

**Information Paper for
Legislative Council Panel on Financial Affairs**

Progress Report on Review of Public Finances

INTRODUCTION

This paper updates Members on the progress of the review of public finances further to the report submitted in November 2000.

BACKGROUND

2. The Financial Secretary announced in March 2000, in the face of projected operating deficits for some years to come, the appointment of the Task Force on Review of Public Finances and the Advisory Committee on New Broad-based Taxes. The Task Force is to determine whether the successive operating deficits are structural or cyclical in nature. It would also consider whether and, if so, what changes should be introduced to our tax system. The Advisory Committee on the other hand is to advise what types of new broad-based taxes would be suitable for introduction in Hong Kong should there be a need for such new taxes. Both the Task Force and the Advisory Committee operate under the overriding principle of maintaining Hong Kong's low and simple taxation regime and preserving its competitiveness. This parallel approach would enable Hong Kong to be ready for timely actions on a potential problem that requires in-depth study.

ADVISORY COMMITTEE ON NEW BROAD-BASED TAXES

3. On 6 August 2001, the Advisory Committee published a consultation document entitled "A Broader-based Tax System for Hong Kong?" to canvass the views of the public on options to improve our tax system (copies have already been sent to all Members). The consultation document addresses the question of whether Hong Kong's tax base is narrow. It notes that –

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

- (b) Hong Kong derives 27% of its tax revenue from personal income - equal to the OECD average but four percentage points lower than the Asia-Pacific benchmark;
- (c) Hong Kong has a noticeably heavy reliance on taxation from corporate profits. As a percentage (32%) of tax revenue, Hong Kong's reliance on corporate profits tax is three and half times that of the OECD average (9%) and slightly higher than that of the Asia-Pacific average (29%);
- (d) taxation from property (rates, stamp duties on real property and shares and estate duty) in Hong Kong is above the international benchmarks as a percentage of GDP, and significantly higher than each of the benchmarks as a percentage of total taxation (24%, against 5% for the OECD benchmark and 10% for the Asia-Pacific benchmark);
- (e) Hong Kong has a very low reliance on taxation from goods and services, and is the only developed economy that does not have any form of general consumption tax. The OECD countries on average raise 18% of tax revenue from general consumption taxes, and 12% from specific goods and services taxes, while on average the Asia-Pacific benchmark economies raise 12% from general consumption taxes and 16% from specific goods and services taxes. The global trend is towards a greater reliance on consumption taxes and less reliance on taxes on income and property;
- (f) Hong Kong is more reliant on taxation from property, personal income and corporate profits than the OECD or Asia-Pacific averages, but its tax levels are below the averages of these groups. It has an outstandingly low reliance on taxes from goods and services. Considering the limited number of taxes levied, Hong Kong's tax base is narrow in comparison to other developed jurisdictions;

- (g) separately, because of the limited scope of the liability to some of the taxes levied, the composition of Hong Kong's tax base is narrow; and
- (h) Hong Kong derives a significant proportion of its total revenue (approaching half) from non-taxation sources – substantially above international 'norms'. This revenue is derived substantially from land sales and earnings from the investment of accumulated fiscal reserves. Hong Kong's revenue base, with its increasing reliance on non-tax revenue sources, is heading in the opposite direction to the overseas trend.

4. The Advisory Committee identified a total of 13 options which could raise additional revenue and/or broaden the tax base. These options reflect the deliberations of the Advisory Committee in the past year but the Committee has not taken any stand on them. The options fall into two groups –

- (I) those that seek to increase the revenue productivity of existing taxes through raising rates or reducing allowances, comprising –
 - (a) increase salaries tax rates;
 - (b) increase profits tax rates;
 - (c) increase stamp duties on property;
 - (d) reduce personal allowances and reductions under salaries tax;and
- (II) those that involve the introduction of new taxes listed below –
 - (e) capital gains tax;
 - (f) tax on interest;
 - (g) tax on dividends;
 - (h) tax worldwide income of business and individuals;
 - (i) land and sea departures tax;
 - (j) payroll and social security taxes;
 - (k) poll tax;
 - (l) general consumption tax;
 - (m) tax on mobile phones and signboards.

5. The public consultation will last until 6 October 2001. The Advisory Committee will report to the Financial Secretary by the end of this year, taking into account the views of the public.

TASK FORCE ON REVIEW OF PUBLIC FINANCES

6. The Task Force is continuing with its detailed examination of the question of structural deficit. In the 2001-02 Budget, the operating deficits (which first appeared in 1998-99) are forecast to continue throughout the current Medium Range Forecast period (until 2004-05), i.e. seven consecutive years in total. We have not projected the fiscal position beyond this period and therefore do not know at this stage whether the operating deficits would continue further. The Task Force has augmented studies on the correlation between economic performance and government revenue, focusing on the following major revenue items –

- (a) profits tax;
- (b) salaries tax; and
- (c) stamp duties.

7. Concurrently, the Task Force has also initiated a study on the importance of indirect taxes on government finances, with the assistance of a team of local academics.

8. For the longer term, the Task Force is developing a comprehensive model to project the state of government finances up to 2027-28. Noting the economic strains posed principally by the aging of the population on the expenditure side and the narrow tax base of Hong Kong on the revenue side, the model seeks to test the sustainability of our fiscal finances in the longer term. It encompasses demographic, economic and budgetary variables.

9. The various studies of the Task Force are continuing. We intend to present the key findings to the Financial Affairs Panel when they become available.