contributions as classified by the OECD statistics, but do still have alternative compulsory retirement income arrangements, while others still use general revenue to fund pensions. For example, Australia requires mandatory employer contributions to superannuation/pension schemes that are managed by the private sector; however, these are supplemented by a means tested age pension system that is funded out of general taxation revenue. Singapore also requires high levels of compulsory retirement savings by both employers and employees. Hong Kong also has a system of mandatory retirement saving through Mandatory Provident Fund schemes which require both employee and employer contributions.

Compulsory employer contributions to either government (considered taxes by the OECD definition) or to private pension/retirement schemes (not considered taxes by the OECD) have a similar effect from the employer's perspective. They impose an additional cost of employing labour. Compulsory employee contributions often have the same impact from an employee's perspective as an income tax, although they may have greater control over the investment of 'their' contributed money. These types of contributions are de facto taxes in an economic sense, although direct comparison or benchmarking of the variety of different types of schemes used in developed jurisdictions is difficult. The comparison of the representative jurisdictions will discuss these issues further.

For the purposes of benchmarking Hong Kong it is suffice to say that with the sole exception of New Zealand, all other developed jurisdictions have a form of mandatory retirement contribution, either from employers, employees or both.

5.3.10 Tax on goods and services/consumption

Taxation on goods and services (or consumption) includes all those indirect taxes that are levied on the purchase of either specific or general goods and services for private (or household) use/consumption. It typically covers taxes from GST and sales tax through to excises and specific taxes on services, such as betting duties in Hong Kong.

This is another component of taxation where Hong Kong deviates seriously from the typical developed jurisdiction's tax system in its very low reliance on taxation from goods and services, and in particular of general consumption.

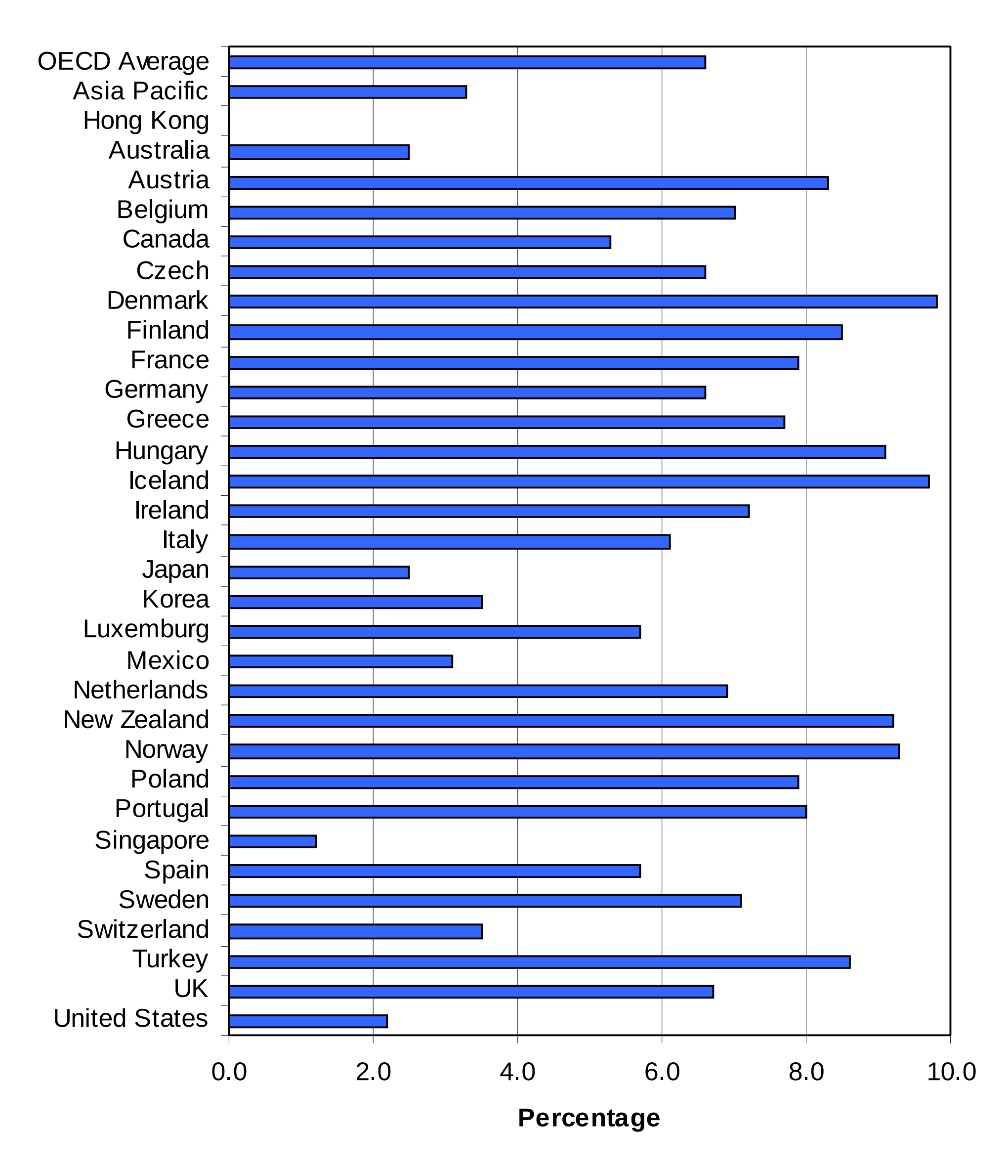
Chart 5.3.10a below shows, as Hong Kong does not have either a general sales tax (retail or wholesale) or a goods and services tax (value-added tax), it is the only jurisdiction in the comparison with such an omission from its tax base. Not only do all other developed jurisdictions have a broad based indirect tax, but their taxation revenues are usually derived to a significant extent from this tax source. Table 5.3.10a below expresses the international benchmarks for this form of taxation:

Table 5.3.10a
General Consumption Taxes Benchmarks

	Hong Kong	**OECD Benchmark**	**Asia Pacific Benchmark**
% of Tax Revenue	0%	18%	12%
% of GDP	0%	7%	3%

Source: OECD Revenue Statistics (2000), Hong Kong Finance Bureau. Hong Kong revenue data is for FY97/98 and GDP data is for calendar year 1997.

Chart 5.3.10a
Taxes on general consumption as percentage of GDP (1998)



Source: OECD Revenue Statistics (2000), Hong Kong Finance Bureau, Singapore Ministry of Finance. Note: Greece information based on 1997. Hong Kong revenue data is for FY97/98 and GDP data is for calendar year 1997.

Table 5.3.10b and Chart 5.3.10b below show the taxes on specific goods and services as compared to the international benchmarks:

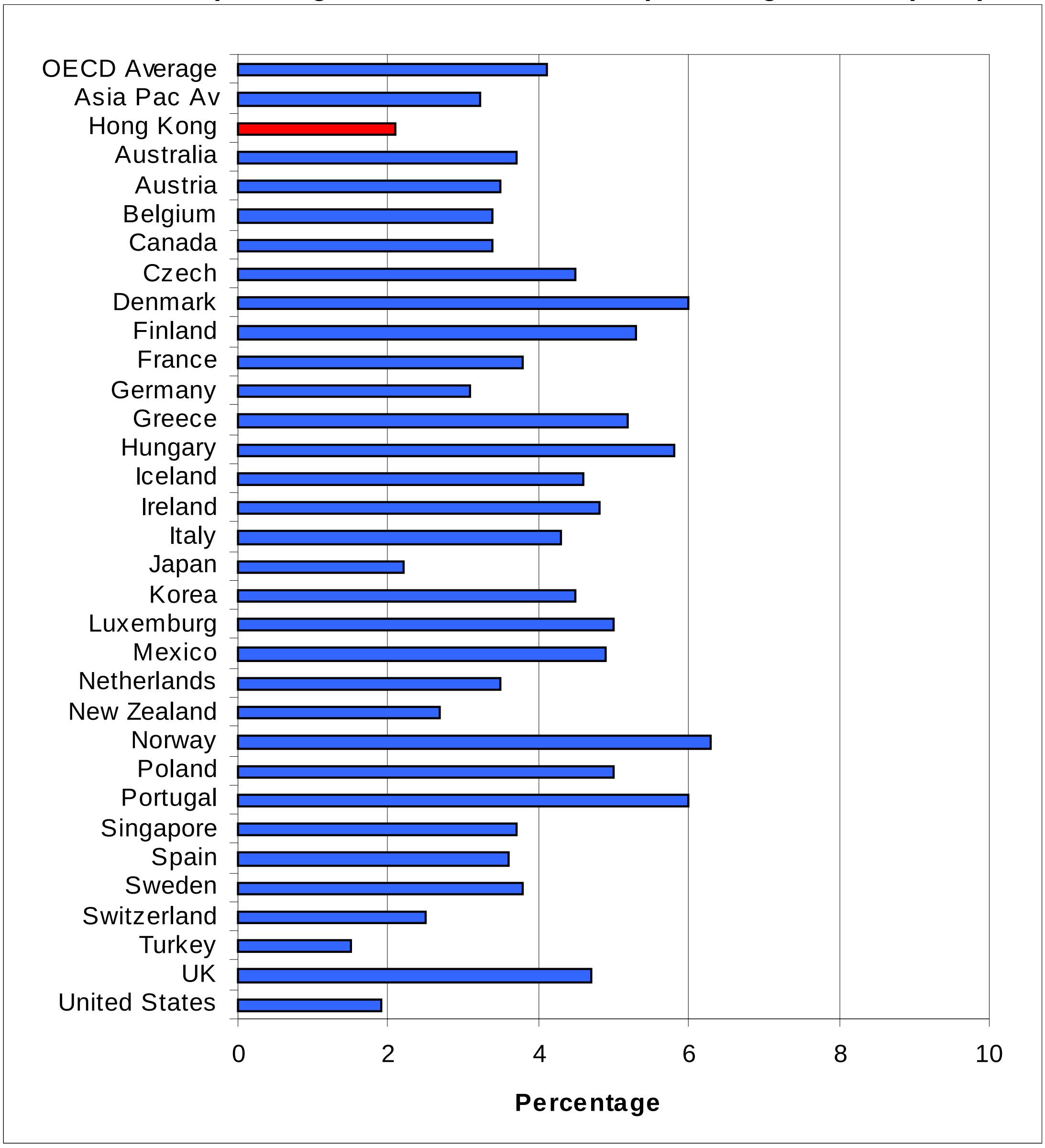
Table 5.3.10b
Taxes on Specific Goods and Services Benchmarks

	Hong Kong	**OECD Benchmark**	**Asia Pacific Benchmark**
% of Tax Revenue	18%	12%	16%
% of GDP	3%	4%	3%

Source: OECD Revenue Statistics (2000), Hong Kong Finance Bureau. Hong Kong revenue data is for FY97/98 and GDP data is for calendar year 1997.

As indicated at the outset, taxes imposed on selective commodities are discriminatory and distortionary (i.e. they are “narrow” on the “neutrality” measure). Depending on the elasticity of demand of the commodities involved and of their correlation to the general economy, such taxes can also be “narrow” on the “reliability” measure described in 5.3.1.

Chart 5.3.10b
Taxes on specific goods and services as a percentage of GDP (1998)

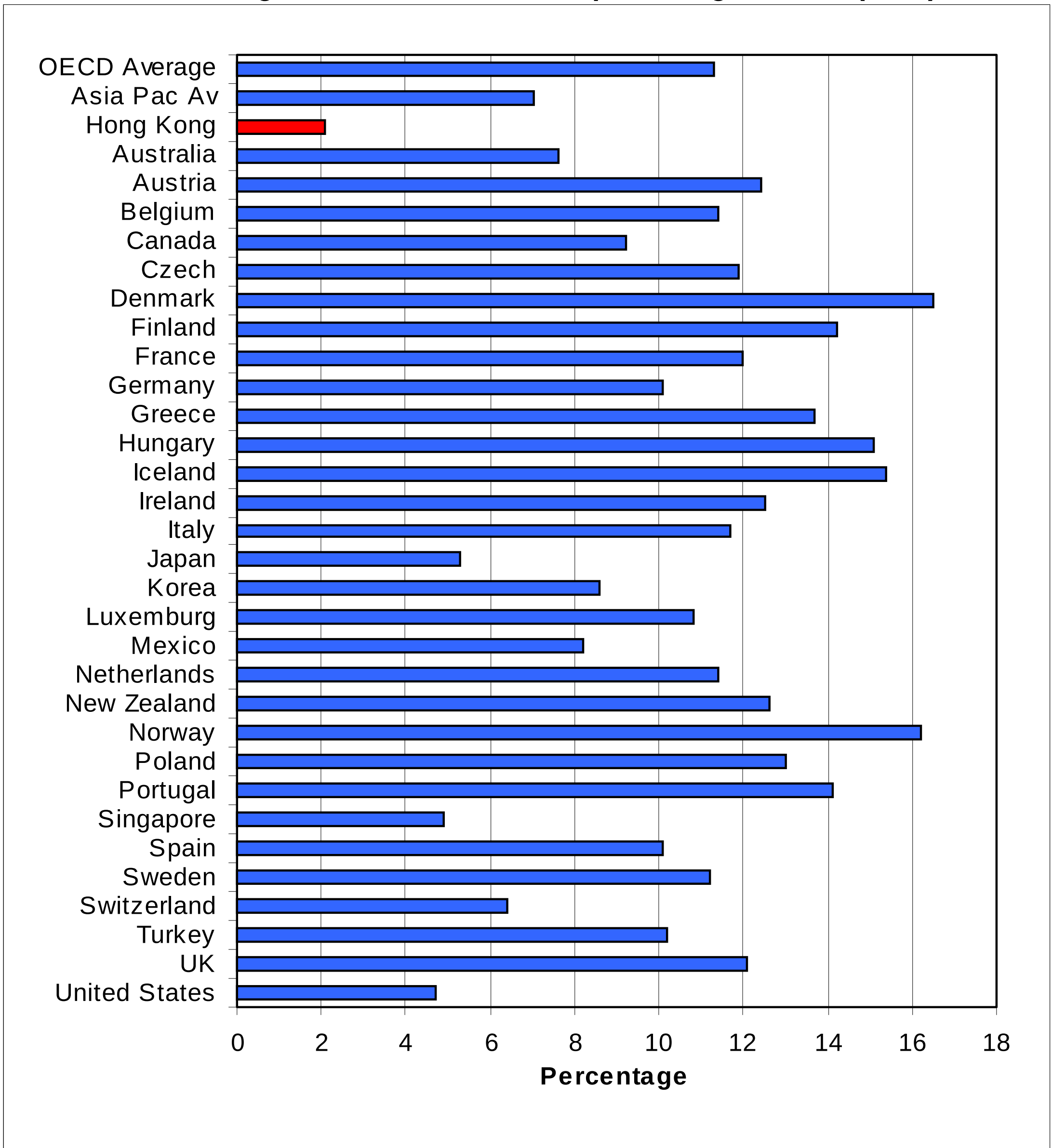


Source: OECD Revenue Statistics (2000), HK Finance Bureau, Singapore Ministry of Finance. Notes: Greece information based on 1997. Singapore data comes from IMF Report (HK Government). Hong Kong revenue data is for FY97/98 and GDP data is for calendar year 1997.

Chart 5.3.10c below illustrates that Hong Kong derives some revenue from its tax base on goods and services. However, this is entirely sourced from a few narrow taxes on specific goods and services, for instance, alcohol, tobacco, petroleum products and gambling.

Chart 5.3.10c also illustrates taxes on goods and services, which represents a combination of Chart 5.3.10a (taxes on general consumption) and Chart 5.3.10b (taxes on specific goods and services).

Chart 5.3.10c
Taxes on goods and services as a percentage of GDP (1998)



Source: OECD Revenue Statistics (2000), Hong Kong Finance Bureau, Singapore Ministry of Finance. Note: Greece information based on 1997. Hong Kong revenue data is for FY97/98 and GDP data is for calendar year 1997.

5.3.11 Non-Tax revenue

One feature of Hong Kong's revenue base that is inconsistent with most of the jurisdictions in the comparison is the significant proportion of revenue derived from non-taxation sources. Total non-tax revenue at almost half of total revenue is substantially above international 'norms'. This is illustrated in Chart 5.3.11 below.

Hong Kong's historically high level of non-tax revenue is due to its revenue from land sales and earnings from investments as a consequence of its past policy of accumulating and investing large Budget surpluses. This level of non-tax revenue supports a low taxation environment but, in the event that the non-tax revenue cannot be maintained at required levels, the otherwise "narrow" taxation base is put under "reliability" pressure.

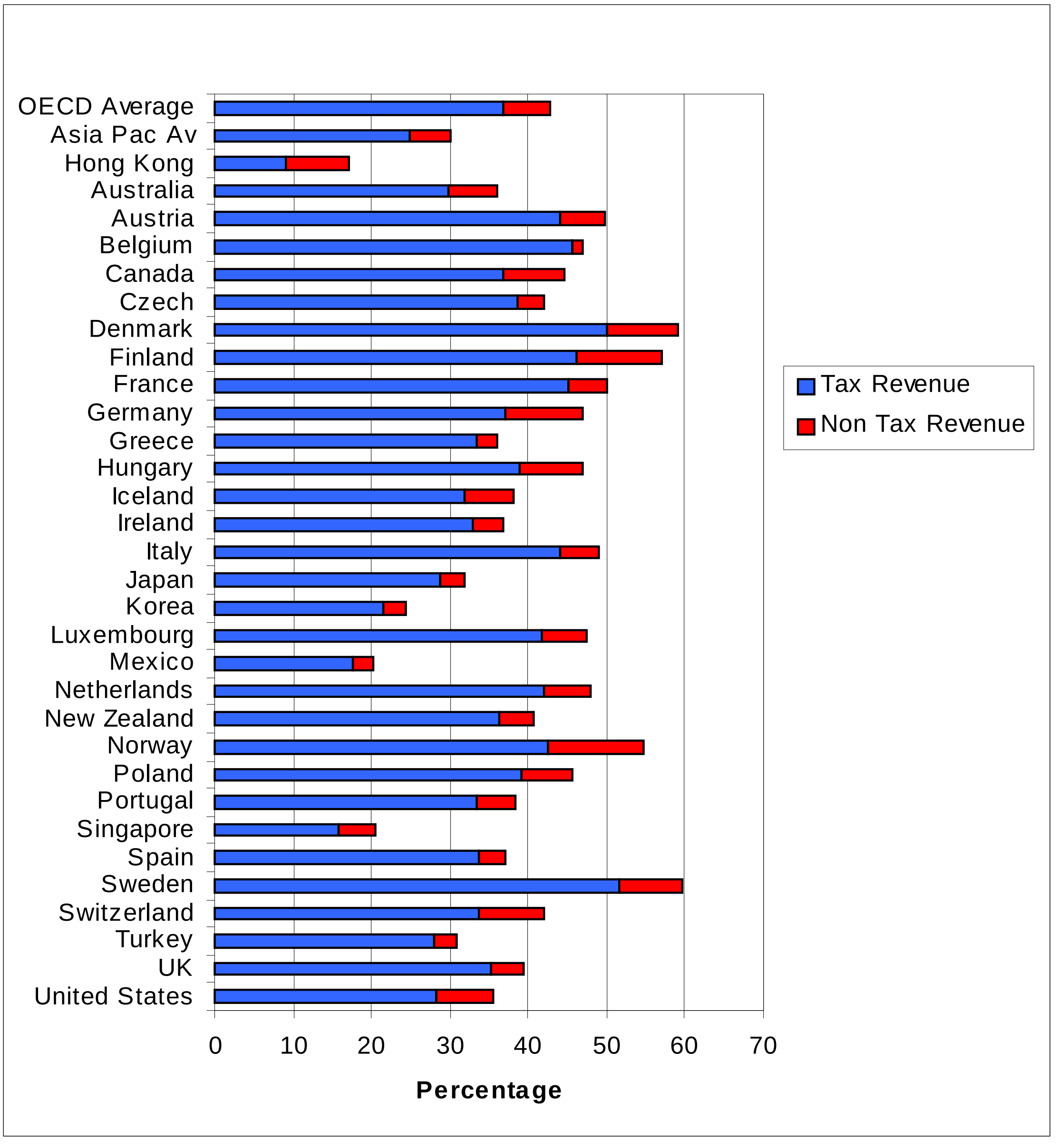
Accordingly, the average measure of non-tax revenue in Table 5.3.11 is a feature of the Hong Kong taxation system that tends to bring focus on the "narrowness" of the taxation base.

Table 5.3.11
Non-Tax Revenue Benchmarks

	Hong Kong	OECD Benchmark	Asia Pacific Benchmark
% of Tax Revenue	80%	16%	22%
% of GDP	9%	6%	7%

Source: OECD Revenue Statistics (2000), Hong Kong Finance Bureau. Hong Kong revenue data is for FY97/98 and GDP data is for calendar year 1997.

Chart 5.3.11
Tax and Non-Tax Revenue as a percentage of GDP (1997)



Source: OECD Revenue Statistics (2000), HK Finance Bureau, Singapore Ministry of Finance. Hong Kong revenue data is for FY97/98 and GDP data is for calendar year 1997.

5.3.12 Findings

The international comparison to benchmark Hong Kong's tax base shows prima facie that Hong Kong is:

- overall a low tax burden jurisdiction;
- when its taxation sources are examined, the status of a low taxation environment is less significant but its taxation imposts are still less than average as a percentage of GDP; and
- the tax base is "narrow", in that it is heavily reliant on a limited range of taxes and hence not as neutral nor as reliable as the taxation systems in the comparison jurisdictions.

The two international benchmarks used in the Charts and Tables above show an OECD average benchmark, for both GDP and weighting of tax type to total tax, and a similar benchmark based on Asia-Pacific averages. The Asia-Pacific averages are generally lower than the OECD ones and are useful to highlight regional competitive nations.

Hong Kong ranks as one of the lower taxed jurisdictions in the international comparison of overall tax burdens of OECD jurisdictions. Based on the *total taxation revenue* collected by governments as a proportion of GDP, Hong Kong along with other newly developed and regional jurisdictions, Singapore, Korea, and Mexico, are the lowest taxed jurisdictions in the international comparison. These jurisdictions all enjoy tax to GDP ratios of around 20% or less, while the next group of relatively lowly taxed jurisdictions includes Japan, Turkey, the United States of America and Australia (all at or less than 30% of GDP).

Hong Kong's low tax level status applies to most components of taxation revenue, including taxes on personal income and goods and services.

In many key comparison components of taxation, Hong Kong has no tax revenue at all. This includes social security contributions to government, taxes on payroll tax and general consumption.

Hong Kong is the only jurisdiction in the comparison without a broad based tax on consumption. Hong Kong has limited reliance on the taxation of goods and services because its indirect tax base is narrow in that it only taxes a few goods and services. Broad based consumption taxes are a significant source of tax revenue in most developed jurisdictions.

Charts 5.3.12a and 5.3.12b summarise Hong Kong's deviation (expressed as a percentage variation/difference) from the international benchmarks, where Hong Kong imposes those major tax types. For instance, there is no deviation shown for general consumption tax because Hong Kong does not have one of these tax types.

When compared as a percentage of GDP, in only two major tax types, taxes on corporate income and property, does Hong Kong exceed the benchmarks and therefore has a positive deviation.

Chart 5.3.12a
Hong Kong taxes as a percentage of GDP and as a percentage of total taxation compared with OECD averages (1998)

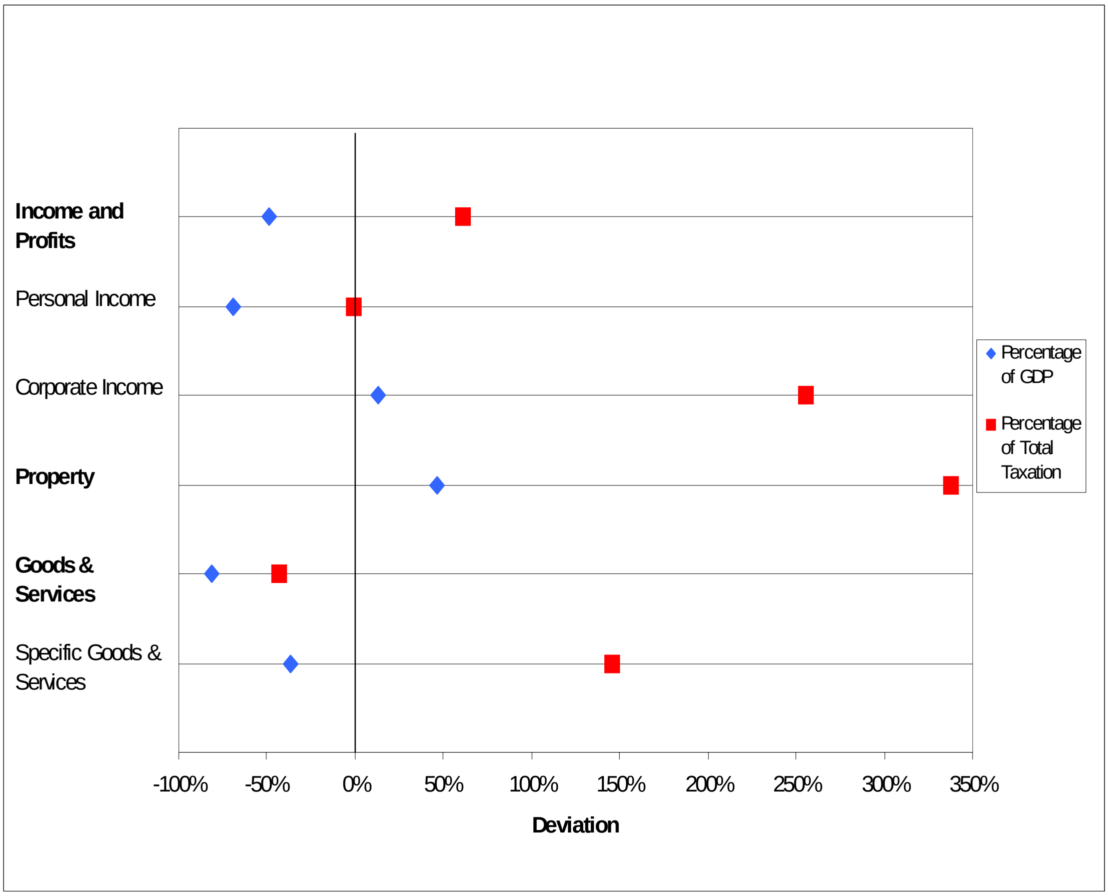
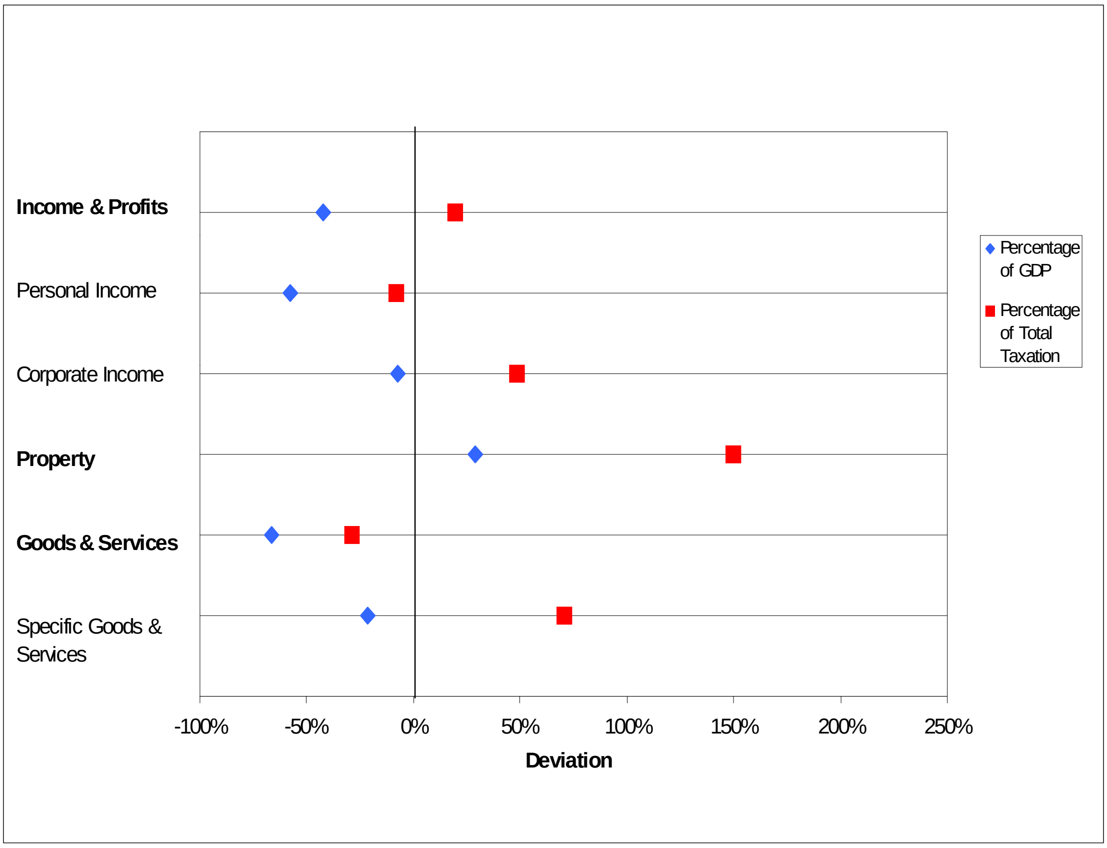


Chart 5.3.12b
Hong Kong taxes as a percentage of GDP and as a percentage of total taxation compared with Asia Pacific averages (1998)



Source: OECD Revenue Statistics (2000), HK Finance Bureau. Hong Kong revenue data is for FY97/98 and GDP data is for calendar year 1997.

5.4 Components and features – the representative comparison group

5.4.1 Purpose

The international comparison above illustrates some major differences in tax systems, the relativities of different taxes within them, and allows benchmarking at a macro level.

The study employs a more focused approach in this section to determine the key drivers or factors that are behind the similarities or differences identified in the international comparisons. This more in depth analysis provides further benchmarks with which to assess Hong Kong's tax base.

5.4.2 Approach

To allow for a more in depth analysis and assessment of Hong Kong's tax base, a smaller number of representative jurisdictions are used for comparison. These selected jurisdictions are Australia, Canada, Korea, Ireland, New Zealand and Singapore.

These jurisdictions have taxation systems that are **representative** of others that might be used for comparisons in relation to the "narrowness" of a taxation base. They include an appropriate mix of jurisdictions that are comparable from the following benchmarks so as to make the comparison appropriate:

- developed economies;
- most share regional influences;
- mainly similar legal and economic structures; and
- many have undergone tax reform programs of relatively recent significance (the Study tasks require reference to be made to recent examples of taxation reform in other jurisdictions).

It is important to emphasise that the selection of the broader and narrower group of jurisdictions is not to identify a taxation system that Hong Kong might like to emulate. Rather, the purpose of the comparison is to measure the relative "narrowness" of Hong Kong's taxation system when measured against international benchmarks.

However, it should be noted that Hong Kong rates as a comparatively low tax level jurisdiction against the other representative jurisdictions selected for specific comparison. This section will assess further whether Hong Kong's low tax level system derives from a narrow tax base.

A range of measures has been used to further assess Hong Kong's tax base in comparison to the representative comparison group. These measures have been selected to provide more understanding of the incidence and nature of the tax base. As a tax system is a combination of base and rate, it is important that both these aspects are analysed. Benchmarks against the measures used are then applied to assess Hong Kong's tax base relative to these other jurisdictions.

5.4.3 Overview of representative jurisdictions tax systems

Table 5.4.3 below illustrates the breadth of the different taxes that are currently levied in the selected representative jurisdiction compared with the Hong Kong system.

Table 5.4.3
International comparison analysis of tax features (2001)

	Australia	Canada	Hong Kong	Ireland	Korea	New Zealand	Singapore
Taxes on Income and Profits							
Capital Gains	Y	Y	N	Y	Y	N	Y
Dividends and Interest	Y	Y	N	Y	Y	Y	Y
Business Income and Profits	Y	Y	Y	Y	Y	Y	Y
Wages and Salaries	Y	Y	Y	Y	Y	Y	Y
Fringe Benefits Tax	Y	N	N	N	N	Y	N
Dividend Imputation System	Y	N	N	Y	N	Y	Y
Worldwide Income	Y	Y	N	Y	Y	Y	N
Social Security/Mandatory Retirement Savings Contributions*							
Employees	N	Y	Y	Y	Y	N	Y
Employers	Y	Y	Y	Y	Y	N	Y
Taxes on Payroll and Workforce							
Payroll Tax	Y	Y	N	N	N	N	Y
Taxes on Property							
Estate and Inheritance	N	Y	Y	Y	Y	N	Y
Stamp Duties	Y	N	Y	Y	Y	N	N
Rates	Y	Y	Y	Y	Y	Y	Y
Taxes on Goods and Services							
Customs and Import Duties	Y	Y	N	Y	Y	Y	Y
Excises	Y	Y	Y	Y	Y	Y	Y
General Sales Tax	N	Y	N	N	N	N	N
Goods and Services Tax	Y	Y	N	Y	Y	Y	Y
Betting/Gambling Taxes	Y	Y	Y	Y	Y	Y	Y

*Source: KPMG Tax Facts. Y= Yes, N= No, not a feature. * Includes OECD definition plus mandatory contributions to non-general government funds*

All of the economies surveyed (including Hong Kong), impose tax on individual and corporate income.

Australia, Canada Ireland, Korea and New Zealand impose tax on worldwide income, while income earned offshore (i.e. foreign source) is exempt from tax in Hong Kong. In Singapore, foreign source income is taxed on remittance only.

Australia, New Zealand, Ireland and Singapore have dividend imputation. Canada attempts integration with income tax to avoid double taxation of dividend income. In Hong Kong, dividends are not subject to tax in the hands of shareholders.

Australia, Canada, Ireland and Korea have capital gains taxes, although in Australia and Canada up to 50% of the capital gain is not subject to tax, while Ireland has a special lower tax rate for capital gains. Singapore and New Zealand have some tax arrangements designed to capture speculative income; in Singapore these taxes are aimed at capital gains on real property. In Hong Kong capital gains are not taxed.

Australia and New Zealand are the only economies surveyed that have a specific fringe benefits tax systems in which the employer is taxed for the provision of certain fringe benefits provided to employees. In Canada, Ireland, Korea and Singapore taxes on employment income paid by employees includes some fringe benefits provided by their employers. Hong Kong similarly taxes fringe benefits when taxing employment income, but in a rather limited scope, for example housing quarters are taxed at less than market value, passages and holiday warrants are exempt. Fringe benefits are only included if they can be convertible into cash or represent a liability of the employees discharged by their employers.

Social security is categorised differently between the economies. The OECD only includes compulsory contributions to government as 'social security contributions' for its tax revenue purposes. However, in light of many representative jurisdictions adopting compulsory retirement schemes that are not covered by the OECD definition, Table 5.4.3 above also includes those as de facto taxes. Australia has a system of compulsory employer contributions (based on 8% of salary) to employee retirement superannuation schemes, predominantly outside the government sector. Canada, Ireland and Korea have compulsory employer and employee funded employment insurance and pension plans. Singapore has a compulsory government Central Provident Fund into which individuals must contribute 20% of salaries, while employers contribute 16%. New Zealand does not have a compulsory salary-based social security schemes, but rather draws upon general revenue to fund social security. Retirement savings are entirely voluntary in New Zealand. Hong Kong operates its Mandatory Provident Fund schemes that require employees and employers to contribute 5% each.

Payroll taxes are only levied by Australian State governments, some Canadian Provincial governments and Singapore.

Taxes on property vary significantly. Municipal/local authorities typically levy rates to support local services. Canada applies a probate duty and Ireland, Korea and Singapore levy estate duty. Ireland abolished its probate duty in its last budget. Hong Kong also has estate duty.

All of the economies analysed, with the exception of Hong Kong, have broad-based multi-stage goods and services tax; Australia (10% introduced on 1 July 2000), Canada (7%), Ireland (reduced to 20% from 1 January 2001), Korea (10%), New Zealand (12.5%) and Singapore (3%). Canada has additional retail sales taxes that are levied by Provincial governments that are combined, when applicable, with the Federal GST. Hong Kong has neither a broad-based goods and services tax nor sales tax.

All of the economies have customs and/or excise duties that are imposed on alcohol, tobacco and petroleum products. Hong Kong as a free port does not impose import or customs duties.

Stamp duties are levied by Australian States on property transactions and trade in securities (although from 1 July 2001, Australia will no longer apply stamp duty to quoted marketable securities). Hong Kong, Ireland and Korea also apply stamp duties to similar transactions. Canada and Singapore do not apply stamp duties, while New Zealand has progressively abolished its stamp duties, with the last remaining major duties, on conveyancing and leases, abolished in May 1999.

Other taxes imposed in various economies include taxes on bank and credit card transactions, hotel accommodation, gambling and import tariffs.

5.4.4 Multiple internal tax jurisdictions

Jurisdictions with only one level of government do not have an issue with the interaction of taxing powers between the different levels of government. Australia, and Canada are federal systems and therefore have more than one level of government with taxing responsibilities.

Canada has the most complex taxation arrangements, with individual and corporate income taxes levied by Federal and Provincial governments. Indirect taxes in Canada also include goods and services tax levied by the Federal government and a range of sales taxes on goods that are levied by Provincial governments. In Australia, the States levy a range of stamp duties, property taxes and payroll tax, however, they do not levy income or general consumption taxes. The Federal government levies these.

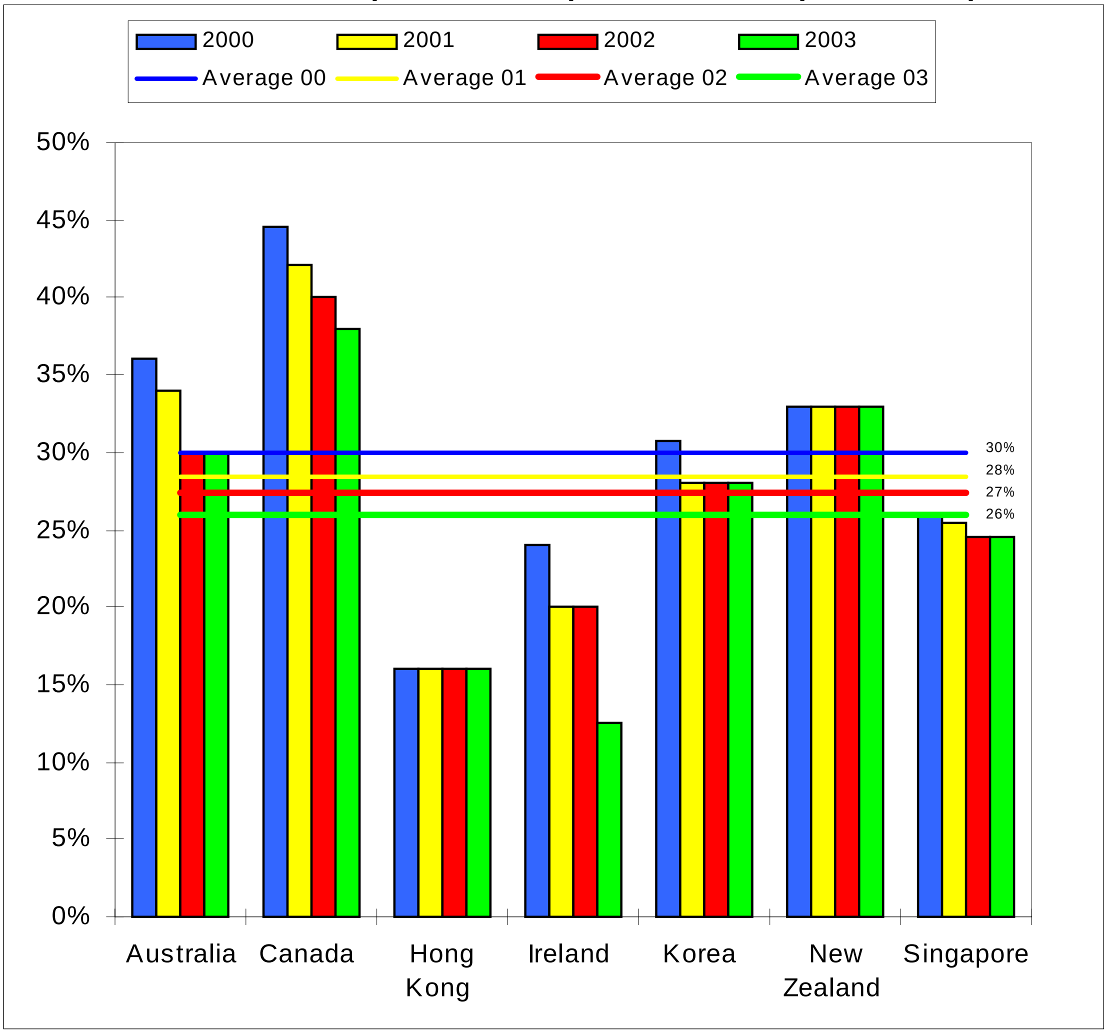
5.4.5 Corporate tax

One of the most visible features of the business tax system of a jurisdiction is its company tax rate. While it is restricted in using this comparison as a measure for the narrowness of a tax system, it is a feature that attracts considerable attention, as many investors will regard the 'headline' tax rate as an indicator of other aspects of the taxation system. In other words, it can be a potent symbol of business competitiveness.

Corporate tax rates range from 16% in Hong Kong to an average 45% in Canada. All of the economies of the representative jurisdictions for the study have some special corporate tax arrangements in place for particular sectors of their economies (such as shipping or natural resources).

Hong Kong has the lowest corporate profits tax rate amongst the representative jurisdictions. Corporate tax rates for these jurisdictions averaged around 30%. Chart 5.4.5a below shows the statutory corporate tax rates for the next 4 years. As can be seen from this, the trend over that period is clearly towards reducing corporate tax rates.

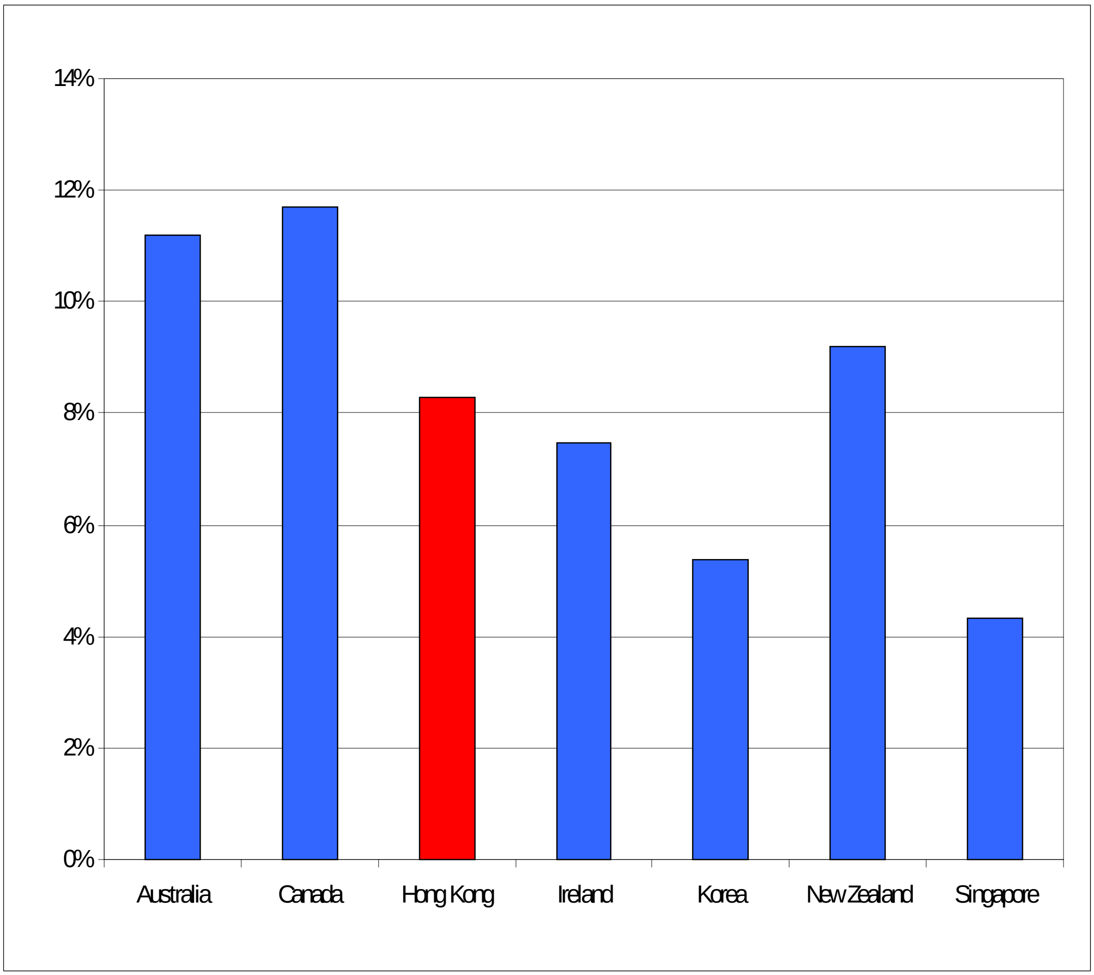
Chart 5.4.5a
International comparison of corporate tax rates (2000 – 2003)



Sources: KPMG Corporate Tax Rate Survey (2000); National Budget Papers (Singapore, Hong Kong, New Zealand, Ireland); Statistics of Corporate Taxation (Tax Department, Korea).

While Hong Kong's headline corporate tax rate is significantly lower than the other representative jurisdictions, its profits tax yield as a percentage of gross operating surplus (a useful economy wide measure of business profits) is marginally, but not significantly, lower than the other representative jurisdictions, as depicted in Chart 5.4.5b below. In fact, even though Hong Kong's corporate tax rate is half that of New Zealand, its yield is only 1% of GOS (or a mere 11%) lower.

Chart 5.4.5b
International comparison of business profits tax as a percentage of gross operating surplus (1998)



Sources: OECD Revenue Statistics (2000), National Accounts of OECD Countries (1998), Hong Kong Finance Bureau, Singapore Department of Statistics. Note: New Zealand information based on 1997, Ireland gross operating surplus based on international average.

Table 5.4.5 provides information of the relative proportion of tax paid by the highest taxpayers (based on the nearest approximation to the highest 1% of tax contributions that is officially published), for those economies where information is published and current. In this respect, Hong Kong's corporate tax is less concentrated in the terms of fewer payers than other developed jurisdictions.

Table 5.4.5
Corporate tax paid by proportion of highest paying taxpayers (1999)

Jurisdiction	Proportion of taxpayers (represented by highest tax payers)	Proportion of tax paid
Hong Kong	1.0%	63%
Australia	1.1%	75%
Ireland	1.2%	72%
Korea (South)	1.6%	82%
Singapore	3.0%	75%

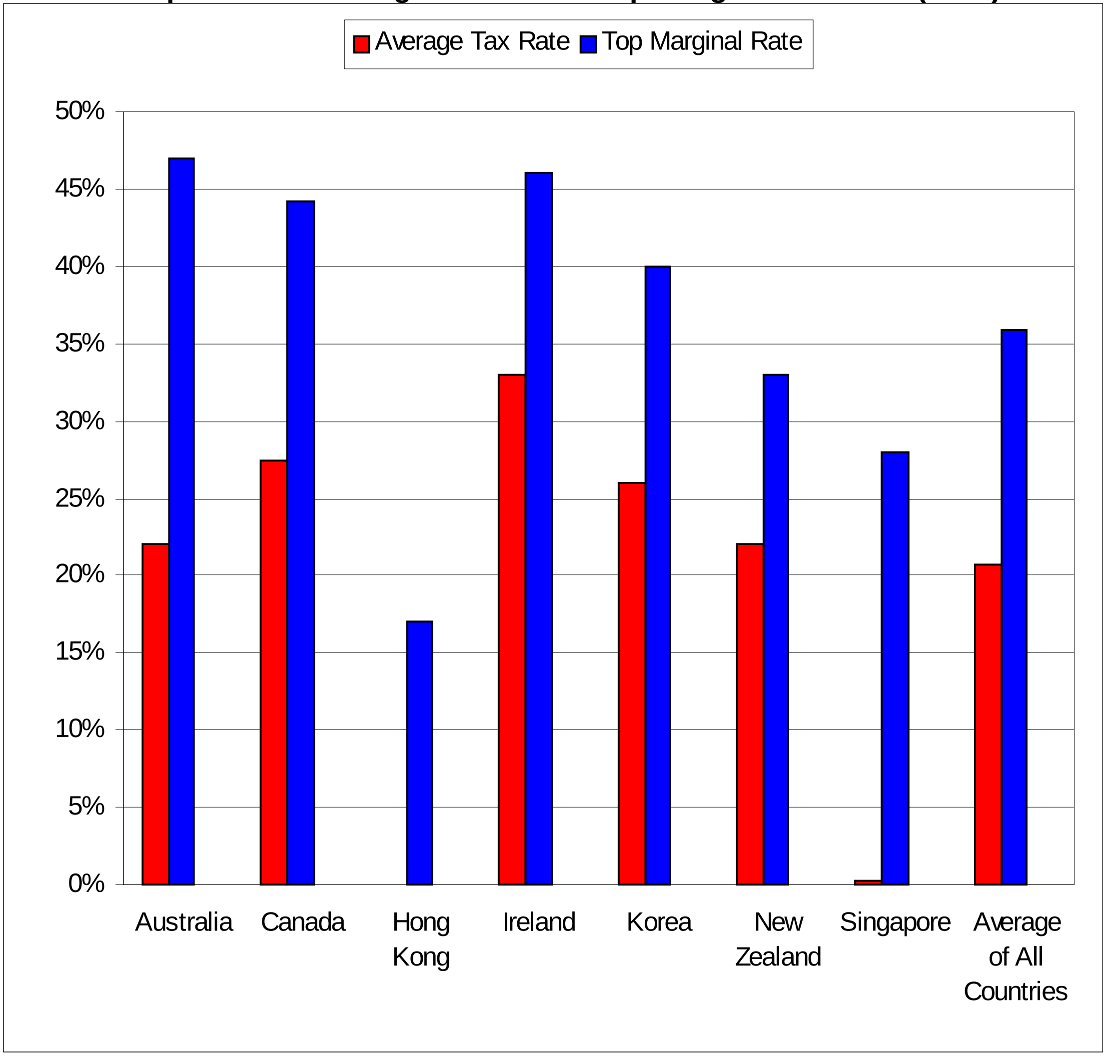
Source: National revenue authorities

5.4.6 Individual Income/Salaries tax

Personal or individual income tax is usually a key tax revenue source (see Chart 5.3.4 above). The following Charts and Tables examine Hong Kong's tax on personal income (mainly through salaries tax) in the context of tax rates, yields, taxpayers, and finally when considered with other taxes borne by an average Hong Kong family. These comparisons benchmark Hong Kong for these different variables to allow an overall assessment.

The top marginal tax rates on individual income range from 17% in Hong Kong to 53% in one Canadian Province. The high marginal rates are, however, not reflective of the average tax rates (as represented by tax paid by an average wage or salary earner) paid in most economies due to their progressive (increasing as income rises) tax rate scales. Chart 5.4.6a shows the top marginal rate and the average rate. In Hong Kong, an average earner is not a salaries taxpayer at all, as the personal allowances have the effect of reducing their tax to nil. This is not the case for any of the other selected jurisdictions, where the average tax rate is close to 20%. Only Singapore comes close to Hong Kong's nil tax position for the average earner, with a low average rate of less than 1%.

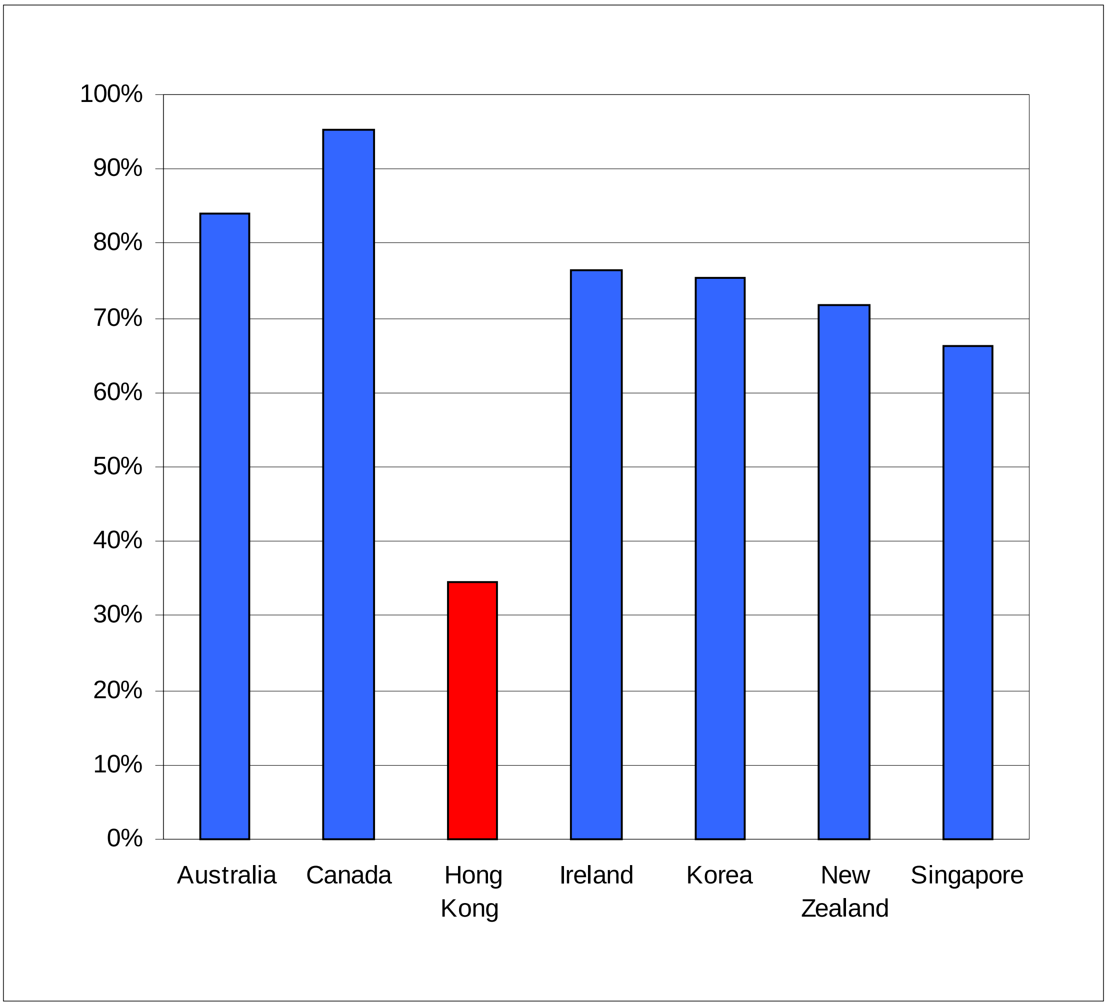
Chart 5.4.6a
Comparison of average tax rates to top marginal tax rates (1998)



Sources: OECD Revenue Statistics (2000), OECD National Accounts (1998), Hong Kong Finance Bureau, Singapore Inland Revenue Authority, Statistics Canada. Note: Average tax rates based on tax on average compensation of employees. Canada includes Ontario provincial tax, in addition to Federal tax and Federal tax surcharge. Australia does not include the additional compulsory Medicare Levy of 1.5%.

In Chart 5.4.6b, we can also see that Hong Kong's salaries tax base is also unusual in that only a minority of potential taxpayers are in fact actual taxpayers. Therefore, while theoretically the taxable income base should include a considerable breadth of earned income and income earners, the practical application of the system is to significantly reduce the base from these perspectives.

Chart 5.4.6b
Coverage of actual taxpayers relative to number of persons potentially chargeable (2000)



Source: OECD Revenue Statistics (2000), Hong Kong Finance Bureau, Singapore Department of Statistics. Notes: 2000 Figures other than Australia (1998), Canada (1997), Ireland (1999)

Table 5.4.6 shows that Hong Kong – and even more so Singapore – is also more dependent on a small proportion of taxpayers for most of this tax type.

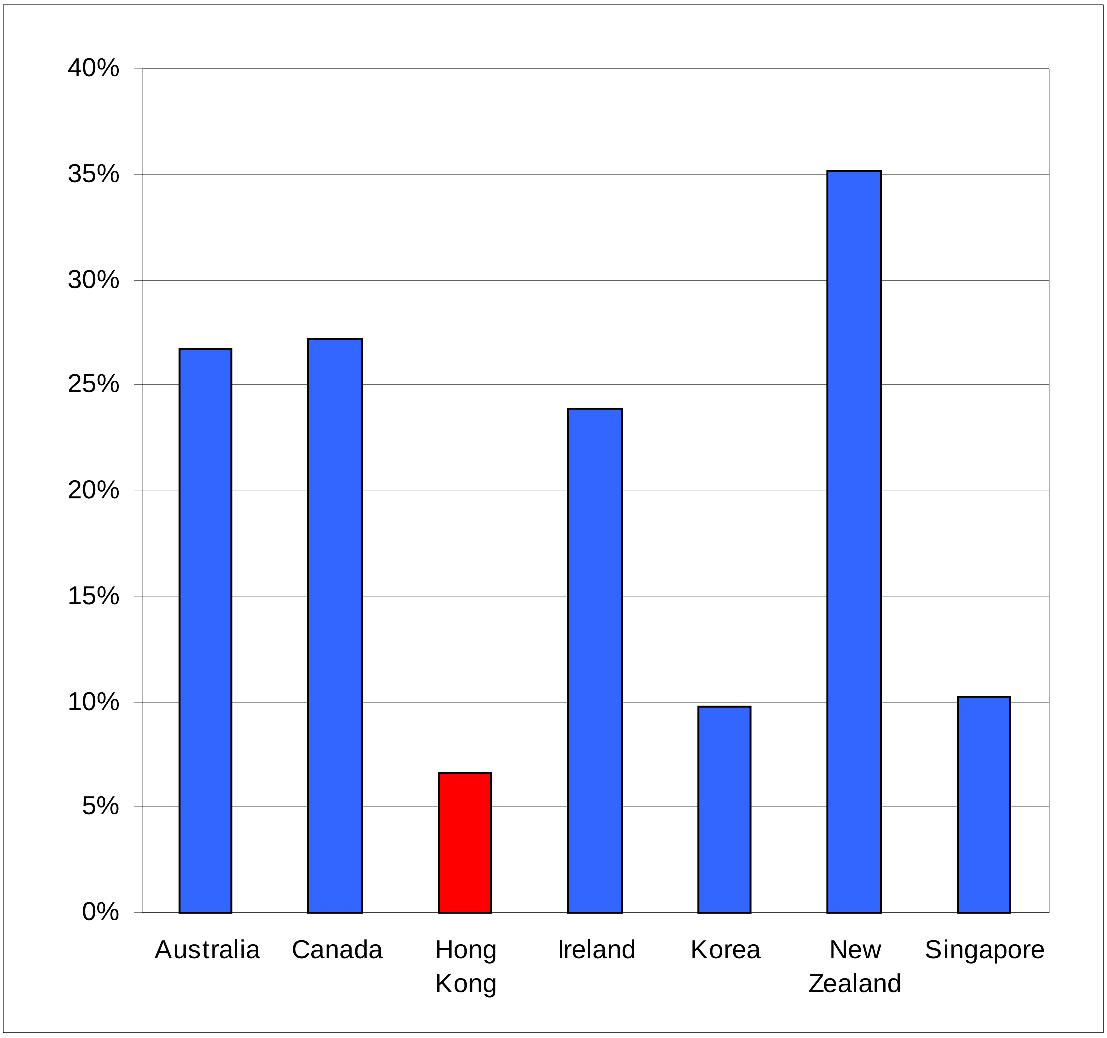
Table 5.4.6
Proportion of tax paid by highest taxpayers (1999)

Jurisdiction	% of taxpayers (representative of highest tax payers)	% of tax paid
Hong Kong	21%	82%
Australia	38%	75%
Canada	26%	78%
Ireland	29%	77%
Korea	25%	82%
New Zealand	36%	80%
Singapore	13%	79%

Source: National revenue authorities

In addition to the limited number of taxpayers, and consistent with both a low tax rate and small base of taxpayers, Hong Kong also has the lowest yield of tax as a percentage of income earned by wage and salaries earners. Chart 5.4.6c illustrates this below:

Chart 5.4.6c
International comparison of taxes on individuals as a percentage of compensation to employees (1998)



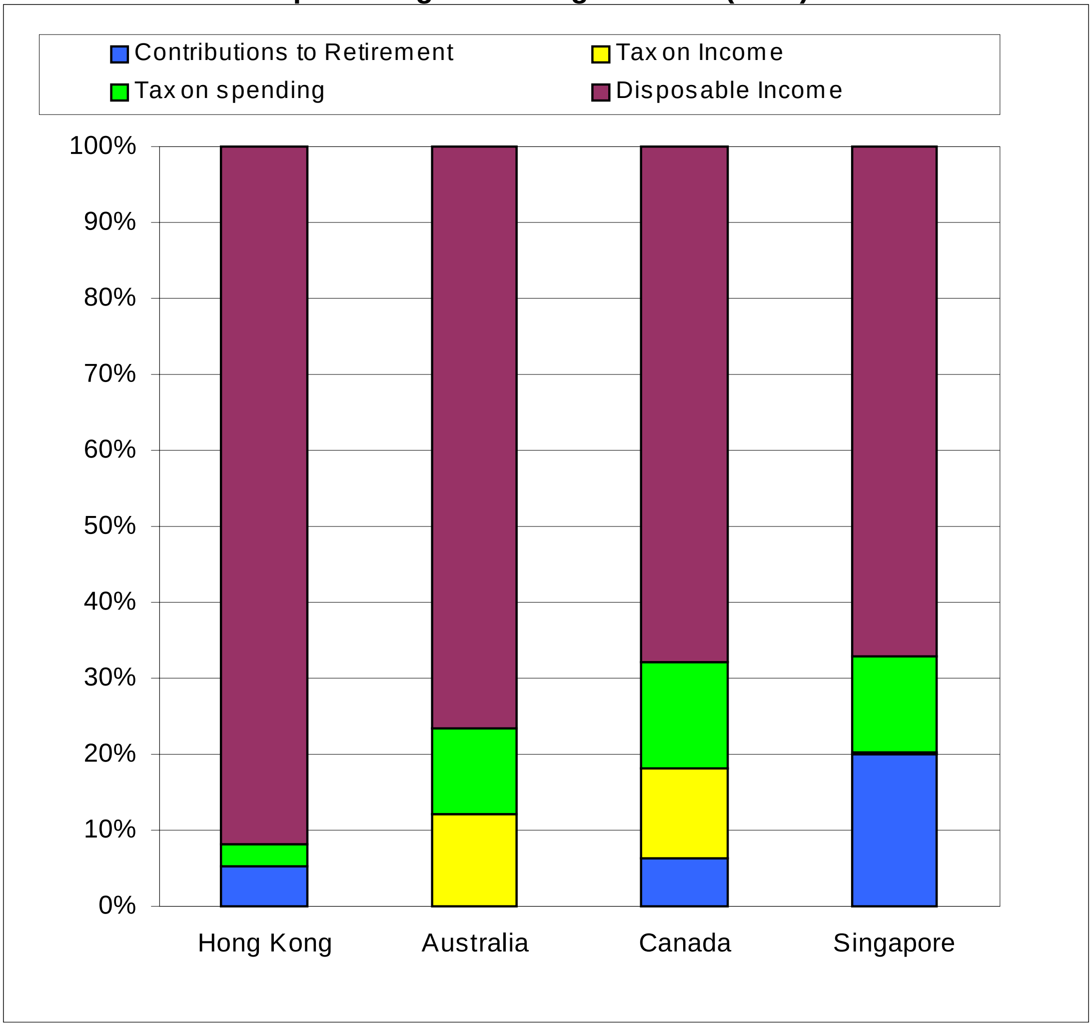
Sources: OECD Revenue Statistics (2000), OECD National Accounts (1998), Hong Kong Finance Bureau, Singapore Department of Statistics. Note: New Zealand information based on 1997

Chart 5.4.6d depicts the overall major direct taxation of a typical Hong Kong family (2 adults – 1 working, 2 dependant children). It demonstrates that such a family would pay much higher level of (and a broader range of) taxes in other representative jurisdictions.

The combination of all these comparisons appears to indicate that not only is personal income taxed at a relatively low level, but also this tax levied and taxpayer base is also relatively narrow by the comparable international standards.

The scope of the personal income tax base and the narrow taxpayer base has the consequence of the tax itself being discriminatory and distortionary in its impact. That is, it is open to, and biased towards activities and structures that avoid its incidence. In this respect, it is inefficient from an economic neutrality perspective. It also fails the reliability test of broadness.

Chart 5.4.6d
International comparison of taxes and retirement contributions as a percentage of average income (1998)



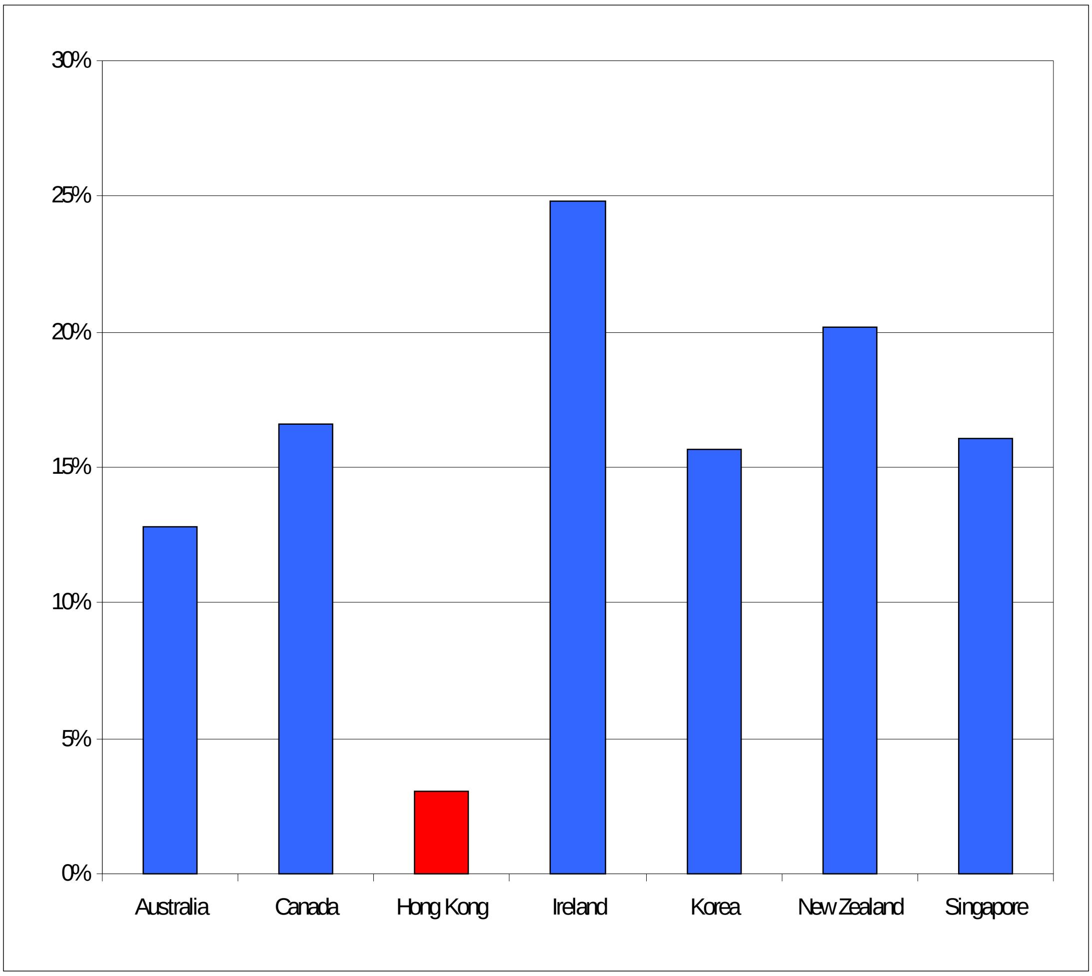
Source: OECD Revenue Statistics. Notes: (1) Average Families are taken to be represented by 2 adults (1 working) and two children (1 under 5 years old) (2) Tax paid on spending is the ratio calculated by taxes on goods and services against household final consumption expenditure for 1998.

5.4.7 Consumption taxes

The evidence from the international comparison (Chapter 5.3.10) showed that Hong Kong's taxation of consumption was very low by international standards. It was the only jurisdiction to rely on narrow specific goods and services tax rather than any broad based consumption or sales taxes.

Consistent with these circumstances, Chart 5.4.7 below illustrates the very small proportion of tax that Hong Kong receives from consumption when measured against private consumption expenditure (a measure of the possible tax base for this type of taxation).

Chart 5.4.7
International comparison of tax on goods and services as a percentage of household final consumption expenditure (1998)



Sources: OECD Revenue Statistics (2000), OECD National Accounts (1998), Hong Kong Finance Bureau, Singapore Ministry of Finance. Note: New Zealand information based on 1997

The benchmark average of representative jurisdictions excluding Hong Kong is over 10%. Hong Kong by comparison, raises tax from consumption of a mere 3.5%, i.e. less than one third the representative jurisdictions' benchmark. Given both the defined narrowness of Hong Kong's taxation of goods and services (being limited to a few items mainly through excise and betting duty) and the statistical analysis which shows the very low yield of taxation from consumption expenditure, it can only be concluded that Hong Kong's taxation of consumption/goods and services is very narrow by international equivalents.

5.4.8 Findings

The representative jurisdictions comparison discussed above supports the findings of the international comparison above (see 5.3).

Hong Kong's tax base has many, albeit fewer overall, of the international benchmark features. Its definition of income is not nearly as comprehensive as other jurisdictions. Even though, it does not have a payroll tax, it does have tax on property, excises, mandatory retirement requirements (in many ways akin to taxes), and other common taxes, such as stamp duty and betting tax.

This comparison highlights that Hong Kong's tax base on definitional grounds for income is narrower than international jurisdictions. The taxation of personal income yields much lower levels of revenue from its base than other jurisdictions. However, the yield of revenue from profits tax, while narrow on definitional grounds, is not significantly different to the other jurisdictions. Both of these taxes have very low rates by the international benchmarks, but the coverage of payers in salaries tax is very low due to the generous personal allowances and concessions that have the same effect as a high tax-free threshold and therefore make its taxpayer base narrow. The corporate profits tax, on the other hand, has minimal concessions and no tax-free threshold, so all income (even if on a narrow international definition) is still taxed at the low rate.

Hong Kong's tax base is lacking in a major feature of developed jurisdictions, a broad based goods and services tax. Taxation of goods and services (or consumption) is a major source of taxation revenue and part of the tax base in most international jurisdictions.

The combined lack of a consumption type tax and narrow personal income tax features again indicate a narrow overall tax base in Hong Kong.

5.5 International trends

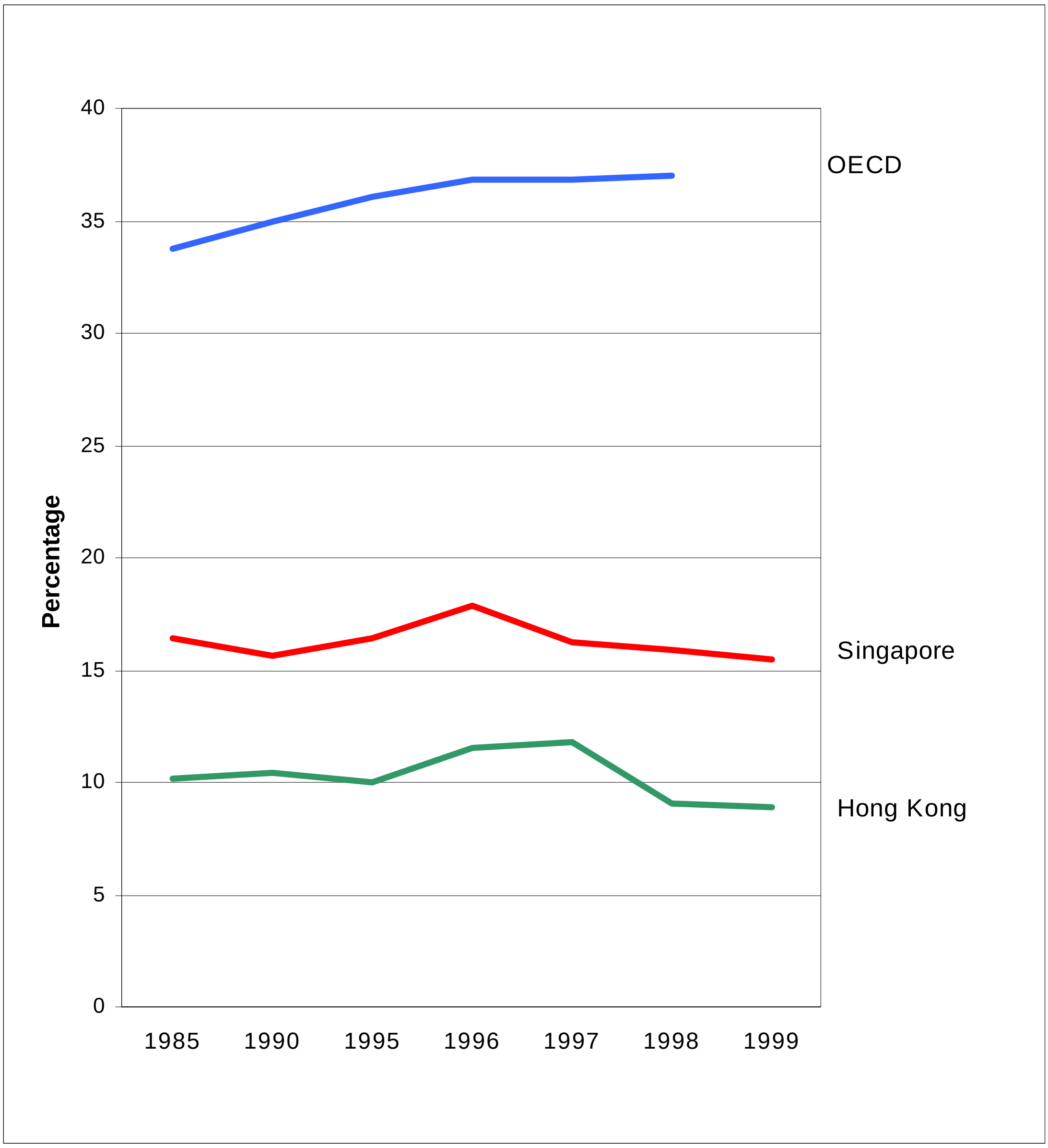
5.5.1 Overall Level

The overall trend in taxation revenue in the OECD developed economies has been towards higher overall levels of taxation, as a percentage of GDP. Although this trend has slowed throughout the 1990s where the trend increase in the OECD has risen by only around 2% of GDP, compared to 3% in each of the previous two and half decades. Indeed in many economies the overall level of taxation has fallen throughout the 1990s, e.g. New Zealand, Mexico, Japan, Ireland, and Sweden. In Singapore, the level of taxation (to GDP) has remained broadly constant.

Hong Kong's trend in taxation revenue has been more similar to Singapore than the OECD generally, albeit from a lower base. Expressed as a share of GDP, Hong Kong's tax revenue has shown little discernible trend over the last two decades, varying cyclically around a level of 10-11% of GDP. However, in recent years the trend in Hong Kong's tax level has shown signs of beginning to fall slightly below the previous constant trend (part of this may be cyclically attributable).

Chart 5.5.1 illustrates these trends over the last two decades.

Chart 5.5.1
Hong Kong, Singapore and OECD total tax revenue as a percentage of GDP



Sources: OECD Revenue Statistics (2000), OECD National Accounts (1998), Hong Kong Finance Bureau, Singapore Ministry of Finance

5.5.2 Composition

While overall levels of taxation have generally been rising, at the same time, the mix of taxation revenue has been changing. Chart 5.5.2 illustrates the movements of the major taxation types as a percentage of GDP across the OECD.

Personal income tax remains the largest source of taxation revenue in the OECD. Nevertheless, the overall international trend has been towards lower reliance on this form of taxation since the 1990's.

Corporate income tax has been rising slightly and steadily as a proportion of taxation revenue for the past twenty-five years in the OECD.

Social security and payroll taxes have increased in proportion, particularly up until the mid 1990's.

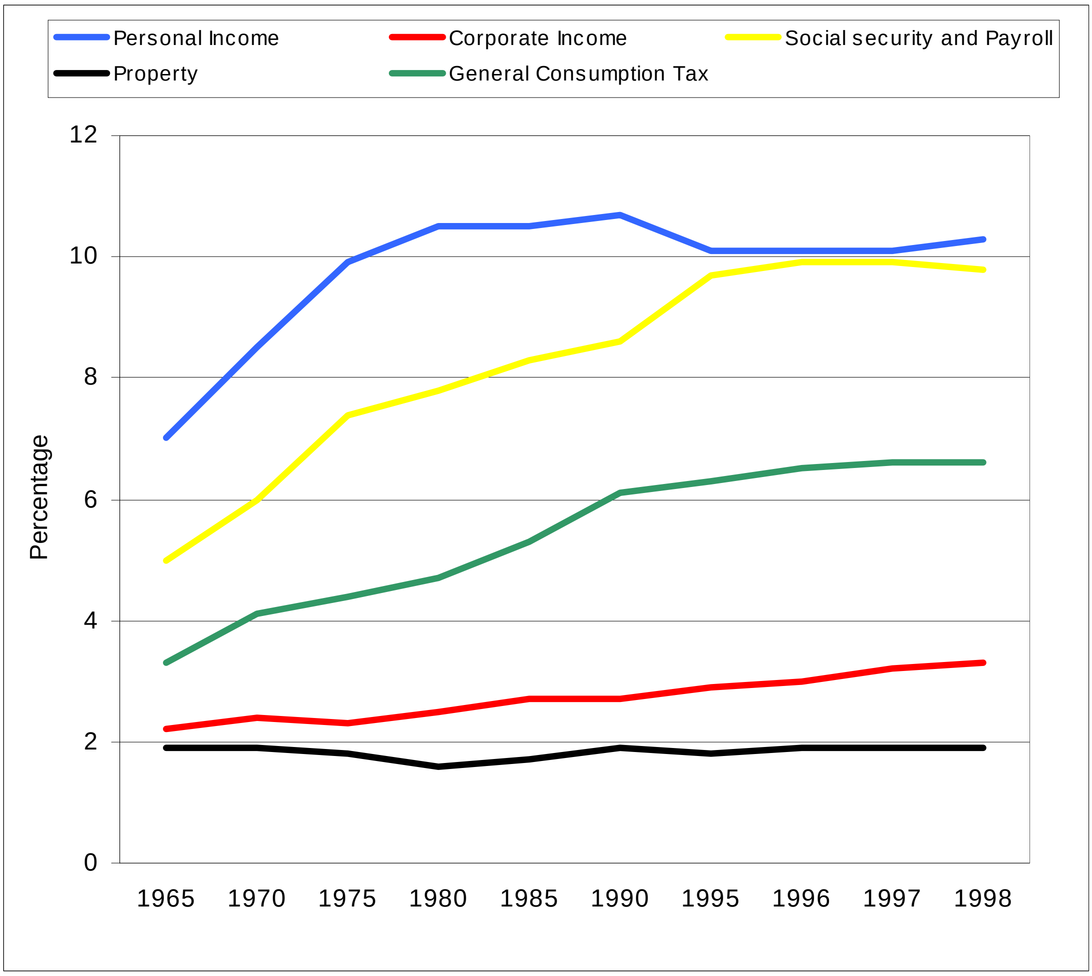
Taxes on property's share of revenue has slightly and gradually fallen in significance over the two and a half decades.

General consumption taxes have risen the most significantly over the twenty-five year period, and are the only major source of taxation revenue to show continuing strong growth throughout the 1990s when overall taxation levels began to stabilise.

Hong Kong's tax revenue has broadly followed the international trends (where similar taxes apply). It has clearly missed out on the significant international trend rise in social security and consumption taxes.

Over the last two decades, in terms of personal income and profits taxes, they have been relatively steady and rising slightly (until recently) respectively. While taxes on property, such as stamp duties have been trending downwards over the last decade – and have been very volatile around the economic cycle.

Chart 5.5.2
Structure of taxation in OECD countries: OECD total tax receipts as a percentage of GDP



Source: OECD Revenue Statistics (2000)

5.6 Findings - Is Hong Kong's tax base narrow?

What is narrow? A narrow tax base is one that does not tax a "normal" (in relative terms) proportion of the possible taxable base. The taxable base that has been considered as an overall tax system, and also the key components thereof.

The international comparison supported by the representative jurisdictions comparison demonstrate that Hong Kong's tax base is both narrow overall and limited to two major areas of significant taxation sources – tax on profits and property.

Hong Kong's tax base is narrow in the taxation of personal income and especially in the taxation of goods and services.

Essentially, a tax base may be "narrow" in the context in which the term is used in the Study Brief because it is not sufficiently broad to:

- Protect the revenue from Distortions and discriminatory effects of taxation of one form of economic activity as opposed to another (neutrality).

- Provide reliability of revenue (buoyancy) as a result of that taxation base is not representative of the economy overall or the Government's requirements to fund its expenditure needs.

Further, the taxation base may suffer from "narrowness" because the activities that are within the base do not grow at the same rate as the economy overall or are more volatile than the general economy – thus not securing a reliable source of revenue to the Government over time.

Equally, a taxpayer base may be narrow if a limited number or type of taxpayers are responsible for contributing the vast majority of the taxation revenue, and hence the tax base is heavily reliant or dependant on a few payers. As evidenced above, for example, the salaries tax base in Hong Kong is largely reliant on a small amount of taxpayers with the highest percentage of tax paid – 21% of taxpayers account for 82% of salaries tax. A "narrow taxpayer base" may make the tax base both unstable and inequitable, as well as lacking in neutrality.

6 Hong Kong Tax Reform Options

6.1 Purpose

Chapters 4 and 5 of the study involve broadly an identification of what widely accepted good tax principles are, how Hong Kong stands against the international benchmarks and if and where it falls short. In Chapter 5, this study concluded that Hong Kong's tax system is narrow in significant respects.

Having reached this conclusion, the study requires an identification of what the reform options there are available to broaden the tax base. The reform options are to be developed with reference to recent overseas tax reform experiences, and are to cater for three broad scenarios:

(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.

The options presented are for further consultation. They are presented as policy proposals at a high level, and detailed discussion of legislative provisions and introduction of administrative arrangements are not included, except in so far as they are relevant to the international experiences.

6.2 Approach

In identifying tax reform options for Hong Kong, this Chapter will draw on recent overseas experiences with tax reform, and in particular will focus on the experiences of the representative jurisdictions discussed earlier. One of the key features of those economies selected was their recent adoption of major taxation reforms.

The options for taxation reform that are discussed canvass policy proposals in all the major tax types, in the context of the analysis and assessment of Hong Kong's tax base in Chapter 5. In considering the available options, reference has been made to the internationally recognised principles of tax design that are included in Chapter 4.

In accordance with the study brief tasks, the following non-exhaustive options are considered:

- increasing tax rates for the existing tax base but still maintaining a low taxation regime;
- reducing personal allowances and abolishing some concessionary deductions; and
- introducing a broadly based, low rate, consumption tax.

Within each of the taxes where options are canvassed, the high level interactions with other taxes and tax principles are also investigated.

In identifying options for reform, the study is concerned with base broadening measures in accordance with the Advisory Committee's terms of reference.

As indicated in Chapter 5, a tax base is narrow if it lacks sufficient breadth to protect the base upon which taxation is levied because of either a lack of "neutrality" or "buoyancy".

The options that are identified in this Chapter are those that are capable of broadening the tax base in the context of these two measures.

At the end of the day, the objective of the options chosen is to identify a tax base for Hong Kong that is not as deficient in terms of "narrowness" as that existing presently. A broader tax base, on these measures, is one that is:

- more robust so that it will ensure revenue adequacy in the long term, that is, sustainable; and
- achieves revenue adequacy with as little distortion or discrimination as possible in respect of the variety of economic activities that might be undertaken in Hong Kong.

While, narrowness has also been examined in terms of the taxpayer base, it is not a measure that the context in which the study is to approach tax reform options requires specific attention to be paid. In this respect, the number of taxpayers in a tax base is not, in our view, a measure of the narrowness of the base such that, of itself, it is a matter that is of significance in identifying the options for reform in broadening the tax base.

The number of taxpayers may be relevant as an indicator of the "neutrality" or "reliability" measures of narrowness but the size of the taxpayer population is not a determinative factor in assessing narrowness under those measures.

6.3 Hong Kong Options

6.3.1 Does Hong Kong need a broadening of its tax base?

Benchmarked against other developed jurisdictions, Hong Kong has a narrow tax base. Notwithstanding that Hong Kong has a low overall level of taxation, the composition and trend of its taxation base is markedly inconsistent with international practice.

Hong Kong's revenue base is at risk of becoming less robust, less balanced and less stable, particularly with respect to international experience and increased international tax competition.

The study's requirements are to consider options for tax reform that provide for a broader, more stable and growing tax base. The reform options need to cater for three broad scenarios –

(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.

For the purposes of this study, 1% of GDP is taken to be approximately $12 billion in 1999/2000 terms.

6.3.2 What base broadening options are available?

The options for broadening the base can be grouped as follows:

1 Options to reduce concessions/allowances from the existing base

2 Options to expand existing taxes in the base

3 Options to introduce new taxes to the base

While another option for raising additional revenue is to increase tax rates within the existing base, the purpose of this study is to identify options for broadening the tax base. As a rate increase is not a base broadening measure, it is not canvassed in this study. In fact, to increase the rate on an existing base would serve to make the base narrower, in both the "neutrality" and "reliability" measures described earlier.

Each of the three approaches will be canvassed in the following sections.

6.4 Options to reduce concessions from existing tax base

Hong Kong's personal income tax system includes generous (by world standards) allowances that have the effect of exempting many wage and salary earners from that tax base. Less than 40% of wage and salary earners currently pay salaries tax.

Allowances have also generally been increasing faster than the cost of living. For instance, the last two increases in 1997-98 and 1998-99 increased the basic allowances by a cumulative 20%, compared to inflation over that period of less than 9%. Over the last decade personal allowances have increased by more than the cost of living (measured by consumer inflation).

The table below illustrates the estimated gain to revenue from a range of reductions in basic allowances. An across the board reduction of 50% in the personal allowances would raise an additional estimated HK$14 billion, while the total abolition could raise $40 billion. Under full abolition, the number of individual taxpayers would rise from 1.2 million to almost 3 million, and the cost of administration for processing tax returns would likely increase by approximately 35%.

A reduction of approximately 75% would raise revenue to the extent of 2% of GDP (Scenario (i)). A 50% reduction (slightly more than Scenario (ii)) would result in an almost doubling of the number of taxpayers to approximately 2.2 million.

With a 50% reduction, 90% of the additional tax revenue would be paid by existing taxpayers, and even under total abolition over 2/3rds of the extra revenue would come from the existing minority of individual taxpayers.

Minor reductions in personal allowances would only deliver a very marginal broadening of the tax base – as by definition very little currently untaxed income would be brought into the base. To deliver any major base broadening in the taxation of personal income a significant reduction or abolition of personal allowances would be necessary. This magnitude of allowance reduction would shift Hong Kong's taxation of personal income to much closer to international norms. The Table below illustrates the revenue gains from reducing personal allowances:

Table 6.4
Tax revenue from personal allowances adjustments (a)

Reduction in personal allowances	Estimated additional tax revenue (HK$)
10%	$2 billion
25%	$6 billion
50%	$14 billion
75%	Over $25 billion
100% (i.e. abolition)	Over $40 billion

Source: Finance Bureau/Inland Revenue Department

In addition to personal allowances, special concessions available to individual taxpayers could be reduced. While the abolition of special concessionary allowances for elderly care, home loan interest and donations to charities would raise an additional estimated HK$2.5 billion. Removing the concessions may prove socially and politically very difficult and would be contrary to other government policy objectives of encouraging care for the elderly (whether in the home or in specialised accommodation), encouraging home ownership and philanthropy.

As Hong Kong uses its personal allowance system in preference to a tax and transfer payments mechanism used in most developed jurisdictions (that is, where income is taxed and then government redistributes the money back to households in the form of family benefits or other welfare payments), the abolition or even significant reduction in these allowances could be quite inequitable as families with dependants would pay the same income tax as singles without dependants, and this tax increase would be borne particularly heavily by families with dependants. Consistent with overseas practice, the removal of these allowances would probably precipitate the necessity to introduce some form of family payments from the government to alleviate the increased burden on families. Given all of these issues, the removal of allowances or concessions may prove socially, politically and economically difficult and unjustifiable.

6.5 Options to expand existing tax bases

Options to expand the existing tax bases include a range of new measures with respect to income taxes, such as taxing capital gains, worldwide income, interest, and dividends.

Each of these measures can be considered alone or as a package. In particular, most income tax measures may be better suited to a wide-ranging package of measures to expand income taxation to more common international definitions. The reason they may best be analysed as a package is because otherwise the interactions of any or some of the measures alone may be lost. Indeed the effectiveness of one without the other may have a perverse policy outcome when behavioural effects operate.

As well as these related income tax measures, the scope of the taxation of fringe benefits and the extension of departure tax are also raised.

6.5.1 Tax on capital gains

Hong Kong could seek to tax capital gains. While Hong Kong is not alone in not taxing capital gains, most developed jurisdictions do tax gains made on speculation or investment of capital.

If the current taxation jurisdiction, i.e. only Hong Kong sourced income, was maintained then there would be a significant incentive for Hong Kong residents to invest offshore and earn capital gains in other economies. There could also be a major detrimental impact on Hong Kong as a destination for regional listings or head offices, as the investors chose other locations for their capital investments.

In addition, resolution of issues such as ‘grandfathering’ (i.e. not taxing capital gains accrued to date), the definition of assets to be included (i.e. will the family home, any small business exemption threshold, rollover relief for reinvestment, personal assets, etc be included) and the treatment of capital losses would also require serious consideration.

In the short term, if capital losses were taken into account, or there was any grandfathering of previous gains, tax revenue gains would be very limited.

Internationally, the trend in the last decade (at least) has been to lessen the taxation of capital gains so as to attract and retain global financial and entrepreneurial capital. This has occurred through a combination of lower rates of tax, deferring (often indefinitely) the taxation of gains, providing targeted exemptions, or only taxing part of the gains. For example, Australia, Canada, Ireland, Germany, the United Kingdom and the United States of America have all reduced significantly the scope and effective taxation of their capital gains tax bases.

Capital gains tax is also notoriously susceptible to economic swings, especially, stock and property market movements. It would have a negative impact on investment attractiveness and adds another layer of complexity to the tax law.

6.5.2 Tax on interest

Interest could be subjected to income tax, as it was in the past. The combination of the abolition of the Interest Tax in 1989 (for individuals) and the introduction of the Exemption for Profits Tax (Interest Tax) Order in 1998 (for interest that constitutes business income) is that interest income is not currently subject to tax – except interest income accrued to financial institutions.

If interest were again subject to tax then Hong Kong's source rules would only tax interest earned in Hong Kong, and thus create an incentive to invest in interest earning funds outside of Hong Kong. Any shift in deposits could have flow on effects to the banking system and may be contrary to other government policies aimed at building up Hong Kong as an international banking centre.

While it is common in most overseas jurisdictions to include interest earned as taxable income such a measure would need to be assessed against the likely behavioural response. Clearly, it would continue to be unviable unless a global taxation base was adopted or else deposits would swiftly shift offshore.

6.5.3 Tax on dividends

Hong Kong could also consider extending its tax base to include the taxation of previously taxed dividends.

If it were to do so it would need to examine and determine what type of dividend taxation system it desired. The two alternatives are a classical system, where the income underlying the dividend is taxed, then the dividend is taxed and no credit is provided to the recipient, or an imputation/integrated system, where a credit is provided to the recipient for the tax already paid. This latter imputation system avoids double taxation of dividends and is used in many international jurisdictions (see previous international comparison).

It can be argued that the present tax rate differential between the corporate profits tax and the standard tax rate constitutes an element of dividend taxation akin to the classical system.

To maintain an internationally competitive environment for company profits and dividend distributions an imputation system would need to be adopted. The introduction of an imputation system in Hong Kong would add to the complexity of the tax system, and as less than 40% of people currently pay income tax would create an extra administrative burden on recipients of dividends to lodge tax returns.

Given the standard tax rate means that any taxed corporate dividends, with imputation credits, would not be subject to further taxation in the hands of recipient shareholders it is doubtful whether such a system would raise much, if any, additional tax revenue. Indeed, if the imputation credits were refundable to shareholders (as in Australia from 1 July 2000) then the tax revenue may in fact decline as shareholders receive cash refunds for prior taxed dividends they receive.

Only taxing Hong Kong sourced dividends would provide an incentive to invest funds offshore, particularly if capital gains from offshore investments were also not subject to Hong Kong tax.

6.5.4 Tax worldwide income

Hong Kong is clearly in the minority (although not alone) in only taxing locally sourced income. One of the main attractions of Hong Kong's tax system for business has been this very feature.

Notwithstanding only taxing locally sourced income, Hong Kong's profits tax provides a significant revenue yield, far exceeding what its low rate would imply. This revenue yield may be due to a number of factors, including the minimal exemptions and special deductions available on business income, but is most likely the result of the attractiveness of declaring and locating profits in Hong Kong.

Therefore any efforts to move towards a worldwide income source of taxation may not materially increase business profits that are subject to tax. On the contrary, a worldwide income definition that also recognises fully overseas tax paid and allows for credits on Hong Kong tax, may even reduce profits tax in Hong Kong.

Equally, where Hong Kong companies have expanded offshore and have loss making ventures the offsetting of these overseas losses (unless subject to some form of quarantining) could also reduce Hong Kong taxed income.

Overseas experience tends to indicate that taxing worldwide income adds significant complexity to the taxation system for business and yet yields very small tax revenue – this would especially be expected to be the case where the home jurisdiction already has a low tax rate.

6.5.5 Taxation of fringe benefits

In addition, either the definition of income could be expanded to include more fringe benefits paid to employees or alternatively a new tax could be imposed on employers representing the value of fringe benefits paid to employees. That is, similar to the dichotomy of treatment of social security benefits, the liability for tax on fringe benefits can be either imposed on the recipients of the benefits, employees or the payers/providers of the benefits, the employers.

While a number of jurisdictions sought to broaden their tax bases in the 1980s through the taxation of fringe benefits (e.g. Australia and New Zealand, which impose the tax on the employer) these taxes are criticised by business as being administratively very burdensome, are unfair if imposed at a single high standard rate, and provide limited additional tax revenue as employers will arrange with their employees to restructure their remuneration packages to avoid the additional impost.

A more viable alternative would be to strengthen the existing taxation of fringe benefits by either taxing benefits at their full value, e.g. accommodation/quarters (that benefit from concessional valuations), and passages and holiday warrants (that are presently exempt) or widen the definition to include benefits that are not readily converted into cash, such as company cars, club memberships and non-business related travel. This approach would theoretically broaden the salaries tax base (by definition of income taxable), although the number of taxpayers is not likely to increase very much, given the concentration of benefits paid to higher income earners. It would also be efficient from an administration point of view – as long as the new valuation rules were simple and clear.

Due to the likely response effect, limited revenue gain is assumed to derive from this option.

6.5.6 Tax on land and sea departure

Hong Kong already has a departure tax on air departures, and could for consistency extend such a tax to cover land and sea departures as well.

The Finance Bureau has estimated that on a $25 charge, around $1 billion could be raised. While other policy considerations may support the adoption of this measure, it would only make a modest impact on addressing the structural tax base requirements. It would therefore have to be considered as part of a wider package of measures, for instance coupled with a broad base consumption tax.

6.6 Options to introduce new taxes

While the range and scope of possible new taxes is almost unimaginable, this study has concentrated on those options that are common overseas and lacking in Hong Kong. For instance, a multitude of new taxes on particular goods or services could be introduced, e.g. televisions or mobile phone usage or restaurant meals, however, a broad-based consumption tax, will include most such items within its tax base anyway and will include them in a non-discriminatory manner.

6.6.1 Tax on social security or payroll

Payroll tax or Social Security tax paid by employers (which is itself akin to a payroll tax) would be potential new taxes not part of the Hong Kong tax base. These taxes would be an additional cost to employing labour in Hong Kong and therefore may jeopardise Hong Kong's international competitiveness. Furthermore, no developed economy has gone down this path of new taxes for at least 20 years. These taxes are usually linked to state funded pensions/retirement schemes. These options are of questionable suitability for Hong Kong as it only has a limited means-tested social welfare system funded through general revenue and supplements this with the MPF schemes to encourage personal savings for retirement.

A social security tax on employees would add a significant complexity to the salaries tax system as only 40% of employees currently pay income tax. It would also be inconsistent with recent introduction of the MPF approach to retirement funding and is not as transparent a way of increasing income taxes.

6.6.2 Broad-based tax on general consumption

There are two types of taxes that could be used to tax general consumption:

- A single level sales tax (either levied at the manufacturer, wholesale or retail level); or
- A multi-level consumption tax (GST/VAT).

The general sales tax approach is now rarely used in any developed economy, other than the United States and Canada - where it continues to be imposed by many States/Provinces. A single stage sales tax is internationally regarded as more administratively complex, prone to tax avoidance and dispute, and not well suited to taxing services or other intangibles (which inevitably account for a greater share of economic activity over time).

The GST or VAT approach has been adopted in every other economy, with Australia the last OECD member (outside the USA[2]) to replace its wholesale sales tax with a GST on 1 July 2000. The GST/VAT approach is the common international practice, regarded internationally as both efficient and administratable, and the only modern option for Hong Kong to consider.

One of the options for reform in respect of which the study requires consideration to be given, is a broadly based, low rate consumption tax. For the purposes of this study, the revenue yield from such a tax has been estimated as 0.5% of GDP for each 1% of consumption tax rate. Based upon information provided by the Finance Bureau, a reasonable estimate suggests that a broad based 3% GST would yield approximately $18 billion in additional tax revenue (in 1999/2000 terms).

Accordingly, in revenue Scenarios (i) and (ii), a consumption tax of between 2% and 5% would satisfy the additional revenue requirements and be contained within the revenue limitations set out by those scenarios.

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[2] Canada has a federal GST, but the Canadian Provinces are divided with some imposing sales tax and some GST (in addition to the federal GST).

In view of the revenue Scenarios with which this study is concerned, a GST rate of 3% has been chosen. This rate achieves approximately 1.5% of GDP as additional revenue (Scenario (i)). This assumption has been made on the basis that the international comparison in Chapter 5 highlighted the significant feature lacking in the Hong Kong taxation regime is a tax on general consumption.

A tax on general consumption of less than 3% is not a feature of any developed jurisdiction, including among those that have been identified in this study. At less than 3%, a general consumption tax is likely to have questionable sustainable base broadening benefits:

- The revenue impact of a nominal rate is not sufficient to significantly enhance reliability or buoyancy
- A nominal rate, of itself, without significant changes to existing non-neutral taxes will not achieve significant base broadening overall.

Further, the compliance and administrative costs are unlikely to be able to be justified in terms of the overall revenue raised. If the quotation from Jean Baptiste Colbert, the Minister for Finance under Louis XIV is to be called upon[3], the hissing would, no doubt, outweigh the feathers.

The IMF has observed that "a GST rate of below 3% could raise questions about the cost-effectiveness of introducing a GST at all." In particular, reference is made to the Singapore experience in this regard where an increase in administrative costs of 22% arose.[4]

Table 6.6.2a
Hong Kong Consumption Tax — IMF Model

A unique Hong Kong GST, based on Singapore/New Zealand model.
Low rate of between 3 and 5%
Broad base, with few exclusions
Main exclusions from tax base: export trade, residential rents and financial services
High registration threshold with option for small business to register

[3] "The art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the least possible amount of hissing."
[4] Glenn P. Jenkins and Rup Khada, "Value-Added Tax Policy and Implementation in Singapore", VAT Monitor, Vol. 9 (March/April 1998).

Of the three scenarios with which the study is concerned, the third involves the broadening of the tax base with no need to raise additional revenue. In this scenario, the options considered will need to contemplate offsetting uses of the estimated additional $18 billion revenue raised by the 3% consumption tax so that the overall effect is revenue neutral.

Similarly, where the second Scenario involves additional revenue to be raised of up to 1% of GDP, consideration needs to be given to compensating uses of the additional minimum $6 billion excess revenue ($18 billion raised by a 3% consumption tax less up to $12 billion additional revenue requirement).

The advantages of such a tax are:

- it is internationally comparable and with a very competitive low rate;

- it is stable and predictable from a revenue perspective, in that consumption expenditure does not fluctuate to anywhere near the extent of income or asset values, so it can provide a robust taxation base for future revenue requirements;

- it is efficient with a broad base, because the cost of administration and collection is low compared to the revenue yielded, plus it can be used to reinforce other tax requirements, such as profits tax and salaries tax deductions, as businesses are registered/recognised and operating in the official economy;

- it is equitable as similar and competing forms of economic activity are taxed the same and capacity to pay – as evidenced through individual consumption- determines the amount of tax paid. The higher the spending on consumption, e.g. purchasing ‘luxuries’, the higher the tax paid;

- it is relatively difficult to avoid, due to both its multi-stage taxing and crediting (which means the revenue at each ‘stage’ is limited to the value added/margin at that stage), and everyone who purchases from registered businesses pays the tax irrespective of their purpose, background or circumstances. Even if a person does not declare their appropriate income, when they spend that money it can be taxed;

- it has a sustainable broad base that is capable of growing with consumption in the economy (which with an ageing population will grow faster than economic growth, and therefore faster than salaries or profits tax); and

- it will maintain Hong Kong's envied low tax business environment.

The main disadvantages with such a tax are:

- the need for a reasonable implementation and education timeframe;
- there will be some additional cost of administration and compliance for business and government (although most alternative options will have varying additional costs too);
- Hong Kong will need effective mechanisms to address cross-border tax leakage/avoidance, for example into/from Shenzen. This will require a 'customs' barrier on border posts/outlets and mechanisms for declaring and taxing imports. Rather than taxing low value imports by individuals (as opposed to businesses) an alternative to collecting tax on these low value items might be the concurrent introduction of the land and sea departure tax, which would raise revenue on those people coming and going. A $25 charge would constitute a de facto 3% tax on $830 worth of spending, providing a basis for setting the low value non-taxable importation threshold;
- the possible need for compensation from the impact on prices, especially for the less well off members of the community – albeit a low rate will have limited inflationary impact. One option that would be capable of reaching most households to provide compensation would be a rebate to property rates in the year of introduction. Another possible option could be to increase CSSA payments;
- other considerations, such as interactions with other taxes, e.g. betting, stamp duty and excise, will need to be resolved (see also 6.7.3 and 6.9 below);
- it is often claimed that such a tax is regressive, in that for any given item purchased, e.g. a bottle of fruit juice, the tax paid on that item by a low income earner will be higher as a percentage of income than for a higher income earner. The corollary to that proposition is that a higher income earner (or someone with other additional means, e.g. wealth) will spend more than the low-income earner and will accordingly be taxed more and as a percentage of spending cannot pay a lower proportion of tax – in this sense it is actually very equitable; and
- the low rate (3%) means that compliance costs can be disproportionately high unless the design mechanisms for collection

and payment are established with minimisation of compliance costs at their core[5].

A further dimension to a broad based consumption tax is that some people will for the first time overtly start paying taxes. Whether this is an advantage or a disadvantage will depend on your perspective. Either directly or indirectly everyone is bearing some tax (either overtly on salaries and rates or indirectly in prices through profits tax and excises) and this form of tax is a transparent way of broadening the tax base to ensure that everyone contributes to the additional tax that is required to maintain the level of government expenditure that they are enjoying.

Overall, a new broad-based consumption tax appears to be the most suitable and viable option for base broadening in the context of this study's brief.

The following chapter sets out in greater detail the model proposed and options available. For the purposes of this study the IMF proposed model has been adopted. The detailed policy and legislative development of the tax is outside the scope of this study, however, it is recognised that further development of the Hong Kong specific issues for such a tax, particularly from an international perspective, requires further expert design and consideration.

Assuming a 3% GST, under Scenarios (ii) and (iii) adjustments need to be made to the existing tax base to deliver both the base broadening features of the tax reform as well as to limit the revenue collected to that specified.

The options for revenue reductions, hence offsetting the additional GST revenue can be grouped as follows:

- Options to reduce tax rates within the existing base;
- Options to increase concessions/allowances in the existing base;
- Options to reduce the existing base; and
- Options to abolish taxes that are a part of the existing base.

These options are considered in the context of delivering the revenue Scenarios while remaining consistent to the overarching objective of tax

[5] Glen P. Jenkins and Rup Khadka (1998), op. cit.

base broadening. Recent international tax reform is also utilised for this purpose.

Table 6.6.2b below sets out the Hong Kong tax revenue figures for 2000. The figures in this table will be used as the basis of discussion in the following sections.

Table 6.6.2b
Tax Revenues by main headings (2000)

Profits tax	$43 billion
Salaries tax	$26 billion
Personal assessment	$3.5 billion
Property tax	$1.1 billion
Stamp duty on shares	$6 billion
Stamp duty on property	$5 billion
Betting duty	$13 billion
Duties/excise	$7 billion
General property rates	$14 billion
Motor vehicle taxes	$3 billion
Estate duty	$1.5 billion
Hotel accommodation tax	$0.2 billion
Air departure tax	$0.5 billion

6.7 In the context of surplus revenue, options to decrease tax rates using the existing bases

The main options for base broadening and reducing revenues raised by other base broadening measures using the existing tax base are through decreasing tax rates.

An option of increasing the tax rate within the existing base is not canvassed in this study as it would serve to narrow the base (refer to 6.3.2 above).

The main tax areas where rates could be reduced are

- salaries tax (personal income tax);
- business profits tax; or
- various indirect taxes or taxes on property, such as, duties, bets and sweeps tax, general rates, motor vehicle taxes and stamp duties.

6.7.1 Reduce salaries tax rates

Salaries tax (personal income tax) rates could be reduced. The following table illustrates the revenue costs that would be involved (assuming no behavioural affects).

Table 6.7.1
Tax revenue from salaries tax adjustments

Personal (Salaries) tax rates	Rate change (%)	Tax revenue decrease (HK$)
All rates (including standard rate)	1%	$2.2 billion
All rates (including standard rate)	2%	$4.4 billion
Bottom rate	1%	$0.4 billion
Top rate	1%	$0.9 billion

Source: HK Finance Bureau/Inland Revenue Department

Hong Kong's salaries tax rates are low by international standards and are regarded as one of the key features of Hong Kong's low tax environment.

The international trend, from Singapore (2001 Budget) to Australia (A New Tax System from 1 July 2000) to Ireland (2001 Budget) to the United States (2002 Budget), is towards reducing personal income tax rates as a means of attracting and maintaining high quality employees by providing increased incentive to work harder and smarter.

Decreasing salaries tax rates will decrease the overall tax burden borne by the minority of individual taxpayers who actually pay salaries tax and would, to some extent, be regarded as a broadening measure, in that, if made in conjunction with a broad based consumption tax, the overall impact is to promote more neutrality and reliability in the overall taxation system.

Many overseas jurisdictions that have introduced a GST as part of a broader tax reform package have included reductions to income tax rates. Recent examples include Australia in 2000, Singapore in 1994, Canada in 1991 and New Zealand in 1986.

If reduced income tax rates are considered in the context of the three revenue scenarios that are to be considered (i.e., neutrality, less than 1% of GDP and 1-2% of GDP), it is significant to note that the following decreases in all the salaries tax rates (including the standard rate) would be necessary to offset the revenue gain from a 3% consumption tax:

- 8 percentage points (i.e., from 15% to 7% for the standard rate), to achieve revenue neutrality (Scenario (iii)); or

- 3 percentage points (i.e., from 15% to 12% for the standard rate), to achieve a 1% net increase in revenue (Scenario (ii)).

Under the Scenario (iii) option - 8 percentage point across-the-board reduction in salaries tax rates, the first two existing tax rates of 2% and 7% would be reduced to 0%, so the first $70,000 of salaries income would become tax free. Under the Scenario (ii) option - 3 percentage point reduction, only the 2% rate would be reduced to 0% and the first $35,000 of salaries income would become effectively tax free.

Further, such changes would reduce the incidence of the salaries tax on only relatively few taxpayers, whereas a new broadly based consumption tax would, by definition, have an incidence on a much larger population. The result may then be subject to criticism on equity grounds in that the tax burden is shifted from a few to many.

It is important to note that any such criticism could only be justified if the existing tax incidence was established to be "fair" and not discriminatory.

Clearly, a decrease in the incidence of a discriminatory and inefficient tax with a more broadly based exaction can be viewed as a positive reform rather than one that is "unfair" because of change in incidence (refer 5.4.6).

An alternative approach would be to target the bigger tax cuts at only those on lower incomes (as a form of 'compensation'). For example, a 1 percentage point reduction in the bottom salaries tax rate would cost only $0.4 billion. The bottom 2% tax rate could be abolished (reduced to 0%) for less than $1 billion. This approach would provide the greatest proportional benefit to lower to middle income salaries tax payers, rather than those paying tax at the higher tax rates. Internationally, Australia adopted this approach with its "New Tax System" reforms where lower and middle personal income tax rates were reduced but the top marginal rate of 47% was left unchanged (although the income level at which it applied was increased). Most other countries have preferred to provide across-the-board income tax cuts as part of their GST related reforms, e.g. Canada, Korea, New Zealand and Singapore.

As a part of a package of reforms, salaries tax rates could all be reduced by 1 percentage point at a revenue cost of $2.2 billion.

6.7.2 Decrease profits tax rates

The profits tax rate could also be decreased (for both corporations and unincorporated businesses) and the following table illustrates the tax revenue impact.

Table 6.7.2
Tax revenue from profits tax adjustments

Profits tax rate decrease	Tax revenue decrease (HK$)
1%	$2.6 billion
2%	$5.3 billion
3%	$7.9 billion
4%	$10.5 billion

Source: HK Finance Bureau/Inland Revenue Department

A decrease in profits tax rate would be the simplest and initially the most efficient way to offset or limit the amount of additional tax revenue raised by a broad based consumption tax .

A decrease in the tax revenue from profits tax would, broaden the overall tax base if performed in conjunction with a low rate broadly based GST.

As the findings in Chapter 5 illustrate, Hong Kong is heavily reliant on its revenue from this source, thus contributing to a narrowness in Hong Kong's base on the neutrality and reliability measures. A reduction in the extent of reliance on this source of revenue, when combined with a broad based consumption tax, would be a significant advantage to the efficiency of Hong Kong's taxation regime.

The extent of the decreases that would be involved to offset the additional revenue from a 3% consumption tax are as follows:

- 7 percentage points (i.e., from 16% to 9% for the corporate profits tax rate), to achieve revenue neutrality (Scenario (iii)); or

- 2 percentage points (i.e., from 16% to 14% for corporate profits tax rate), to achieve a 1% net increase in revenue (Scenario (ii)).

In either case, this would maintain Hong Kong at the lowest level of headline taxation rates of all of the jurisdictions examined in this study.

As a part of a package of reforms, the profits tax rate could be reduced by 1 percentage point (i.e., to 15% for the corporate profits tax rate) at a revenue cost of $2.6 billion.

6.7.3 Duties, bets and sweeps tax, general rates, motor vehicle taxes and stamp duties

Other existing tax rates that should be considered in the context of broadening Hong Kong's tax base by decreasing rates include excise duties, bets and sweeps tax, general rates, motor vehicle taxes and stamp duties. Any reduction in these types of indirect taxes when occurring in conjunction with a GST will have the effect of offsetting (or reducing) the inflationary impact of the GST.

To a considerable extent all of these taxes operate to tax consumption but contribute to Hong Kong's narrow tax base as examined in Chapter 5.

Where the tax base is broadened by the introduction of a broadly based tax on general consumption, the extent of taxation of these items will be increased in line with the general taxation of consumption (unless specifically exempted from the new tax).

For example, Hong Kong imposes excises on tobacco, alcohol and petroleum products. These taxes are levied on a volumetric basis (with the exception of alcohol that has an ad valorem component). The economic rationale for this treatment is that the products have social or regulatory costs that vary according to volume consumed.

In the event that the Hong Kong tax base is broadened by introducing a tax on general consumption, these products will also bear the additional tax cost based on the value of the product consumed.

Accordingly, other jurisdictions that have introduced general consumption taxes have had cause to consider whether the overall level of taxation of these products ought to be maintained. In the recent Australian GST, for example, excises on petroleum and alcohol were decreased in an attempt to achieve a desired price movement, after GST, at the retail level. In particular, the policy was that petroleum prices not increase at the retail level and that alcoholic products increase, generally, only to the anticipated increase in prices generally as a result of the "New Tax System". Tobacco excises were, however, deliberately increased as a part of the tax reform measures with no relief for the additional GST imposition. Also in Australia, the Australian States did not reduce their stamp duties on the transfer of motor vehicles (although the price of new vehicles fell with the replacement of sales tax with GST).

Similar arguments can be made for the reduction of betting taxes and general rates so that, if the commodity can be regarded as being fully taxed under the existing regime, it is relieved from an additional consumption tax impost or the existing taxes are reduced to achieve the same overall tax level.

In the Australian and New Zealand tax reform measures, gambling taxes were reduced by the amount of the additional GST impost. On the other hand, in Australia most local government rates were treated as being, effectively, free of the GST.

Unless some change is made to the basis of taxation of these goods and services, the introduction of general consumption tax in Hong Kong will result in a "tax on tax".

While the revenue from this issue is not significant, consideration needs to be given to the treatment of the taxes in question so that the revenue impact can be factored into the three Scenarios that are the subject of this study.

The treatment of stamp duties and property taxes raises additional issues.

For example, Australia's recent tax reform proposals (before amendment in the legislature) would have abolished all business stamp duties. The final Australian changes include the abolition of stamp duty on quoted securities and financial bank account duties. New Zealand has virtually eliminated all its stamp duties since introducing GST in 1986, while Singapore has not imposed stamp duty on share transactions since 1998. Hong Kong's recent Budget also announced a reduction in stamp duty. To maintain international competitiveness, especially in financial markets, Hong Kong will have to move further away from this source of revenue.

The options for reform of stamp duties and other taxes on property in the context of a general consumption tax are canvassed later.

6.8 In the context of surplus revenue, options to expand concessions in the existing tax base

If the introduction of a 3% broadly based consumption tax is considered, the option of expanding the allowances and concessions needs to be considered as a mechanism for limiting the increase in revenues to the levels contemplated in Scenarios (ii) and (iii).

Significant increases in personal allowances of between 40% and 250% would be necessary to reduce the additional revenue from the consumption tax to net only 1% (i.e. in respect of Scenario (ii)) or 0% (i.e. in respect of Scenario (iii)) respectively in additional revenue.

The following table illustrates the revenue impact of increasing personal allowances.

Table 6.8
Tax revenue from personal allowances adjustments (b)

Increase in personal allowances	Estimated tax revenue decrease (HK$)
10%	$2 billion
40%	$6 billion
100%	$12 billion
250%	$18 billion

Source: Finance Bureau/Inland Revenue Department

The observation has been made in Chapter 5 that the level of these allowances has a significant base narrowing impact. The increase of these allowances as a mechanism to limit the effect of base broadening taxes would counter the basic and fundamental rationale for base broadening. It would only advantage the limited number of taxpayers that are presently subject to salaries tax and promote inefficiencies in this aspect of taxation whereas the desire is the reverse. As a result, it is not considered to be an option worthy of consideration. A more effective mechanism - that would be much less detrimental to the overall tax base – to provide an offset to these taxpayers would be to reduce salaries tax rates (discussed above).

6.9 In the context of surplus revenue, options to reduce the existing tax base

The study must consider options to reduce existing bases as a part of a base broadening reform if the additional revenue raised by base broadening (eg, a 3% consumption tax) exceeds the limitations set out in scenarios (ii) and (iii).

The areas in which Hong Kong could consider reducing its existing tax base, in the context of base broadening, would include the limitation of the scope of some of the narrowly based taxes presently imposed, such as stamp duty, hotel accommodation tax and estate duty.

In practice, any meaningful reduction in any one of these taxes would require the abolition of the tax in its entirety – or at least the abolition of one particular subject of the existing tax. An example may be the abolition of stamp duty on shares but maintaining stamp duty on real property.

These options are dealt with now in the context of considering abolition of existing taxes.

As indicated, the abolition of part of Hong Kong's tax base is an option that will promote the base broadening, particularly when executed in conjunction with the introduction of a low rate, broadly based GST. It should also be noted that to the extent that indirect taxes are reduced or abolished these measures will ameliorate some of the inflationary impact of the new GST.

In Chapter 5 it was found that Hong Kong's existing base is narrow in the context of both neutrality and reliability measures. In particular, from the point of view of indirect tax, Hong Kong's excise and stamp duty regimes are imposed on a narrow range of goods and services.

The excises on alcohol, tobacco and petroleum, and possibly motor vehicle taxes can be argued to be directed at discouraging consumption and raising revenue to meet the social costs associated with the use of those commodities. These taxes effectively fulfil a regulatory policy role rather than simply a revenue raising one. While discriminatory in there nature, the abolition of those taxes would not serve the wider social and economic goals that are under consideration in this study. Accordingly, the abolition of the excises may not be considered tax reform priorities, and therefore not a focus of the options discussed.

Similarly, the abolition of air departure tax is not canvassed as it has been suggested that this tax be expanded to include sea and land departures as well as a complementary measure to the consumption tax.

6.9.1 Stamp duties on shares and property transactions

Australia's recent tax reform proposals (before amendment in the legislature) would have abolished all business stamp duties. The final Australian changes include the abolition of stamp duty on quoted securities and financial bank account duties. Recent Australian State Government Budgets have foreshadowed reductions or abolition of other financial institutions duties and some stamp duties.

Of the representative comparison group, from 1 July 2001, Hong Kong is the only economy that continues to levy a stamp duty on market-traded securities.

Hong Kong's recent Budget also announced a reduction in stamp duty. Singapore removed stamp duty on shares in 1998 in the wake of the regional financial crisis and has not reinstated it. To maintain international competitiveness, especially in regional financial markets, abolition of this stamp duty would deserve serious consideration as a high priority.

The cost in revenue of stamp duty on shares is approximately $5-6 billion.

The other major source of stamp duty revenue is levied on real property transactions. This transaction tax becomes an additional impost to business and home buyers, and drives up the price of property purchasing. This type of stamp duty remains relatively common in overseas jurisdictions, given immovable property is less susceptible to global competitiveness. However, any reduction in this tax would assist to reduce Hong Kong's high cost of property and lessen the heavy taxation on this industry sector.

The cost in revenue of stamp duty on property is approximately $5 billion.

In the context of Scenario (ii), the revenue effect from the abolition of either of these stamp duties will contribute to the desired outcome, while both of these taxes could be abolished under Scenario (iii) of revenue neutrality.

6.9.2 Property rates

The third major source of taxation on property in Hong Kong (after stamp duties on shares and real property) is government property rates.

The revenue from property rates is currently $14 billion. The rates tax base itself is one of the broadest tax bases in Hong Kong. It taxes virtually all property (commercial and residential, for rent or owner occupation) and raises tax from a wide range of taxpayers. It is also much less prone to volatility in revenue provision.

Property rates being one of the major taxes on property, while contributing to Hong Kong's overall tax base narrowness (as it is heavily reliant on taxes on property), has a broad incidence on the community generally. Accordingly, by reducing the revenue reliance on this tax, two advantages arise:

- A reduction in reliance on this particular tax base and hence greater overall base broadness on "reliability" and "neutrality" measures (refer 5.3.8).

- A compensating measure to offset cost increases generally that would result from a 3% GST.

Under Scenario (iii) all property rates could be abolished. However, this would have the effect of replacing one broad tax base with another, albeit much broader, tax base in the GST. As a very efficient, simple and equitable tax, it would not be the most consistent approach to base broadening tax reform.

Being such a broad tax base, that is capable of reaching most individuals and families, property rates could be used as the mechanism to provide some offsetting compensation to households for the GST. A flat rebate on rates, calculated on a per dependent person or family basis, could be a relatively simple and efficient approach to providing wide ranging tax reductions to the population. This measure could be included in any reform package under Scenarios (ii) or (iii) with the excess revenue from a 3% GST.

6.9.3 Other minor taxes

As part of its tax reform measures, Singapore has progressively reduced the rate of property tax, hotel and restaurant surcharge and estate duty. Australia also abolished its hotel accommodation taxes when it introduced GST. Each of these taxes, in the Hong Kong regime contribute to a narrow tax base and, in relation to hotel accommodation tax and estate duty, do not contribute significantly to overall revenue.

Abolition of hotel accommodation tax could be justified on the grounds that the GST would tax this form of consumption, and retaining the tax would only lead to a tax on tax, or double taxation concern.

The Bush Administration's tax plan has just legislated the abolition of estate duty in the United States. Australia and New Zealand abolished this form of tax years ago, while the international trend is clearly towards the removal of estate duties as an inefficient, minor and narrow tax that encourages complex estate planning by those likely to incur it.

To reform the tax regime in a base broadening sense and to contribute to a more internationally competitive model, the abolition of hotel accommodation tax and estate duty could easily be accommodated (from a revenue perspective) and be considered in conjunction with the introduction of a 3% broadly based GST.

The cost to the revenue of abolishing hotel accommodation tax is $0.2 billion. The cost of abolition of estate duty is around $1.5 billion.

The only remaining tax of note, is bets and sweeps duty. While a reduction in the rate applicable was raised in Chapter 6.7.3, it would be financially possible to fund its abolition under Scenarios (ii) or (iii). The cost of abolition is around $13 billion. Internationally special higher taxes on betting are common and while rates may vary, the authors are unaware of any experience where they have been abolished as part of tax reform proposals. In many ways this tax is akin to the excises in Hong Kong and acts as a regulatory/social policy mechanism as much as a revenue raising one. Betting duty is also a very robust and stable tax base, whose abolition would generally be regarded as a very low priority on broad public policy grounds.

6.9.4 Other options to be considered in the context of a 3% GST

As indicated above, some adjustments could be considered in the levels of existing excises and bets and sweep taxes but the revenue involved is unlikely to be significant.

In Singapore, New Zealand, Canada and Australia, when GST was introduced a range of income tax reductions for individuals and companies, welfare adjustments and targeted rebates accompanied the reform. These changes were directed at both the compensation of the community for additional price impacts of the GST as well as the overall structure of the taxation system.

Options for tax reductions, increases in personal allowances and tax abolitions have been discussed above. The two most common additional options contemplated overseas that have been used to “compensate” or offset the new consumption tax are:

- Government transfer payments; and/or
- Tax rebates (negative income tax)

These payments or rebates (delivering the same economic effect through a different mechanism) have been used to ameliorate political and social concerns with the introduction of a GST. The rebates (sometimes referred to as a negative income tax) can be designed to entitle people to a cash payment/refund, akin to a direct payment but through the tax system. By directing cash payments/rebates back to taxpayers or government beneficiaries through this type of targeted means, compensation may be delivered to a wide range of individuals/families. This type of benefit can be limited in both amount to the individual or family, e.g. $500 per individual or $2,000 per family, as well as being restricted by income level, e.g. rebate/payment on available to those up to incomes of $100,000.

Australia, Canada and Singapore all introduced special tax rebates in addition to general income tax cuts for individuals (and increased social security payments for those in receipt of government welfare benefits), to offset those on lower incomes who may not benefit fully from the income tax rate reductions (many of which were for medium to higher incomes). Australia's tax rebates were mainly limited to the year of GST introduction, while Singapore has continued a long transitional period with a gradual scaling back of the tax rebates. New Zealand only relied on income tax cuts and social security.

The difficulty for Hong Kong in employing these approaches is that its social security system is very limited (and while capable of providing benefits to those in it, may not be well suited to a major expansion of scope if even for a short period of time) and also only a minority of personal income earners pay salaries tax and lodge tax returns.

A universal tax rebate scheme could provide targeted tax relief to individuals and their families, and be designed to offset or "compensate" for the new consumption tax. However, the administrative mechanism to manage the more than doubling of tax returns (an estimated 2 to 2.5 million more people would need to lodge tax returns) that would need to be lodged would likely be very inefficient and administratively costly and complex.

Equally, a significant expansion of Hong Kong's welfare system to pay benefits to millions of extra people would add considerable complexity to the tax and welfare systems interactions and run contrary to the government's stated welfare policies and simple tax system.

For example, now consider these options using the typical Hong Kong family referred to in Chapter 5.4.6. The impact of the 3% GST might reasonably be in the order of 2%-2.5% increase in prices (without allowing for any offsets). With disposable income after MPF contributions and salaries tax (which is nil for this family) of around HK$190,000, the impact of the GST could be more than $3,000. Obviously, for someone on an income half that of the typical family the impact could be half or $1,500. To provide this rebate through the tax system, the number of "taxpayers" lodging tax returns would need to rise from the present 1.2 million to somewhere in the order of 3 million.

The Hong Kong personal income tax and welfare systems are limited in their nature due to the limited and low tax and social welfare arrangements. Universal or even widespread "compensation" or rebating arrangements are therefore not well suited to Hong Kong's prevailing systems and would represent a significant cultural and administrative change regarding the role and interaction of government.

A possible further alternative mechanism to provide "compensatory" tax rebates would be through a universal rebate on property rates. As property rates are one of the most extensive taxes in Hong Kong (in reaching virtually all households) adjustment to this tax could provide near universal offsets. Singapore also adopted the reduced property rates approach as part of its GST package in 1994. Either a straight percentage reduction could be used, or a flat dollar value rebate which would provide greater "compensation" to lower income groups. This option could be a simple, efficient and equitable option if universal "compensation" was desired.

6.10 Hong Kong Consumption Tax

The study brief requires consideration of the option of the introduction of a broadly based, low rate consumption tax.

The international comparison conducted in Chapter 5 of this study concluded that Hong Kong's taxation system was narrowly based in that it was heavily reliant on taxes from income and property.

All of the representative jurisdictions that have been used in the comparison of benchmark taxation features and international norms have a value added tax (also referred to as goods and services tax).

In each instance the value added tax is imposed on a different base but, in general, the tax base would be described as broad.

6.10.1 International comparison

The key features of a GST/VAT that differentiate different models that are referred to throughout this section are:

- the threshold – the level of turnover above which a business (or other entity/organization) must be registered and thereby part of the

GST system, e.g. charging GST and claiming GST credits on its inputs;

- taxable – this means the goods and services are subject to the prevailing GST tax rate, while the GST paid on inputs used are eligible for credits;
- zero-rated – this refers to goods and services where there is no GST applicable, i.e. the tax is charged at a 0%. GST paid on inputs is also eligible for credits; and
- exempt – this category of goods and services also does not have GST charged on its sale, however, unlike zero-rated and taxable the GST paid on the inputs is not eligible for a credit. In other words, the GST paid on the inputs becomes a cost to the business and is not directly passed on to the next stage or consumers.

At one end of the scale Singapore imposes a tax on what might be described as the broadest base – with only financial services and residential rent exempt from tax and, in line with international practice, exports zero-rated. New Zealand adopts a similar broad base.

In fact, the Singapore model in practice is narrower than might at first be expected to be the case in that the exemption for financial services is supported by the administrative practice that makes it more akin to a zero rate. In addition, the Singapore GST regime also involves an optional exemption for small enterprises at internationally a very high threshold level ($S1,000,000).

A high threshold of this nature is indicative of a certain narrowness of base that, depending on the market segment of the enterprise concerned, can operate in a distortionary and discriminatory fashion.

At the other end of the scale is the value added tax operative in Ireland and a similar model in Canada. This is the common European Union model, and a prerequisite to entry thereof.

While the Irish model involves a relatively higher standard rate by international comparison, the design features of exemptions and zero rates are similar to that in operation in Canada.

Australia, which introduced its GST on 1 July 2000, initially proposed a model closer to New Zealand, but after parliamentary amendments, e.g. zero rating basic food, has ended up with a model somewhere in the middle.

It is fair to say that multiple rates, zero rates and exemptions add significantly to compliance costs and create non-neutralities thus promoting inefficiencies and inequities in the system. Particularly with a low rate, a broader tax base (with few exemptions) will add to its simplicity, certainty and efficiency.

6.10.2 Hong Kong consumption tax

The model of a consumption tax for Hong Kong that has been adopted for the purposes of this study is a low rate, high threshold limited exemption similar to that in Singapore.

The IMF have recommended a small business exemption of between 3 and 5 million Hong Kong dollars, an exemption for residential rents and a zero rate for financial services and exports.

Arguably value added tax based on these fundamental design features represents the broadest base by international comparisons. In addition, the distortionary aspects that might otherwise arise as a result of the high small business threshold can be minimised by the adoption of the lowest possible rate.

A zero rate for financial services and exports ensures that Hong Kong maintains and promotes it competitiveness both in a regional and international sense.

On the analysis adopted in this study a 1% tax rate will produce revenue of approximately 0.5% of GDP.

The Scenarios do not demand a rate of GST at any higher than 5% and this only for Scenario (i) – raising additional funds of 2.2% of GDP

We have indicated earlier in the study that a rate of less than 3% is unlikely to be adopted, in practice, in view of the costs of administration and compliance with such a broad based tax.

The cost of compliance with such a tax would depend on the sophistication of the taxpayer registered under the system. With a high threshold the number of small businesses would be excluded from the system. Larger businesses and other organizations, such as government, would on overseas experience not incur a major additional cost of compliance, particularly with a simple broad-base design.

As a guide, the cost of administering the tax for the IRD on an ongoing basis could (using Australia's recent implementation experience of a more complex design) be of the order of HK$0.5 - 1 billion per year.

6.11 Findings

There are very few options that have the capacity to broaden the tax base in accordance with the measures of neutrality and reliability described in Chapter 5, and satisfy the revenue scenarios adopted for the purposes of this study, 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.

Of fundamental importance is the selection of a base broadening option that is capable of delivering a sustainable, efficient, internationally competitive tax system, in accordance with the good tax principles and consistent with international trends.

At the heart of any meaningful consideration of base broadening options in Chapter 6 is a broad based low rate GST.

Other options, such as reduced personal allowances, or widening the definition of taxable income, or narrowly targeted new taxes are only capable of limited base broadening from a revenue perspective. Only a very significant reduction or removal of personal allowances could deliver substantive base broadening in the personal income tax area, and that option would be both fraught with social and political difficulties as well as being a second rate option to the base broadening benefit of the GST.

The absence of a general tax on consumption is the single most obvious feature of Hong Kong's tax base that contributes to its narrowness in the measures of neutrality and reliability used in this study.

Further, in Scenarios (i) and (ii) it is the only significant reform that could be used to deliver sustainable increased revenues to the extent required and satisfy the "broadness" requirement of the study – particularly in terms of the reliability measure of narrowness.

A GST at a rate of less than 3% would involve costs of compliance and administrative costs that could not be justified in terms of the overall revenue yield from the measure. Accordingly, the options for broadening the tax base within each of the nominated revenue scenarios have as their starting point a broadly based GST at the rate of 3%.

For Scenarios (ii) and (iii) further, base broadening reforms are necessary to limit the additional revenue yield to the extent required under those scenarios.

Essentially, there are three options for reform recommended by this study, one for each scenario.

6.12 Options

Common to all scenarios, a broad-based GST is introduced at a rate of 3%.

In today's terms this raises an estimated $18 billion in extra revenue. The Options below present the variations of major tax measures around the revenue Scenarios. While a wide range of options have been discussed in this Chapter, the options presented below are consistent with an overall base broadening reform package, draw on recent overseas experiences and would retain Hong Kong's competitive low tax status in conjunction with a new broad-based consumption tax.

6.12.1 Option 1 – Scenario (i)

The scenario requires additional revenue of between 1 and 2% of GDP.

A broad-based GST of 3% introduced. Under scenario (i), the 3% GST gives effect to additional revenue of 1.5% of GDP.

As the 3% GST is consistent with a 1-2% of GDP revenue gain, there would be minimal (if any) excess revenue to provide other tax offsets.

6.12.2 Option 2 – Scenario (ii)

Under Scenario (ii) additional revenue is limited to less than 1% of GDP.

A broad-based GST of 3% provides an estimated $18 billion.

Abolition or reduction of the existing taxes and/or tax rates to the extent permissible to maintain 1% of GDP additional revenue from the reform. As 1% of GDP is around $12 billion, an excess of at least $6 billion is available. The options are divided into the main areas considered, however, combinations or any or all measures could be developed as a reform package.

Possible taxes that could be reduced include:

- Salaries tax reduced by 3 percentage points; or
- Profits tax reduced by 2 percentage points; or
- A combination of smaller reductions to these two major taxes rates plus some reductions to other taxes, such as excises, stamp duties, motor vehicles and hotel accommodation taxes, betting duty and/or general property rates.

Possible allowance increases include:

- 40% increase in personal allowances.

Possible taxes that could be abolished include:

- Stamp duty of shares; or
- Stamp duty on property; and
- Estate duty; and
- Hotel accommodation tax

Possible other measures to 'offset' the revenue include:

- Increased (and significantly expanded entitlement to) government payments to individuals and family households as 'compensation' for the new GST; or
- Tax rebates (probably limited in value) to individuals or family households as an alternative 'compensation' mechanism.

6.12.3 Option 3 – Scenario (iii)

A broad-based GST of 3%.

Abolition or reduction of the existing taxes and/or tax rates to the extent permissible to maintain no net additional revenue from the reform.

Under Scenario (iii) no additional revenue is to arise from the base broadening reform measures. This leaves an estimated $18 billion of excess tax revenue to be redistributed back in the form of abolished or reduced taxes. The options are again divided into the main areas considered, however, combinations or any or all measures could be developed as a reform package.

Possible taxes that could be reduced include:

- Salaries tax reduced by 8 percentage points; or
- Profits tax reduced by 7 percentage points; or
- A combination of smaller reductions to these two major taxes rates plus some reductions to other taxes, such as excises, stamp duties, motor vehicles and hotel accommodation taxes, betting duty and/or general property rates.

Possible allowance increases include:

- 250% increase in personal allowances.

Possible taxes that could be abolished include:

- Stamp duty of shares; and
- Stamp duty on property; and
- Estate duty; and
- Hotel accommodation tax.

Possible other measures to ‘offset’ the revenue including government payments and tax rebates of greater value than in Option 2 above.

7 Conclusions and Recommendations

The objective of this study (as outlined in Chapter 2) is to assess the nature of Hong Kong's tax base and the implications thereof. The objective has been addressed through the series of study tasks that have been covered by Chapters 5, 6 and 7. This final chapter presents the conclusions and recommendations to the Advisory Committee on New Broad-based Taxes for their deliberation.

While the conclusions represent a summary of the findings of the preceding chapters, the recommendations are framed in the context of the terms of reference of the Advisory Committee, and especially the reference therein to "maintaining a low and simple taxation regime and preserving Hong Kong's competitiveness".

7.1 Specific Study Task Conclusions and Recommendations

7.1.1 Hong Kong's tax base is "narrow" in comparison to other developed jurisdictions.

Notwithstanding its low tax status, Hong Kong's tax base is narrow in an overall sense as it is heavily reliant on two forms of taxation that are neither consistent with international trends nor stable in the context of economic cycles. The two major tax sources, on profits and property (i.e. rates and stamp duties) are also not necessarily "low" in terms of international benchmarks. These taxes are costs to businesses operating in Hong Kong and are therefore subject to international comparison.

Hong Kong's tax base is narrow in its composition, in that it does not have many major sources of taxation revenue that are common in international comparisons. Its main personal income tax base, salaries tax, is also characterised by a narrow or limited taxpayer base. In addition, its existing taxes, with the exception of rates on property, do not have comprehensive tax bases, that is, they exclude many types of activities that other jurisdictions include in that form of tax base.

A stark omission from Hong Kong's tax base is any form of general consumption tax. It is the only developed jurisdiction without such a tax.

The overseas trend in taxation has been towards greater reliance on consumption taxes and less reliance on taxes on income or property. Hong Kong's tax base has been heading in the opposite direction to this overseas trend.

Recommendation 1: To overcome Hong Kong's narrow tax base, Hong Kong needs to broaden its tax base. To be more consistent with international benchmarks, the most obvious tax areas to be addressed are taxes on personal income and/or general consumption.

7.1.2 There are limited tax reform options for Hong Kong with the ability to broaden the tax base and provide the additional revenue sought by the three nominated Scenarios

The three nominated revenue Scenarios that are to be addressed by tax reform options are:

(i) where the additional revenue to be raised is in the region of 1-2% 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 the additional revenue but options should be considered to broaden the tax base.

Seven areas of tax reform options were canvassed (the latter four in conjunction with one or other of the first three) in this study:

1. Removing concessions and/or allowances;

2. Widening the base of existing taxes;

3. Introducing new taxes;

4. Reducing the tax rates of existing taxes;

5. Increasing concessions and/or allowances;

6. Reducing the base of existing taxes; and

7. Abolishing existing taxes from the base.

In terms of their capacity to produce additional revenue in line with the revenue Scenarios and deliver anything more than marginal base broadening, only two measures alone were capable of generating the revenue necessary. They are:

- A significant reduction in personal allowances of between 50% and 70% for Scenarios (ii) and (i) respectively; or

- The introduction of a broad-based GST/VAT of 3%.

Obviously, combinations of these options – with or without other minor revenue measures – could be contemplated.

Hong Kong could increase tax rates on existing taxes, in particular, salaries and profits tax, and while this could raise enough additional tax revenue to meet the revenue Scenarios, in the longer term it would almost certainly undermine Hong Kong’s low tax status, and particularly with respect to profits tax would almost certainly be internationally uncompetitive. These options would also further narrow, an already narrow tax base as the limited existing taxpayers have to carry an increased burden. They fail the prerequisite test of broadening the tax base.

A reduction in personal allowances and/or concessions may in the short to medium term provide a viable source for additional revenue. If reduced in a significant manner, it would, nonetheless, increase the number of salaries taxpayers and effectively broaden the salaries tax base and taxpayer base. It would, however, raise fundamental equity and efficiency issues, especially as Hong Kong uses these tax allowances as an alternative to a more comprehensive government benefits transfer system, i.e. government paying benefits through its transfer payments to families for dependents. It would therefore only be feasible on a more limited basis in conjunction with other measures – in which case its base broadening effect would be quite marginal.

Other measures considered in this study, including widening the definition of income for income tax purposes, or introducing new narrow taxes, could be considered on there own individual policy merits irrespective of this study, however none of them, and not even all of them together, could realistically address the revenue Scenarios in the longer term, nor provide sufficient reform to guarantee a sustainable broader tax base. Equally, new taxes on payroll or social security (which would be on top of the MPF requirements and be either an increased income tax or akin to a payroll tax) would be inconsistent with recent overseas trends, government policy (e.g. on private sector managed retirement savings or maintaining competitive wage costs) and also susceptible to a reducing base over time, i.e. wage costs as a percentage of the economy.

A new broad-based consumption tax, even with a low rate of 3%, would be the most appropriate option to consider because:

- it will broaden the tax base in an equitable manner, consistent with overseas trends and benchmarks;

- it can meet the additional revenue required in Scenarios (i) and (ii), without jeopardizing Hong Kong's low tax status and international competitiveness (note: the burden of a consumption tax is not borne by business but rather by domestic consumers);
- it may provide a stable, reliable and sustainable tax base into the future (which is also able to withstand any ageing of the population in the longer term);
- of all the options, it is the most consistent with other developed international jurisdictions; and
- it is the only option that provides a comprehensive solution to all the issues covered by this tax study as set out in the study brief.

Three broad options packages have been developed for illustrative purposes. All included using a new broad-based consumption tax as a key component (complemented by a modest land and sea departure tax). Without the inclusion of a GST, it is almost impossible to develop an options package that can address the fundamental objective of a broader tax base, while at the same time being consistent with good tax design principles and the terms of reference of the Advisory Committee, especially maintaining a low tax rate environment and international competitiveness. All other options are likely to be of only marginal value.

Recommendation 2: The most appropriate option for broadening Hong Kong's tax base is for Hong Kong to introduce a new broad-based tax on general consumption as part of any tax reform package.

7.2 Overall Conclusions and Recommendations

Not only does the present Hong Kong tax system suffers from a having a narrow tax base – and in some instances a narrow tax payer base – but also that its main taxation revenue sources, such as profits tax and taxes on property, especially stamp duties, are likely to come under increasing international competitive pressure.

The increased international pressure on tax rates and tax types reinforces the need to consider options that are both consistent with international experience and will not undermine international competitiveness. Hong Kong requires an equitable and stable broad tax base that is capable of providing the necessary tax revenue in a sustainable fashion.

Overall Recommendation: With respect to the Study Brief, the Advisory Committee should consider seriously the option of recommending the introduction of a broad-based consumption tax, for the reasons set out in the conclusions above.

A Study Brief

Objective of the Study

1. The objective of the study is to assess the nature of the tax base of Hong Kong, in comparison with other developed jurisdictions, with particular reference to whether it is narrow and/or has a shrinking base; and to identify options for reform in the context of the deliberations of the Advisory Committee on New Broad-based Taxes.

Background

2. The Inland Revenue Ordinance (IRO) taxes profits and earnings derived from property rentals, business profits and employments. No other sources of **income** are subject to tax.

Property Tax

3. All income derived from the rental of property in Hong Kong is currently subject to tax. Individuals pay property tax on their net rental income and, for corporations, property rentals are assessed as a source of business income that is subject to profits tax. As all income derived from property rentals is already subject to tax, the tax base as regards property income is already wide.

Profits Tax

4. Every person and corporation carrying on a business in Hong Kong is liable to profits tax. Profits tax is not payable on profits derived from sources outside of Hong Kong. As the IRO currently taxes all Hong Kong-sourced profits, the only active businesses in Hong Kong not paying profits tax are those operating in a loss situation (with no profits to tax) and those whose profits arises outside of Hong Kong. For Hong Kong-sourced income, the profits tax base is already very wide. The only scope for further widening it is to tax the income of Hong Kong businesses sourced outside of Hong Kong.

Salaries Tax

5. Personal allowances are deductions granted to individuals in the computation of their assessable incomes for salaries tax. Their effect is to free part (or all) of an individual's income from a liability to salaries tax. Private expenses are not related to the derivation of assessable income and are generally not deductible in computing assessable income. Concessionary deductions are deductions granted to individuals for all or

part of certain categories of private expenditure incurred during the year. To the extent that deductions are allowed in computing salaries tax liabilities, these expenses are paid out of income that is not subject to tax.

6. For many years, Hong Kong has granted reasonably high levels of personal allowances. In the recent past, these allowances have been regularly increased at rates higher than that of inflation. In the last few years, in the light of the economic situation, the range of concessionary deductions granted has also been expanded. As a consequence, in the last five years the proportion of the working population paying salaries tax has been reduced from 47% to less than 40%. Currently, 17% of taxpayers contribute almost 80% of the salaries tax yield.

7. With buoyant economic conditions, the Government had resources available to finance tax concessions that have both reduced the number of taxpayers liable to salaries tax and reduced the tax burdens of most of those remaining within the tax net. That the tax net has been narrowed in recent years is unquestionable. Hong Kong is not alone in this area and tax reforms in many other jurisdictions have likewise lightened the salaries tax burdens of their citizens and reduced the size of tax bases. The issue for determination is whether, over the medium term, the rate of reductions in tax burdens and removal of taxpayers from the tax net has been occurring in Hong Kong at a higher rate than, overall, changes in burdens in other jurisdictions. In particular, have recent personal taxation policies contributed to a further narrowing of the tax base?

8. Hong Kong has long had a policy of maintaining its earnings and profits taxes at low levels. This policy will continue into the future. It has also, to date, had a policy of not imposing broad-based consumption taxes. The principal issue to be addressed is whether the low rate tax base (for both individuals and businesses) is able to be supported by a narrow tax base. First, can the tax base continue to be narrow by reference to its number of taxpayers and secondly, should it be narrow by reference to the limited range of taxes it imposes?

9. In the absence of a significant turnaround in the economic performance, further tax concessions, without compensatory revenue raising measures, would perpetuate the Government's revenue problem. The maintenance of the "taxation" status quo may deprive the Government of access to stable revenue flows that are reasonably well insulated from any future economic downturns.

10. Has Hong Kong turned into a developed economy that is no longer capable of producing, over the longer term, substantial increases in economic growth? If the current revenue problems are not cyclical but

structural, revenue collections will not self-correct with changes in economic cycles. To maintain Government revenues at current levels, other options must be examined.

Study Tasks

11. To achieve the objectives of the Study, the Consultant shall:

(a) define what is a "narrow tax base". Any tax base has two aspects - the breath of scope of the taxes charged and the coverage of actual payers, relative to the overall number of persons potentially chargeable, of those taxes. A comparison of the impact of the different taxes in a number of overseas jurisdictions is necessary to develop objective benchmarks which could be regarded as international "norms". It would be against these international "norms" that Hong Kong's tax system could be objectively tested to determine whether the proposition that the tax base is "narrow" is supportable.

The survey of overseas jurisdictions cannot be limited to taxes on profits and earnings. Whilst Hong Kong may not have any broad-based consumption taxes and only a few other duties and levies, revenue mixes as between jurisdictions do vary. Many jurisdictions impose a wide range of charges including income taxes, consumption taxes, compulsory social security levies and excise duties. A comparison of the composite effect of these taxes on individuals and the relative movement in overall tax burdens borne by taxpayers at differing income level is essential to providing an overall picture of trends in overseas taxation;

(b) identify, for further consultation, reform options to broaden the tax base with reference to recent examples of reforms in other countries. The non-exhaustive options include -

- increasing tax rates for the existing tax base but still maintaining a low taxation regime;
- reducing personal allowances and abolishing some concessionary deductions;
- introducing broadly based, low rate consumption tax.

The reform options should cater for three broad scenarios –

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; and

(c) present the conclusions and recommendations to the Advisory Committee on New Broad-based Taxes.

B Terms of Reference 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,

(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.

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