

LEGISLATIVE COUNCIL BRIEF

Final Report of Public Consultation on Tax Reform

INTRODUCTION

At the meeting of the Executive Council on 12 June 2007, the Council took note of the outcome of the tax reform consultation exercise as set out in the Final Report of Public Consultation on Tax Reform (Final Report) attached.

BACKGROUND

2. In July 2006, the Government launched a public consultation on how we should reform our tax system and to seek public views on the proposed introduction of a Goods and Services Tax (GST) to broaden the tax base. We conducted an interim review late last year and released an interim report on 5 December 2006 to take stock of the views collected in the first half of the consultation period.

3. The consultation ended on 31 March 2007. Over the consultation period, we received about 2 400 written submissions from organisations and individuals. Of these, some 2 200 submissions were received before the release of the interim report. In addition to collecting feedback through submissions made by the public, we commissioned an independent organisation to conduct regular opinion surveys on tax reform over the consultation period.

PUBLIC VIEWS

4. During the consultation, we found that the public has generally obtained a better understanding of the problems of our narrow tax base. They understand that the Government has been heavily reliant on a limited number of taxes and taxpayers to generate the bulk of revenue to meet our expenditure. This has rendered our fiscal health vulnerable to economic cycles and fluctuations.

5. The community is also aware that our population is ageing rapidly and the pressure of government expenditure on health care and social welfare would increase. However, government revenue from Salaries Tax would drop and this would reduce the Government's flexibility in dealing with additional long-term expenditure items. Moreover, in order to maintain our competitiveness, we have to cope with a number of challenges. These include globalization and the trend that many overseas economies are reducing their direct tax rates to attract capital and talent. In addition, we have to upgrade our human capital. As education and manpower training are long-term investment, they need to be funded by stable revenue. The public generally agrees that there are deficiencies in our narrow tax base, and is more receptive to the need to broaden our tax base. They also broadly agree that a more stable revenue base would enhance our fiscal health in order to cope with the aforementioned longer-term challenges.

6. While the community generally understands that GST can broaden our tax base, there are concerns that GST would complicate our tax system, widen the wealth gap and adversely affect our economy. We have proposed a number of tax relief and compensation measures to address the regressivity of this tax, and have provided the public with additional information and overseas experience in implementing GST to illustrate that its introduction would not lead to the problems that they are concerned about. Despite such efforts, we have been unable to remove their worries. In view of the strong public opinion against GST, we announced during

the release of the interim report in December 2006 that the Government would not advocate GST in the rest of the consultation period but would continue to listen to views on other viable options to broaden our tax base.

7. The interest of the community in the discussion on tax reform has declined significantly following the publication of the interim report, as shown by the drastic drop in the number of written submissions.

OBSERVATIONS

8. Although members of the community have made other suggestions for broadening the tax base (e.g. introducing a green tax, land and sea departure tax, tax on luxury goods, progressive Profits Tax as well as reducing personal allowances under Salaries Tax), most of these options had been carefully considered by the Advisory Committee on New Broad-based Taxes (Advisory Committee) set up in 2000. The Advisory Committee pointed out that none of these options could solve the problems of our narrow tax base in the long run. It is also found that the public does not have any clear inclinations on which option or options that the Government should adopt. Moreover, there are suggestions that the Government should not rely on only a single option but should deploy a basket of options to broaden the tax base and stabilise our revenue source. There are also calls that the Government should study the health care financing proposals as soon as possible so as to curb increase in government expenditure on health care arising from our rapidly ageing population.

9. As for green tax, it is one of the most popular options suggested by the public but was not studied by the Advisory Committee at that time. Overseas experience shows that such a tax is introduced to promote environmental protection rather than for raising government revenue. Notwithstanding this, we consider that green tax is an option worth exploring when we consider the introduction of new taxes.

RECOMMENDATIONS

10. The Final Report concludes that introducing the options as suggested in paragraph 8 above cannot fundamentally address the problems of our narrow tax base. In the face of our ageing population, Hong Kong's dependency ratio would be rising rapidly. Moreover, globalization would bring challenges to our education and manpower training. In the long run, our narrow tax base would limit our ability to allocate resources to invest for the future and to respond to these challenges. This would affect the stability of our public finances and would undermine our competitiveness. Hence, the Final Report recommends that:

- (a) having raised public awareness on the deficiencies of a narrow tax base, the Government should continue to study options for broadening the tax base and address this fundamental issue at a suitable time in the future;
- (b) in studying the options for broadening the tax base, the Government should take into full account the views collected in this consultation exercise and consult the public further on those options which are more practical;
- (c) as the problem of ageing population is getting more serious and this would bring additional pressure to our public finances, the Government should consult the public on the health care financing proposals as soon as possible; and
- (d) to enhance Hong Kong's competitiveness, the Government should continue to advance education and manpower training, and should explore sustainable financial arrangements so as to respond to the long-term needs.

PUBLICITY

11. The content of the Final Report has been uploaded to the tax reform website (www.taxreform.gov.hk) on 12 June 2007. A press release will be issued and a spokesman will be available to answer media and public enquiries.

ENQUIRY

12. Enquiries should be directed to Mr Vincent TANG, Principal Assistant Secretary for Financial Services and the Treasury (Treasury) at 2810 3757.

Financial Services and the Treasury Bureau
12 June 2007

Public Consultation on Tax Reform Final Report

June 2007

Financial Services and the Treasury Bureau

The Government of the Hong Kong Special Administrative Region

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Executive Summary

The Government published on 18 July 2006 a Consultation Document entitled “Broadening the Tax Base, Ensuring our Future Prosperity: What’s the Best Option for Hong Kong?” and launched a public consultation exercise for some nine months on how to reform Hong Kong’s tax system for broadening our tax base. The Consultation Document explains in detail the existing problems of Hong Kong’s narrow tax base and the possible challenges that we will face in the future. The purpose of the public consultation is to raise the community’s awareness of our narrow tax base and the problems it brings, and to stimulate public discussion on ways of broadening it.

The public consultation ended on 31 March 2007. We received about 2 400 written submissions from the public by e-mail, post, facsimile, etc. during the consultation period. Government representatives attended some 350 meetings and seminars to explain to the public the contents and recommendations of the Consultation Document, and to listen to their views directly on tax reform. Moreover, the Government commissioned an independent agency to conduct regular opinion surveys between July 2006 and March 2007 on broadening the tax base.

During the consultation, we can see that the public has gained a better understanding of the relevant issues and they generally agree that Hong Kong’s tax base is narrow. They recognise the problems of our tax system: our revenue relies heavily on Salaries Tax, Profits Tax and non-tax revenue (including land premium and investment income from our fiscal reserves). Such income is susceptible to the ups and downs of economic cycles, which render our public finances highly volatile.

The community is also aware that our population is ageing rapidly and the pressure of the government expenditure on health care and social welfare would increase. However, government revenue from Salaries Tax would drop and this would reduce the Government's flexibility in dealing with additional long-term expenditure items. Moreover, in order to maintain our competitiveness, we have to cope with a number of challenges. These include globalisation and the trend that many overseas economies are reducing their direct tax rates to attract capital and talent. In addition, we have to upgrade our human capital. As education and training are long-term investment, they need to be funded by stable revenue. The public generally agrees that there are deficiencies in our narrow tax base, and is more receptive to the need to broaden our tax base. They also broadly agree that a more stable revenue base would enhance our fiscal health in order to cope with the aforementioned longer-term challenges.

In the Consultation Document, we recommend the introduction of a Goods and Services Tax (GST) as we consider that it is the most appropriate option to broaden our tax base. The community has held extensive discussions on this proposal.

Members of the public are mainly concerned about the regressive nature of GST, which would widen the wealth gap and add to the financial burden of low-income earners. They are also concerned that GST would dampen public consumption and tourist spending. Some are also worried that GST, if introduced, would complicate our tax system and undermine our competitiveness. We have proposed a number of tax relief and compensation measures to address the regressivity of this tax, and have provided the public with additional information and overseas

experience in implementing GST to illustrate that its introduction would not lead to the problems that they are concerned about. Despite such efforts, we have been unable to remove their worries. Although the public generally understands that GST is effective in broadening the tax base and stabilising public finances, they cannot accept at this point in time that it is an appropriate option to tackle the narrow tax base problems.

In view that the public was strongly against GST when we conducted the Interim Review last December, we considered that there was insufficient public support nor were the conditions right for the introduction of GST. We have, however, decided to continue to listen to public views on other options for broadening the tax base.

Regarding other options to broaden the tax base, many have proposed introducing a green tax, a land and sea departure tax, a tax on luxury goods, a progressive Profits Tax and reducing personal allowances under Salaries Tax. In addition, some people and organisations have put forward other options such as introducing a capital gains tax, increasing the progressive element of Salaries Tax, introducing a tax on dividends, a tax on interest, taxing the worldwide income of businesses and individuals, and increasing Rates on tenements.

Apart from the above suggestions, there are some views that the rapidly ageing population would increase government expenditure on health care. To relieve the Government of the pressure of this expenditure, they suggest that the Government should study the health care financing proposals as soon as possible.

As to how we should broaden our tax base, the public does not have any clear inclinations or mainstream views on which option or options that the Government should adopt. From the views gathered, there are suggestions that the Government should not rely on only a single option but should deploy a basket of options to broaden the tax base and stabilise our revenue source.

In considering the most appropriate options for broadening the tax base, we consider that we should take account of the following three principles:

- (a) The option must be effective in broadening the tax base and providing stable and considerable revenue for the Government to meet its future needs;
- (b) The option must be fair and in line with the “capacity to pay” principle, and should not widen the wealth gap; and
- (c) The option is in line with our simple and low tax system so as to attract capital and talent and maintain our competitiveness.

In light of the above, we are of the view that no single option other than GST can satisfy all these conditions. In fact, the Advisory Committee on New Broad-based Taxes (Advisory Committee) had examined most of the above options in depth and pointed out in its Report released in 2002 that they are not long-term solutions to our problems of narrow tax base.

As for green tax, it has frequently been mentioned by the public but was not studied by the Advisory Committee at that time. Although the

objective of introducing this tax is not solely to increase government revenue, it is an option worth exploring when we consider the introduction of new taxes.

While the introduction of a green tax or adoption of a basket of options can partly achieve the effect of increasing government revenue, such initiatives cannot effectively broaden the tax base. As our economy has recovered and the Government's financial position has improved, the public generally does not consider that there is any urgency for introducing tax reform immediately to broaden the tax base. In the face of our ageing population, Hong Kong's dependency ratio would be rising rapidly. Moreover, globalisation would bring challenges to our education and manpower training. In the long run, our narrow tax base would limit our ability to allocate resources to invest for the future and to respond to these challenges. This would affect the stability of our public finances and undermine our competitiveness. Hence, we recommend that :

- (a) having raised public awareness on the deficiencies of a narrow tax base, the Government should continue to study options for broadening the tax base and address this fundamental issue at a suitable time in the future;
- (b) in studying the options for broadening the tax base, the Government should take into full account the views collected in this consultation exercise and should consult the public further on those options which are more practical;

- (c) as the problem of ageing population is getting more serious and this would bring additional pressure to our public finances, the Government should consult the public on the health care financing proposals as soon as possible; and

- (d) to enhance Hong Kong's competitiveness, the Government should continue to advance education and manpower training, and should explore sustainable financial arrangements so as to respond to the long-term needs.

Chapter 1

Background

1. The Government has all along been very concerned about the problems of Hong Kong's narrow tax base. In 2000, it established the Advisory Committee on New Broad-based Taxes (Advisory Committee) to study the various possible options to broaden the tax base.

2. The Advisory Committee studied the tax base of Hong Kong in depth and compared the tax base of Hong Kong with those of other developed jurisdictions. In its Final Report published in February 2002, the Advisory Committee pointed out that by international standards, the tax base of Hong Kong is very narrow. After comparing the various options for broadening the tax base, the Advisory Committee considered that the most viable option is to introduce a Goods and Services Tax (GST). Subsequently, the Government set up an internal working group in 2003 to explore further the feasibility of introducing GST and study the relevant details.

3. After a detailed study, the Government published on 18 July 2006 a Consultation Document entitled "Broadening the Tax Base, Ensuring our Future Prosperity: What's the Best Option for Hong Kong?" and launched an extensive public consultation exercise on how to reform Hong Kong's tax system in order to broaden our tax base. The purpose of the public consultation is to raise the community's awareness of our narrow tax base and the problems it brings, and to stimulate public discussion on ways of broadening it.

4. The Consultation Document explains in detail the existing problems of Hong Kong's narrow tax base and the possible challenges that we will face in the future. As the subjects for consultation are very complex, involving different social dimensions, and have far-reaching implications on members of the public, we have provided a considerable amount of information in the Consultation Document for public reference. We have also allowed a period of about nine months for the consultation to provide the public with sufficient time and information to participate in the discussion.

5. During the consultation period, the Government listened extensively to the views on tax reform from all walks of life. In December 2006, we conducted an interim review of the public views collected. In early February 2007, the Government uploaded to its Tax Reform Website (www.taxreform.gov.hk) a brief outlining the main options for broadening the tax base put forward by different sectors of the community, and providing a preliminary assessment on these options in order to assist the public in giving their views on other options for broadening the tax base.

6. The public consultation ended on 31 March 2007. We received about 2 400 written submissions from the public by e-mail, post, facsimile, etc. About 2 200 of these submissions were collected before the release of the Interim Report, and only about 200 submissions thereafter. A list of the submissions and the full contents of the submissions are available at the Tax Reform Website (www.taxreform.gov.hk).

7. During the consultation period, government representatives attended some 350 meetings and seminars to provide the public a better understanding of tax reform. The Financial Secretary attended four regional forums organised by the Home Affairs Department and three seminars held by professional bodies and the media. The Secretary for Financial Services and the Treasury attended meetings of the 18 District Councils (DCs) (a list of motions passed by the DCs in connection with the tax reform consultation is at Appendix A and a list of websites which contain the minutes of the DC meetings on tax reform consultation is at Appendix B). Besides, different political parties, trade associations, professional bodies and district organisations organised a series of meetings, forums and seminars during the consultation period to discuss the Consultation Document and express their views on the proposed tax reform.

8. To collect public views on tax reform and GST more systematically, the Government commissioned an independent agency to conduct regular opinion surveys between July 2006 and March 2007. Similar opinion surveys were also conducted by different community groups.

9. We have collected views through different channels. Generally speaking, the views of the public can be grouped under three topics:

- (a) Is there a need for Hong Kong to broaden the tax base?
- (b) Is GST an appropriate option to broaden the tax base?

- (c) Are there any other viable and appropriate options to broaden the tax base?

Chapter 2 to 4 of this Report set out the public views on these three topics.

10. We would like to thank members of the public and the various organisations for the valuable views they have expressed during the consultation period. We also appreciate that a number of organisations have actively organised various activities such as briefings, seminars and opinion surveys to stimulate extensive discussions within the community so that we can hear public views on tax reform clearly.

Chapter 2

Is there a need for Hong Kong to broaden the tax base?

11. In the Consultation Document on tax reform, the Government has explained in detail the weaknesses of our existing public finances and consulted the public on whether our tax base is narrow and whether there is a need to broaden the tax base. In the interim review conducted last December, we found that the majority of the public agrees that the existing tax base is too narrow and there is a need to explore ways to broaden it. Following the conclusion of the consultation period, public views on this have not changed and the people generally remain supportive of the position that the Government should continue to study ways for tax reform and broadening of the tax base in order to ensure that we have a healthy public finance system.

12. According to the opinion surveys carried out by the independent agency commissioned by the Government, the percentage of people who agreed that the tax base was relatively narrow rose from about 57% in July 2006 to about 62% in March 2007, and the percentage of people who supported the Government to reform the tax system and broaden the tax base also rose from about 51% in July 2006 to about 61% in March 2007. Besides, all DCs held discussions on tax reform and most of them agreed that the Government should continue to explore ways of broadening the tax base and to consult the public in this regard.

13. Major views of those who are in favour of a tax reform and broadening the tax base can be summarised as follows:

- (a) The current tax base in Hong Kong is too narrow and the Government is over-reliant on a small number of taxpayers and property-related revenue to meet most of its expenditure;
- (b) Government revenue is highly volatile as it is susceptible to changes in economic cycles, fluctuations in the property market and outside economic conditions. On the other hand, most of government expenditure goes to areas related to people's livelihood and is therefore relatively rigid. As such, there is a need for the Government to broaden the tax base in order to enhance the stability of our public finances;
- (c) The rapid ageing of Hong Kong's population would result in increasing pressure on government expenditure on health care and social welfare, and our tax base will shrink gradually. Therefore, the Government should plan ahead and identify stable sources of income to meet expenditure needs;
- (d) To face the challenges of globalisation, the Government needs to upgrade our human capital. As education and training are long-term investment, we need a broad tax base to generate stable streams of revenue to maintain Hong Kong's competitiveness;
- (e) With a broad tax base, we can maintain stable tax revenue. This would obviate the need to raise tax rates drastically or cut expenditure on public services in the event of an

economic downturn, as these would have a negative impact on people's livelihood;

- (f) A broad tax base would allow us more room for reducing direct tax rates to attract talent and capital; and
- (g) Through broadening the tax base, more people can contribute to public expenditure, thereby enhancing the public's sense of civic responsibility.

14. While the majority of the public supports the Government to explore ways of broadening the tax base, some, however, hold the opposite view. Their arguments can be summarised as follows:

- (a) If we take into account Rates, government rents, land premium, stamp duty, betting duty and duties on liquor, tobacco and fuel, Hong Kong's tax base is actually not narrow. It is therefore not necessary to consider any options for broadening the tax base;
- (b) There are no fundamental problems with our public finances. Moreover, with the current economic upturn, the Government's financial position has greatly improved, and our fiscal reserves are increasing. Even if an economic downturn occurs, we should have sufficient fiscal reserves to meet expenditure needs. It is therefore not necessary to change the existing tax regime;

- (c) The Government can increase the investment return from the Exchange Fund and revise the method of sharing the investment income between the fiscal reserves and the Exchange Fund to stabilise government revenue;
- (d) The main reason why we have a small number of taxpayers is that there is a serious wealth gap problem. To address this problem, the Government should improve economic conditions to help increase workers' income, thereby increasing the number of taxpayers;
- (e) The pressure of expenditure on health care and social welfare resulting from our rapidly ageing population should be addressed through health care financing or adjusting the population policy, rather than through broadening the tax base; and
- (f) The Government should reduce its expenditure further before exploring new sources of revenue.

Chapter 3

Is GST an appropriate option to broaden the tax base?

15. In the Consultation Document, we recommend the introduction of a GST as we consider that it is the most appropriate option to broaden our tax base. The proposed GST framework is simple and broad-based, with a low, single tax rate and a high registration threshold. Besides, the Consultation Document sets out a series of tax offsets and relief measures in order to reduce the impact of GST on the community.

16. During the consultation period, members of the public have put forward many views on GST. Those who support its introduction generally agree that GST is broad-based and that it can generate a stable source of revenue for the Government and help solve the problems of ageing population and rigid public expenditure. They are also of the view that since GST is a tax on personal consumption, those who consume more would have to pay more tax, hence it is a fair tax.

17. Some members of the public also hold the view that the introduction of GST can provide the Government more room for reducing Salaries Tax and Profits Tax to attract more talent and capital. Some also point out that GST can help broaden the tax base by bringing into the tax net those who earn considerable income from dividends and interest which are not subject to tax. They are also of the view that through paying GST, members of the public can fulfil their civic responsibility of paying tax according to their ability.

18. As for those against the introduction of GST, although they understand that the tax can effectively broaden the tax base, they do not accept at this point in time that it is an appropriate option to tackle the narrow tax base problems. They are concerned that GST is regressive in the sense that people with different income levels are charged at the same rate, which would add to the financial burden of low-income earners and widen the wealth gap. They are also concerned that GST would dampen public consumption and tourist spending, and damage our reputation as a “shopping paradise”, thus hampering the development of tourism. Since GST would cover most goods and services and would be collected at each stage of production or distribution, some are worried that GST, if introduced, would complicate our tax system and undermine our competitiveness.

19. Besides, some businesses are worried that GST would entail high compliance costs, which would in turn increase their expenditure. The transportation and logistics industries are also worried that the introduction of GST would lead to an increase in the costs of logistics services and complicate the import and export procedures, thus jeopardising Hong Kong’s role as an international trading and shipping centre.

20. Some people are worried that the proposed compensation measures cannot offset the impacts of GST on low-income families. They think that the Government should explore other means of compensation such as increasing cash allowances or providing exemption in other areas including public education, transport and medical services, so as to ensure that the introduction of GST would not impose an additional burden on low-income families and affect their quality of life.

21. The Government understands that the public is very concerned about the introduction of GST. We have responded actively to address their concerns. Regarding the question of whether GST would widen the wealth gap, our primary consideration at the time of drawing up the GST framework is to ensure that the livelihood of low-income households would not be affected by its introduction. For these households, we have proposed a package of relief measures including cash allowance and GST credits on Rates and water and sewage charges.

22. As to whether GST would dampen consumption, according to overseas experience, the impact of GST on consumption is minimal and short-term. As tourists would be eligible for a refund of GST under the proposed Tourist Refund Scheme, the tax should not have an adverse impact on tourism.

23. Besides, as the proposed GST framework is simple, business compliance costs would not be high. With a high registration threshold whereby small and medium-sized businesses would generally not be required to register, GST would not undermine our simple tax system.

24. During the consultation period, we have tried to explain to the public and provide them with additional information and overseas experience in implementing GST to show that its introduction would not lead to the problems that they are concerned about. Moreover, we have clearly elucidated that the proposed framework and compensation measures are just a starting point to facilitate discussion and that we welcome views from the public on how they should be revised. The Government will make adjustments to our proposals in light of their suggestions. However, most members of the public still have

reservations on GST. Many hold the view that as the economy of Hong Kong has recovered and the public finances have improved, there is no pressing need for introducing any new taxes to increase government revenue. Our opinion surveys in the past few months also show that around 60% of the public are opposed to the introduction of GST.

25. Following a debate on 19 October 2006, the Legislative Council passed a motion against the introduction of GST. In the discussion of the Consultation Document, most of the DCs were also opposed to the introduction of GST at this stage.

26. In view of the strong public objection to the introduction of GST, we had, during the interim review conducted in December 2006, decided not to advocate GST for the remaining part of the consultation and to continue to listen to public views on other options to broaden the tax base.

27. After the release of the Interim Report, there was a marked decrease in the number of public submissions on GST. While the majority of the public is still against introducing GST, some hold the view that this is an ideal way to broaden the tax base and they hope that the Government would re-consider it at a suitable time in the future. Some members of the public and organisations have put forward other options and views on ways to broaden the tax base.

Chapter 4

Other options to broaden the tax base

28. During the consultation period, many people and organisations have expressed their views on other options to broaden the tax base. These mainly include:

- (a) introducing a green tax;
- (b) introducing a land and sea departure tax;
- (c) introducing a tax on luxury goods;
- (d) introducing a progressive Profits Tax;
- (e) reducing personal allowances under Salaries Tax;
- (f) introducing a capital gains tax;
- (g) increasing the progressive element of Salaries Tax;
- (h) introducing a tax on dividends;
- (i) introducing a tax on interest;
- (j) taxing the worldwide income of businesses and individuals;
and

- (k) increasing Rates on tenements.

Public views on the above options are outlined below.

(a) Introducing a Green Tax

29. Many people consider that the Government should levy taxes on substances that are harmful to the environment, such as plastic bags, tyres and batteries. Some others suggest introducing a tax on electricity or other forms of energy. They think that a green tax can improve the environment while broadening the tax base and bringing additional revenue to the Government. They recommend that the tax, if introduced, be levied on the “user pays” principle.

30. Some people have reservations about whether a green tax can bring stable and significant revenue to the Government. Since the purpose of introducing a green tax is to reduce the use of energy and environmentally unfriendly substances, the more successful a green tax is, the less revenue the Government will receive in the long term.

31. Besides, some are of the view that a green tax would increase business operating costs and affect Hong Kong’s economy. However, some people hold the opposite view. They think that with Hong Kong’s environment improved, we would be able to attract more overseas talent or institutions to work or invest here, thereby enhancing Hong Kong’s competitiveness and contributing to our sustainable development.

(b) Introducing a Land and Sea Departure Tax

32. Some people are in favour of introducing a land and sea departure tax because persons departing from Hong Kong by air and travelling to Macau or the Mainland by sea already have to pay a departure tax or embarkation fee under the current tax regime. Should this tax be introduced, all outbound travellers by sea or by land from Hong Kong would be subject to such payment, which is in line with the principle of fairness.

33. However, some people are worried that this tax would have a negative impact on the integration of Hong Kong with the Mainland and on inbound tourism. Furthermore, unless the rate was set at a very high level, the tax collected would be limited and the disadvantages of introducing this tax might outweigh the advantages.

(c) Introducing a Tax on Luxury Goods

34. Many people consider that the Government should introduce a tax on luxury goods because this tax would help broaden the tax base and generate additional government revenue. Besides, since this tax is generally levied on more valuable goods rather than necessities, it would not increase the burden of low-income earners and is in line with the “capacity to pay” principle.

35. However, some people are concerned about the difficulties in implementing this tax. It is because there is no internationally or socially recognised definition of luxury goods. To tax certain types of goods selectively would be unfair to the affected businesses or

individuals. Besides, in order to bring significant revenue to the Government, the rate of this tax must be set at a very high level. This would have a negative impact on our retail and tourism industries.

(d) Introducing a Progressive Profits Tax

36. Some people think that the Government should consider introducing a progressive Profits Tax because the current Profits Tax rate in Hong Kong is lower than those in many developed tax jurisdictions and charging the businesses with higher profits at higher tax rates is in line with the “capacity to pay” principle.

37. However, some point out that this tax would not be effective in broadening the tax base because the burden of the additional tax would only fall on businesses currently within the tax net. Moreover, corporate profits would drop during economic downturns, and it is doubtful whether a progressive Profits Tax is conducive to stabilising government revenue. Some people are even concerned that this option would go against the international trend of reducing direct tax rates and dampen the intention of businesses to invest in Hong Kong, hence eroding our competitiveness.

(e) Reducing Personal Allowances under Salaries Tax

38. Some people are of the view that the most simple and direct way to broaden the tax base is to reduce the personal allowances under Salaries Tax. They think that by drawing wage earners currently paying no Salaries Tax into the tax net through reduction of such allowances, the tax base can be broadened.

39. However, some people point out that personal allowances have all along been provided as a means of financial assistance to individuals and dependents' families in Hong Kong. They are worried that a substantial reduction of personal allowances under Salaries Tax would severely affect the quality of life of low-income families. Furthermore, much of the additional revenue thus collected would come from existing taxpayers who do not pay tax at the standard rate. As for new taxpayers, tax revenue from them would be very limited.

(f) Introducing a Capital Gains Tax

40. Some people consider that a capital gains tax can help broaden the tax base and bring additional revenue to the Government. Besides, this tax is fair as it applies to capital gains only and would not widen the wealth gap.

41. However, some doubt whether the tax can bring stable revenue to the Government because capital value is easily affected by economic cycles. During economic downturns, capital value and related transactions would drop, and hence, the Government may not be able to raise stable revenue from this tax. In addition, some are concerned that the tax may prompt investors to invest offshore in order to avoid tax on their investment gains in Hong Kong. This would affect the status of Hong Kong as an international financial centre.

(g) Increasing the Progressive Element of Salaries Tax

42. Some people hold the view that high-income earners should pay more tax. Although Salaries Tax is currently levied in a progressive

manner in Hong Kong, our Salaries Tax rates are relatively low compared with other developed tax jurisdictions. On the “capacity to pay” principle, increasing the progressive element of Salaries Tax is therefore a viable option.

43. However, some people have reservations on this proposal. They consider that while this option can increase government revenue, it cannot broaden the tax base because additional revenue would come from existing taxpayers. Besides, this option goes against the international trend of reducing direct tax and would undermine our ability to retain and attract talent.

(h) Introducing a Tax on Dividends

44. Some people point out that many overseas jurisdictions levy a tax on dividends and hence, there should be similar arrangements in Hong Kong to tax the dividend income earned by investors in order to broaden the tax base.

45. However, some are of the view that the introduction of a tax on dividends in Hong Kong would easily lead to double taxation of businesses’ income and undermine Hong Kong’s attractiveness to investors. To avoid double taxation, complicated legislation would be required, and this would be prejudicial to our simple tax system. Furthermore, under Hong Kong’s existing territorial source principle of taxation, the new tax would only apply to dividends paid by Hong Kong companies. This may prompt investors to invest overseas in order to avoid paying the tax.

(i) Introducing a Tax on Interest

46. Some people consider that introducing this tax would increase the types of taxes and help broaden the tax base. Some believe that the richer one is, the more savings one would have, and levying a tax on interest is therefore in line with the “capacity to pay” principle.

47. However, some think that interest earnings are susceptible to interest rate movements and investment market environment, and thus would not generate stable revenue for the Government. Moreover, under our territorial source principle of taxation, interest would be free from tax if it is received from deposits located outside Hong Kong. As interest received from deposits offshore is free from tax, the introduction of this tax may also drive away savings from Hong Kong and hence affect the status of Hong Kong as a financial centre.

(j) Taxing Worldwide Income of Businesses and Individuals

48. Some people consider that this option can extend the scope of income subject to tax, thereby broadening the tax base.

49. However, those opposing this tax consider that the revenue yield for the Government would be negligible. This is because according to international practice, if the income earned by businesses and individuals from overseas has been taxed in the jurisdiction where it originates, the income will be granted credits for foreign taxes paid. Moreover, in recent years, some jurisdictions such as Singapore and Malaysia have exempted most foreign-sourced income from taxation. If we abandon this established policy, Hong Kong’s competitiveness in

attracting talent and capital would be eroded.

(k) Increasing Rates on Tenements

50. Some people think that the scope of Rates collection at present is already very broad. Therefore, by increasing Rates on tenements alone, we can increase government revenue in a simple and direct manner.

51. However, some point out that this is not an option to broaden the tax base because the increased Rates would only be borne by the existing Rates payers. Besides, they hold the view that increasing Rates on tenements would render our public finances more vulnerable to changes in the property market. Moreover, this would increase business operating cost, thus hindering our economic development.

Chapter 5

Conclusion

52. In the some nine-month consultation period, we have engaged the community through a variety of channels in discussing the problems of our public finances and our narrow tax base, as well as our tax reform proposals. During the consultation, we can see that the public has gained a better understanding of the relevant issues and they generally agree that Hong Kong's tax base is narrow.

53. The public recognises the problems of our tax system: our revenue relies heavily on Salaries Tax, Profits Tax and non-tax revenue (including land premium and investment income from our fiscal reserves). Such income is susceptible to the ups and downs of economic cycles, which render government revenue highly volatile. On the other hand, the majority of government expenditure goes to areas related to people's livelihood and is therefore relatively stable and rigid. As such, we are likely to face fiscal deficits during economic downturns.

54. The community is also aware that our population is ageing rapidly and the pressure of the government expenditure on health care and social welfare would increase. However, government revenue from Salaries Tax would drop and this would reduce the Government's flexibility in dealing with additional long-term expenditure items. Moreover, in order to maintain our competitiveness, we have to cope with a number of challenges. These include globalisation and the trend that many overseas economies are reducing their direct tax rates to attract capital and talent. In addition, we have to upgrade our human capital.

As education and training are long-term investment, they need to be funded by stable revenue. The public generally agrees that there are deficiencies in our narrow tax base, and is more receptive to the need to broaden our tax base. They also broadly agree that a more stable revenue base would enhance our fiscal health in order to cope with the aforementioned longer-term challenges.

55. Regarding how we should reform our tax system to broaden our tax base, we have explained in the Consultation Document that GST can effectively broaden the tax base, stabilise public finances, comply with the “capacity to pay” principle and help maintain Hong Kong’s competitiveness and its low-tax business environment.

56. Our proposal has stimulated extensive discussions within the community. While the public generally understands that GST is effective in broadening the tax base, they have expressed some concerns about the tax. These concerns include: GST is regressive and would add to the financial burden of low-income earners and widen the wealth gap; the tax would dampen public consumption and tourist spending; the tax, if introduced, would complicate our tax system and undermine our competitiveness.

57. We have proposed a number of tax relief and compensation measures to address the regressivity of GST, and have provided the public with additional information and overseas experience in implementing GST to illustrate that its introduction would not lead to the problems that they are concerned about. Despite such efforts, we have been unable to remove their worries.

58. In view that the public was strongly against GST when we conducted the interim review last December, we considered that there was insufficient public support nor were the conditions right for the introduction of GST. We have, however, decided to continue to listen to public views on other options for broadening the tax base.

59. After the release of the Interim Report, public discussions on tax reform have declined significantly. Regarding other options to broaden the tax base, many have proposed introducing a green tax, a land and sea departure tax, a tax on luxury goods, a progressive Profits Tax and reducing personal allowances under Salaries Tax. In addition, some people and organisations have put forward other options such as introducing a capital gains tax, increasing the progressive element of Salaries Tax, introducing a tax on dividends, a tax on interest, taxing the worldwide income of businesses and individuals, and increasing Rates on tenements.

60. Apart from the above suggestions, there are some views that the rapidly ageing population would increase government expenditure on health care. To relieve the Government of the pressure of this expenditure, they suggest that the Government should study the health care financing proposals as soon as possible.

61. As to how we should broaden our tax base, the public does not have any clear inclinations or mainstream views on which option or options that the Government should adopt. From the views gathered, there are suggestions that the Government should not rely on only a single option but should deploy a basket of options to broaden the tax base and stabilise our revenue source.

62. In considering the most appropriate options for broadening the tax base, we consider that we should take account of the following three principles:

- (a) The option must be effective in broadening the tax base and providing stable and considerable revenue for the Government to meet its future needs;
- (b) The option must be fair and in line with the “capacity to pay” principle, and should not widen the wealth gap; and
- (c) The option is in line with our simple and low tax system so as to attract capital and talent and maintain our competitiveness.

63. In light of the above, we are of the view that no single option other than GST can satisfy all these conditions. In fact, the Advisory Committee had examined most of the above options in depth and pointed out in its Report released in 2002 that they are not long-term solutions to our problems of narrow tax base.

64. As to a green tax which has frequently been mentioned by the public during this consultation but was not studied by the Advisory Committee at that time, overseas experience shows that the main objective of introducing this tax is to change the attitude and behaviour of the community in resource utilisation to conserve the environment and to reduce waste and pollution. Although the objective of a green tax is not solely to increase government revenue, it is an option worth exploring and to be studied in detail when we consider the introduction of new

taxes.

65. While the introduction of a green tax or adoption of a basket of options can partly achieve the effect of increasing government revenue, such initiatives cannot effectively broaden the narrow tax base. As the Government's financial position has now improved and the fiscal reserves have been building up again following the recovery of our economy, the public generally does not consider that there is any urgency for introducing tax reform immediately to broaden the tax base. In the face of our ageing population, Hong Kong's dependency ratio would be rising rapidly. Moreover, globalisation would bring challenges to our education and manpower training. In the long run, our narrow tax base would limit our ability to allocate resources to invest for the future and to respond to these challenges. This would affect the stability of our public finances and undermine our competitiveness. Hence, we recommend that :

- (a) having raised public awareness on the deficiencies of a narrow tax base, the Government should continue to study options for broadening the tax base and address this fundamental issue at a suitable time in the future;
- (b) in studying the options for broadening the tax base, the Government should take into full account the views collected in this consultation exercise and should consult the public further on those options which are more practical;
- (c) as the problem of ageing population is getting more serious and this would bring additional pressure to our public

finances, the Government should consult the public on the health care financing proposals as soon as possible; and

- (d) to enhance Hong Kong's competitiveness, the Government should continue to advance education and manpower training, and should explore sustainable financial arrangements so as to respond to the long-term needs.

Motions passed by the 18 District Councils in connection with the consultation on Tax Reform

	Date of Meeting	District Council	Motions passed by District Councils
(1)	7 November 2006	Tai Po District Council	The Tai Po District Council is opposed to the introduction of Goods and Services Tax (GST) at this stage, and urges the Government to study different proposals to broaden the tax base so as to further improve the Hong Kong business environment and labour market.
(2)	7 November 2006	Tuen Mun District Council	The Tuen Mun District Council is opposed to the introduction of GST at this stage, and calls for extensive consultation on every proposal to broaden the tax base and the tax net, as well as taking into account of the views of the grass roots and their affordability.
(3)	7 November 2006	Wong Tai Sin District Council	The Wong Tai Sin District Council is opposed to the introduction of GST.
(4)	9 November 2006	Kwai Tsing District Council	Motion (1): The Kwai Tsing District Council is strongly opposed to the introduction of GST. Motion (2): The Kwai Tsing District Council requests the Government to consider the long-term interest of Hong Kong, study carefully the various options of broadening the tax base and listen to public views. However, this Council is opposed to

	Date of Meeting	District Council	Motions passed by District Councils
			GST being the only option when the majority of the public are strongly opposed to its introduction.
(5)	16 November 2006	Kwun Tong District Council	With regard to the consultation document on tax reform issued by the Government on 18 July 2006, the Kwun Tong District Council is of the view that GST should not be introduced at this stage and that the Government should continue to study options to broaden the tax base and conduct extensive consultations.
(6)	16 November 2006	Kowloon City District Council	The Kowloon City District Council has discussed the proposed tax reform but has not passed any related motion.
(7)	20 November 2006	Southern District Council	The Southern District Council considers it inappropriate to introduce GST at this stage. However, for the long-term interest of Hong Kong, the Government should carefully consider various options for broadening our tax base and conduct extensive consultations.
(8)	21 November 2006	Wan Chai District Council	The Wan Chai District Council has discussed the proposed tax reform, but has not passed any related motion.

	Date of Meeting	District Council	Motions passed by District Councils
(9)	23 November 2006	Central and Western District Council	<p>Motion (1): The Central and Western District Council is opposed to the introduction of GST.</p> <p>Motion (2): Despite the sustained economic growth in Hong Kong, the lower income group still cannot benefit from it and the unemployment rate of some sectors remains high. Therefore, it is inappropriate to introduce GST at this stage. However, for the long-term interest of Hong Kong, there is a need to maintain stable tax revenue to cover the huge public expenditure. We consider that the Government should continue to explore ways to broaden the tax base and promote economic development.</p>
(10)	28 November 2006	Tsuen Wan District Council	The Government should study how to broaden the tax base and this Council is opposed to the introduction of GST at this stage.
(11)	30 November 2006	Sha Tin District Council	The Sha Tin District Council is opposed to the introduction of GST at this stage, and urges the Government to continue to consult the public widely so as to maintain Hong Kong's existing edges and the long-term development in various aspects, perfect the tax system and strengthen the

	Date of Meeting	District Council	Motions passed by District Councils
			foundation of our public finances.
(12)	5 December 2006	Sai Kung District Council	The Sai Kung District Council welcomes the Government has followed public views and decided not to advocate GST for the remaining part of the consultation, and will continue to consult the public on the options for broadening the tax base.
(13)	7 December 2006	North District Council	The North District Council welcomes the Government has followed the public views and decided not to advocate GST at this stage.
(14)	14 December 2006	Yuen Long District Council	The Yuen Long District Council welcomes the Government has followed the public views and decided not to advocate GST for the remaining part of the consultation and not to introduce the tax at this stage, and for the long-term interest of Hong Kong, will continue to consult the public on the options for broadening the tax base so as to secure sustainable revenue to meet public expenditure.
(15)	14 December 2006	Yau Tsim Mong District Council	The Yau Tsim Mong District Council has discussed the proposed tax reform but has not passed any related motion.

	Date of Meeting	District Council	Motions passed by District Councils
(16)	18 December 2006	Islands District Council	The Islands District Council has discussed the proposed tax reform but has not passed any related motion.
(17)	19 December 2006	Sham Shui Po District Council	The Sham Shui Po District Council welcomes the Government has followed public views and decided not to advocate GST for the remaining part of the consultation, and will continue to consult the public on the options for broadening the tax base.
(18)	21 December 2006	Eastern District Council	The Eastern District Council has discussed the issue of tax reform but has not passed any related motion.

[Note : The motions contained in this table are the translated version of the original Chinese version passed by the District Councils]

**Websites of the minutes of meetings held by the 18 District Councils
in connection with the consultation on Tax Reform**

1. Minutes of the Tai Po District Council Meeting held on 7 November 2006

[http://www.districtcouncils.gov.hk/tp_d/Document/Agenda%20&%20Min/Min%2007/Dec%2006/TPDC-M6\(7.11.2006\)\(R\).doc](http://www.districtcouncils.gov.hk/tp_d/Document/Agenda%20&%20Min/Min%2007/Dec%2006/TPDC-M6(7.11.2006)(R).doc)

2. Minutes of the Tuen Mun District Council Meeting held on 7 November 2006

http://www.districtcouncils.gov.hk/tm_d/chinese/doc/min07.11.2006.doc

3. Minutes of the Wong Tai Sin District Council Meeting held on 7 November 2006

[http://www.districtcouncils.gov.hk/wts_d/chinese/doc2004-2007/2_DC\[M19\].doc](http://www.districtcouncils.gov.hk/wts_d/chinese/doc2004-2007/2_DC[M19].doc)

4. Minutes of the Kwai Tsing District Council Meeting held on 9 November 2006

http://www.districtcouncils.gov.hk/kc_d/doc_2006/dc/dc44_mc.doc

5. Minutes of the Kwun Tong District Council Meeting held on 16 November 2006

http://www.districtcouncils.gov.hk/kt_d/Chi_minutes/DCFB/KTDC_19C.PDF

6. Minutes of the Kowloon City District Council Meeting held on 16 November 2006

http://www.districtcouncils.gov.hk/klc_d/chinese/doc/2DC_19cminF.pdf

7. Minutes of the Southern District Council Meeting held on 20 November 2006

http://www.districtcouncils.gov.hk/south_d/chinese/doc/DC/DC%20Mins%2019.pdf

8. Minutes of the Wan Chai District Council Meeting held on 21 November 2006

http://www.districtcouncils.gov.hk/wc_d/chinese/doc_2006/minutes/DC/DC-min19.doc

9. Minutes of the Central and Western District Council Meeting held on 23 November 2006

http://www.districtcouncils.gov.hk/central_d/chinese/Minutes/doc/DC/20.doc

10. Minutes of the Tsuen Wan District Council Meeting held on 28 November 2006

http://www.districtcouncils.gov.hk/tw_d/chinese/doc/minutes_19_28.11.06.doc

11. Minutes of the Sha Tin District Council Meeting held on 30 November 2006

http://www.districtcouncils.gov.hk/st_d/chinese/doc/dc_minutes_06_11.doc

12. Minutes of the Sai Kung District Council Meeting held on 5 December 2006

http://www.districtcouncils.gov.hk/sk_d/chinese/doc/Minutes/DC_0607_5_mc.doc

13. Minutes of the North District Council Meeting held on 7 December 2006

http://www.districtcouncils.gov.hk/north_d/chinese/doc/NDC06m21.doc

14. Minutes of the Yuen Long District Council Meeting held on 14 December 2006

[http://www.districtcouncils.gov.hk/yl_d/chinese/doc/DC%20\(Agenda%20&%20Minutes\)/2006/DCM6-06.doc](http://www.districtcouncils.gov.hk/yl_d/chinese/doc/DC%20(Agenda%20&%20Minutes)/2006/DCM6-06.doc)

15. Minutes of the Yau Tsim Mong District Council Meeting held on 14 December 2006

[http://www.districtcouncils.gov.hk/ytm_d/DC%20Minutes/Minutes%20of%20DC%20\(20th\)%20dd.%2014.12.2006\(12\).doc](http://www.districtcouncils.gov.hk/ytm_d/DC%20Minutes/Minutes%20of%20DC%20(20th)%20dd.%2014.12.2006(12).doc)

16. Minutes of the Islands District Council Meeting held on 18 December 2006

http://www.districtcouncils.gov.hk/island_d/doc2006/DCmin1206.doc

17. Minutes of the Sham Shui Po District Council Meeting held on 19 December 2006

[http://www.districtcouncils.gov.hk/ssp_d/chinese/doc/minutes/DC\(04-07\)/DC-M21.doc](http://www.districtcouncils.gov.hk/ssp_d/chinese/doc/minutes/DC(04-07)/DC-M21.doc)

18. Minutes of the Eastern District Council Meeting held on 21 December 2006

http://www.districtcouncils.gov.hk/east_d/chinese/doc/EDC_17th_minute_061221_c.doc