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Legislative Council
Panel on Financial Affairs

Minutes of special meeting held on
Friday, 1 March 2002 at 11:00 am
in the Chamber of the Legislative Council Building

Members present	**:**	Hon Ambrose LAU Hon-chuen, GBS, JP (Chairman) Hon Henry WU King-cheong, BBS (Deputy Chairman) Hon James TIEN Pei-chun, GBS, JP Hon LEE Cheuk-yan Hon Eric LI Ka-cheung, JP Hon NG Leung-sing, JP Hon Bernard CHAN Hon CHAN Kam-lam Hon SIN Chung-kai Dr Hon Philip WONG Yu-hong Hon Jasper TSANG Yok-sing, JP Hon Emily LAU Wai-hing, JP Hon MA Fung-kwok
Non-Panel members attending	**:**	Hon Cyd HO Sau-lan Hon LI Fung-ying, JP Hon Audrey EU Yuet-mee, SC, JP
Members absent	**:**	Hon Albert HO Chun-yan Dr Hon David LI Kwok-po, GBS, JP Hon James TO Kun-sun

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Public officers attending	**:**	Miss Denise YUE, GBS, JP Secretary for the Treasury Mr Moses CHENG Chairman of the Advisory Committee on New Broad-based Taxes Mr Tim LUI Member of the Advisory Committee on New Broad-based Taxes Mr Marshall BYRES Member of the Advisory Committee on New Broad-based Taxes Mr Michael OLESNICKY Member of the Advisory Committee on New Broad-based Taxes Mr Albert LAM Principal Assistant Secretary for the Treasury
Clerk in attendance	**:**	Ms Anita SIT Chief Assistant Secretary (1)6
Staff in attendance	**:**	Ms Pauline NG Assistant Secretary General 1 Mr WONG Tin-yau, Anthony Senior Assistant Secretary (1)8

I Report of the Advisory Committee on New Broad-based Taxes

Briefing by the Chairman of the Advisory Committee

At the Chairman's invitation, Mr Moses CHENG, the Chairman of the Advisory Committee on New Broad-based Taxes briefed members on the final report (the Report) of the Advisory Committee on New Broad-based Taxes (The Advisory Committee) to the Financial Secretary. The Report was tabled at the meeting.

2. In his presentation, Mr Moses CHENG outlined the background of the task given to the Advisory Committee, which was to consider the suitability of new types of broad-based tax for introduction into Hong Kong. Mr Moses

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CHENG also presented the Advisory Committee's deliberations and consultation in the course of carrying out its task, and the subsequent recommendations made to FS as contained in the Report. The salient points of his presentation were as follows-

(a) The Advisory Committee had been asked by FS to work under the principle of maintaining a low and simple taxation regime to preserve Hong Kong's competitiveness. The decision on whether and how to introduce new tax(es) or to raise additional revenue from existing taxes rested with FS. The Advisory Committee was nevertheless aware of the possible impacts of the introduction of new taxes on the economy and the community of Hong Kong, and the relevant analyses had been included in the Report;

(b) In the course of its work, the Advisory Committee had been mindful of the Administration's objective of ensuring fiscal sustainability in the long term;

(c) The Advisory Committee launched a public consultation on 6 August 2001 on the options for broadening the tax base. The consultation ran for two months and ended on 6 October 2001. Respondents generally agreed that Hong Kong had a narrow tax base, and that broadening the tax base while maintaining a simple and low-rate taxation regime had merits in the long term. The Advisory Committee however recognised the fact that it would be difficult to solicit full endorsement from the community on particular options of broadening the tax base, and/or increasing the tax burden of existing taxpayers;

(d) The Advisory Committee had assessed 14 revenue options against the principles of good tax systems. Apart from new taxes, the Advisory Committee had also assessed the potential for increasing the revenue productivity of Hong Kong's existing taxes to ensure that the review was comprehensive; and

(e) The Advisory Committee recommended that a Goods and Services Tax (GST) be adopted over the longer term to raise additional revenue to help solve Hong Kong's structural fiscal problem. As it took time to implement a GST, the Advisory Committee further recommended an increase in rates on tenements, a reduction in personal allowances under salaries tax and the introduction of a land and sea departure tax to help bridge the gap pending the implementation of GST. These options were broad-based revenue sources and were relatively simple to administer.

3. In his conclusion, Mr Moses CHENG said that while the work of the Advisory Committee had been completed with the submission of the Report to

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FS, there was much work to be done by FS and the Administration to address various issues related to Hong Kong's tax regime. He expressed his thanks for the professional bodies including the International Monetary Fund (IMF) and KMPG for their valued input during the course of the work of the Advisory Committee.

Discussion with members

Towards a broader-based tax system

4. Mr James TIEN noted that the terms of reference of the Advisory Committee were limited to considering different types of new broad-based taxes to increase government revenue. He pointed out that at present only 1.2 million out of 3.2 million in the workforce were required to pay salaries tax and some 80% of the salaries tax revenue was borne by the 21% highest-paid taxpayers. He asked to what extent the Advisory Committee expected that Hong Kong's tax base should be broadened and how the principle of 'fairness' as propounded in the Report should be applied in broadening Hong Kong's tax base.

5. In response, Mr Moses CHENG replied that tax equity was based on the principle of vertical equity, i.e. taxpayers were taxed in proportion to their abilities to pay. Therefore, the current distribution of tax responsibility within the community might not necessarily be inequitable. The Advisory Committee was not tasked with reviewing the principle of fairness as applied to the tax infrastructure of Hong Kong, although it had given due regard to the principle of tax equity in assessing different tax options. The issues of overall fairness of Hong Kong's tax system, and which segment(s) of the community should be taxed would be considerations for the Administration and subjects for community-wide discussions.

6. In regard to the extent to which Hong Kong's tax base should be broadened, Mr Moses CHENG said that this would depend on the economic conditions and fiscal issues that the community was and would be confronted with. The Advisory Committee was however of the view that Hong Kong should broaden its tax base given the structural economic changes taking place, the effects of globalisation on Hong Kong's competitiveness and the need to ensure fiscal sustainability under these changes. In response to a further questions from Mr James TIEN, Mr CHENG acknowledged that the Advisory Committee had not studied issues relating to Hong Kong's economic revival and revival of the property market at great length, as these issues were not within its terms of reference. Nevertheless, notwithstanding Hong Kong's economic situation, broadening Hong Kong's tax base would still be a viable and preferred direction. This was because hitherto almost half of Hong Kong's public expenditure was funded by non-tax income sources, and this had held Hong Kong susceptible to fiscal problems particularly at times of adverse economic conditions. Broadening the tax base would help maintain stability of Hong Kong's fiscal system and achieve a more robust tax system. He opined that an

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economy which based its strength on high property prices was not beneficial to the community or the business sector in the long term. In this regard, he personally felt that an administration which exercised prudent financial management should not as a matter of principle overly depend on revenue generated from the property market, or income from other non-tax sources which were vulnerable to fluctuations in external economic conditions.

7. Mr CHAN Kam-lam commented that the Advisory Committee had placed too much emphasis on the idea that Hong Kong's tax system was suffering from a narrow base and hence the need to broaden the tax base. He enquired when the "narrowness" of Hong Kong's tax bases was first identified. In response, Mr Tim LUI, member of the Advisory Committee, said that the issue of Hong Kong's tax base being narrow had already been acknowledged by tax experts and academics for a number of years, though the issue had not been a cause of concern until recently, when Hong Kong was confronted by fiscal deficits and unfavourable economic conditions.

8. Miss Emily LAU thanked the Advisory Committee for their work. She stated that the Cross-party Coalition of Legislative Council Members would not support any proposal to introduce new taxes within this fiscal year. Miss LAU noted that in assessing the narrowness or otherwise of Hong Kong's tax base, the Advisory Committee had compared Hong Kong's tax income from corporate profits tax, rates, estate duty and stamp duty with similar sources of tax income in the member countries of the Organisation for Economic Co-operation and Development (OECD) in the Asia-Pacific region. She expressed doubt on the soundness of these comparisons, and highlighted that Hong Kong's situation was somewhat unique in its concentration of wealth among a small segment of the community. She was concerned that if this characteristic of Hong Kong's economic profile was over-looked in developing proposals to broaden Hong Kong's tax base, such proposals would probably further widen the disparity between the rich and poor in the community.

9. Mr LEE Cheuk-yan commented that the Advisory Committee's recommendations for broadening the tax base would have the effect of taking away from the poor in support of the rich. According to his estimation, a GST of 3% would be equivalent to a 2% tax on the income of the 25 percentile lowest-income sector of the population. By contrast, a 3% GST would only amount to a 0.6% tax on the income to the 25 percentile highest-income sector of the population. Introduction of a GST would therefore impose a much greater financial burden on the lower-income sector than the higher-income sector of the community, which would contravene the principle of fairness, i.e. taxing in proportion to taxpayers' abilities to pay.

10. Mr LEE Cheuk-yan also expressed grave reservation on the Advisory Committee's proposal to broaden the tax base by reducing the existing levels of personal allowances under salaries tax, as this proposal simply sought to bring the lower-wage earners into the tax net. In this regard, Mr LEE sought

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information on the respective numbers of new taxpayers brought into the tax net if the personal allowances were reduced by different percentages. The Secretary for the Treasury agreed to provide the information after the meeting.

(*Post-meeting note:* The relevant information provided by the Administration was forwarded to members vide LC Paper No. CB(1)1269/01-02 dated 11 March 2002.)

11. Miss Emily LAU and Mr LEE Cheuk-yan opined that instead of pursuing tax options which would increase the financial burden of the lower-income sector, the Administration should actively consider those options which would only affect the higher-income minority, such as increasing the profits tax rate.

12. In response, Mr Moses CHENG explained that the comparison of the sources of Hong Kong's tax income (e.g. corporate profits tax, rates, estate and stamp duty) with OECD member countries in the region was aimed at assessing whether Hong Kong had a comparatively narrower tax base or otherwise. The comparison was not made with a view to identifying which additional sector(s) of the community should be brought into the tax base. Regarding the concerns of Miss LAU and Mr LEE about the impact of the Advisory Committee's proposals on the lower-income families, Mr Moses CHENG said that the Advisory Committee was aware of these concerns, although it was not tasked to deal with these concerns. He believed that the Administration would put in place appropriate measures to avoid the lower-income families being unduly affected by the proposed GST or by the reduction in personal allowances under salaries tax.

13. Mr Marshall BYRES, member of the Advisory Committee, supplemented that generally any proposal to broaden the tax base would inevitably affect the less affluent sectors of the society. This was especially true in the case of GST which applied to all people in their consumption of goods and services. There were different measures adopted by other developed tax jurisdictions to alleviate the financial burden of GST on the lower-income families. For example, in Singapore, the government granted a tax credit to compensate the lower-income families for the GST imposed.

Corporate profits tax

14. With regard to the suggestion of raising additional revenue from corporate profits tax, Mr Moses CHENG explained that one of the objectives of broadening the tax base was to distribute the tax responsibility across a wider spectrum of the society, such that the Government would not have to rely on a narrow tax base to support public expenditure. Increasing the rate of corporate profits tax to generate additional revenue would not achieve this objective since the increased tax burden would fall entirely on existing taxpayers. Mr Moses CHENG further clarified that although Hong Kong's profits tax rate was lower

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than most developed tax jurisdictions, many other tax jurisdictions had been offering tax incentives to attract foreign investments. As such, some corporations investing in these other tax jurisdictions in reality were subject to a lower profits tax rate than that in Hong Kong.

15. Mr CHAN Kam-lam noted from the Report that the Advisory Committee did not advocate a significant increase in profits tax rates. He sought clarification on the extent of increase in profits tax that the Advisory Committee would consider as acceptable. Mr CHAN also noted that the Advisory Committee did not recommend the introduction of a progressive tax rate for profits tax because it would encourage the division of existing businesses into economically less efficient smaller units for the sole purpose of having corporate profits taxed at a lower tax rate. He expressed doubt on this viewpoint, pointing out that making such a move for the sole purpose of avoiding taxation would hardly be an economical option for most large businesses.

16. Mr Tim LUI said that while Hong Kong's corporate profits tax rate was comaparatively lower by international standards, the profits tax paid by a handful of companies in Hong Kong accounted for a large proportion of tax income for the Government, and raising the corporate profits tax rate would only further increase the tax burden on these companies. Taking into account also the global trend to lower direct tax rates, the Advisory Committee therefore did not recommend a significant increase in the corporate profits tax rate, lest Hong Kong's international competitiveness would be seriously undermined. As regards the effectiveness of introducing progressive tax rates for profits tax, Mr LUI said that in some other tax jurisdictions practising progressive tax rates for profits tax, quite a significant number of large commercial conglomerates had in fact been operating their businesses under smaller subsidiary companies, and one of the purposes of this arrangement was to reduce their profits tax liabilities.

Goods and Services Tax (GST)

17. Miss Cyd HO shared the views of Mr LEE Cheuk-yan that the recommendations of the Advisory Committee tended to target at the lower-income sector of the community to raise tax revenue. She stressed that the possible adverse impact on lower-income families should be seriously addressed should a GST be introduced. In this regard, she suggested that the Government should define the minimum income level or standard of living such that those who fell below such a minimum level should be given some form of compensation or subsidy in respect of the GST levied.

18. Mr SIN Chung-kai said that some tax jurisdictions had built into the design of their Goods and Services Tax (GST) systems certain features such as providing exemptions for daily necessity items and granting rebates for certain sectors of the community to alleviate the financial burden that might be created by the imposition of a GST. He asked if the Advisory Committee had considered similar measures in drawing up its proposal for introducing a GST in

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Hong Kong.

19. Mr Moses CHENG replied that the Advisory Committee had been aware of the concern about the possible adverse impact on the quality of life of low-income families if a GST was introduced in Hong Kong, and had therefore recommended that some form of compensation arrangements should be made such that the adverse impact would be minimised. In regard to actual details and design features of the proposed GST, Mr CHENG considered that the Administration should draw reference from the experience of other tax jurisdictions and take account of Hong Kong's particular situation in order to ascertain how the proposed GST could be best practised in Hong Kong. Mr CHENG remarked that implementation of the proposed GST was a complex issue and required careful planning. The Government should bear in mind that attempts to contain the impact of GST through measures such as exemptions or rebates should not unduly complicate the tax system or require substantial administrative and compliance costs.

20. Highlighting that the economy of some other tax jurisdictions had suffered as a result of the implementation of general consumption tax, Mr CHAN Kam-lam enquired if the Advisory Committee had assessed the impact of introducing a GST on the local economy, in particular the impact on the retail market. In response, Mr Tim LUI said that the extent of the impact on the economy depended on the prevailing economic climate, the GST rate and the reaction of businesses and consumers to the GST. The experience of other tax jurisdictions was that implementation of a GST tended to impact adversely on the economy in the short term. In general, a lower GST rate would be easier for the economy to absorb and help minimize the short-term negative economic effects. He informed Members that the Advisory Committee had made some recommendations on the design of a GST system in Hong Kong and the details were set out in Annex F of the Report.

21. Mr Eric LI expressed appreciation that the Advisory Committee was given a very difficult task, since most people would not welcome the introduction of new taxes. He pointed out that "goods and services tax" was a generic name, and the GST practised in different countries could vary significantly in design. He suggested that the Advisory Committee or the Administration should explain in greater detail the basic design and key features of the GST proposed for introduction in Hong Kong to obviate unwarranted controversies, which might hinder the implementation of the new tax in Hong Kong.

22. In response, Mr Marshall BYRES, member of the Advisory Committee, said that having perused the "IMF's Report on a Goods and Services Tax for Hong Kong" (Annex G to the Report), he personally felt that it was worth drawing reference from the GST systems currently practised in Australia, Canada, New Zealand and Singapore in developing a GST system in Hong Kong, bearing in mind that the design of the GST system should be kept simple in order to be efficient. He agreed with Mr Eric LI that the impact of the proposed GST could

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be cushioned if the community could be better informed of the rationale and mechanics of the GST system by effective educational programmes. Indeed, keeping the tax design simple would also contribute towards more effective public education. Mr BYRES further said that to cater for the necessary administrative preparatory work, it would take about three years from the time a decision was taken to introduce a GST to the actual implementation of the tax. Thus, there would be adequate lead-time to thoroughly review the design of the proposed GST and for launching the related public education programmes.

23. Regarding the estimated revenue yield of a GST in Hong Kong, Mr Marshall BYRES advised that assuming that some 50% of the GDP of Hong Kong, which was $1.2 trillion in 2000-01, was subject to GST, it was estimated that a GST would yield some $6 billion annually for each single percentage point. Thus, if a 3% GST was implemented, the estimated annual revenue yield was around $18 billion. He however remarked that exemptions and rebates built into the GST system would reduce the revenue yield.

24. In response to Mr NG Leung-sing's enquiry about the appropriate timing for introducing GST in Hong Kong, Mr Marshall BYRES said that the Advisory Committee had not reviewed at length when would be the best time for the introduction of GST in Hong Kong. There were diverse schools of thought on this subject. In consideration that a broader-based tax regime would help maintain the stability of Hong Kong's economy and fiscal system, the Advisory Committee recommended that a policy decision to implement GST or not should be taken as soon as possible.

25. Mr NG Leung-sing asked if the Advisory Committee had considered the option of introducing a wholesale tax prior to the actual implementation of a GST in Hong Kong. In response, Mr BYRES advised that wholesale tax was one type of single-stage sales taxes and single-stage sales taxes had now been replaced by GST in most developed jurisdictions such as the United Kingdom and Australia. Both the IMF and the Advisory Committee considered that it would be better for Hong Kong to go straight to the implementation of GST.

Comparison with other tax regimes

26. Mr Henry WU noted that in the Tax Base Study commissioned by the Advisory Committee, apart from the OECD countries, Singapore had been selected for comparative analyses of Hong Kong's taxation system. He considered that the inclusion of Singapore for the comparative analyses was appropriate as Singapore was a competitor of Hong Kong in many ways, and the two jurisdictions also bore many similarities such as the lack of natural resources. He sought the views of the Advisory Committee on whether Singapore had a robust and efficient tax regime and whether the introduction of GST in Hong Kong would undermine Hong Kong's competitiveness against Singapore.

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27. Mr Michael OLESNICKY, member of the Advisory Committee said that the selection of countries for the comparative analyses in the Tax Base Study was based on the views of academics, tax experts and the Advisory Committee. He acknowledged that Singapore had considered Hong Kong to be its competitor and vice versa, as the economies of both jurisdictions had a number of common features. However, the differences between the two jurisdictions were also crucial for the analyses. For example, while Singapore had *prima facie* a higher corporate profits tax rate than Hong Kong, the Singaporean government however had proactively induced foreign investment by granting tax concessions or even exemptions for foreign investments in Singapore, allowing much room for foreign companies to negotiate with the government in this regard. The strength of Singapore's economy, to some extent, relied on such government initiatives to attract capital in-flow. On the other hand, tax experts and academics had commented that the strength and robustness of Hong Kong's economy depended very much on maintaining a low-rate and simple tax regime. If tax incentives similar to those offered in Singapore were introduced in Hong Kong, they would complicate the tax system and undermine Hong Kong's competitiveness. Mr OLESNICKY further said that Hong Kong was unique in not having a GST, as compared to other tax jurisdictions in the Asia Pacific region. He therefore did not think that the proposed GST of 3% would undermine Hong Kong's competitiveness in the region.

28. Mr Henry WU noted in the Tax Base Study that in comparison with other jurisdictions, Hong Kong had the lowest percentage (about 35%) of actual taxpayers relative to the number of persons potentially chargeable. This was much lower than Singapore, which displayed a percentage of close to 70%. He sought the Advisory Committee's view on the extent to which the personal allowances under salaries tax in Hong Kong should be reduced so that the tax responsibility could be shouldered by a higher percentage of potentially chargeable taxpayers.

29. In reply, Mr Michael OLESNICKY said that reducing the personal allowances under salaries tax would broaden the tax base. However, the new taxpayers brought into the tax pool would only contribute a small percentage of the additional revenue yield, as the balance of the additional revenue yield would come from existing taxpayers. He therefore considered that although reducing personal allowances under salaries tax would generate additional revenue, this would not be a very effective measure in broadening the tax-base. Mr OLESNICKY further commented that it would be difficult to identify or develop a tax system that would be perfect. The Advisory Committee had recommended the introduction of a GST as this new tax had the long-term capacity to broaden the tax base and was not incompatible with Hong Kong's external competitiveness.

30. Mr NG Leung-sing noted that according to the Advisory Committee's Report, the taxes from specific goods such as cigarettes, alcohol and hydrocarbon fuels generated less than 6% of total tax revenue in Hong Kong, as against 16%

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in other Asia Pacific countries on average. He asked if the Advisory Committee considered that the tax revenue from specific goods should be increased in Hong Kong.

31. Mr Marshall BYRES said that a direct comparison of the percentage of tax revenue from specific goods between Hong Kong and other countries in the Asia Pacific Region might be somewhat distorted, as other tax jurisdictions in the region also levied general consumption tax over a broad range of goods and services, and that the tax revenue from this source also contributed a significant percentage of tax revenue in those jurisdictions. The Advisory Committee had not recommended that the tax revenue generated from specific goods in Hong Kong should be increased. Instead, if a general consumption tax was implemented, the Administration might have the option to reduce, rather than increase, the current taxes chargeable on specific goods. He highlighted, however, that taxes on specific goods involved other issues, such as moral considerations, apart from the basic principles of a good tax system design.

Other concerns

32. In response to Miss Cyd HO's enquiry on why the Advisory Committee had not examined the introduction of soccer betting duty, Mr Tim LUI said that the Advisory Committee was of the view that whether this tax option could be regarded as a broad-based tax was questionable. Coupled with the fact that there was insufficient information on this tax item, the Advisory Committee therefore had not included this tax item for detailed examination.

33. In response to Miss Emily LAU, Mr Moses CHENG confirmed that the Advisory Committee had not made any such last-minute additions to the Report. He clarified that in the Advisory Committee's Consultation Document issued in August 2001, increasing rates charged on tenements was not included as a revenue option. However, during the public consultation, this option was put to the Advisory Committee on the grounds that rates, being a broad-based tax, might be used to enhance revenue productivity as a short-term measure. The Advisory Committee had therefore evaluated this tax option in the current Report.

34. Miss Emily LAU suggested that as the Advisory Committee had completed its task and presented its Report to FS, the Panel should arrange follow-up sessions to discuss the issues arising from the Report, and it might be preferable to invite academics and various related bodies to join the discussion as the issue of new taxes posed far-reaching implications for the whole community. She also requested the Secretariat to explore more detailed information on exemptions and compensation arrangements in respect of GST and the practices of progressive rates for profits tax etc. in other tax jurisdictions as raised at this meeting to facilitate further discussion.

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35. The Assistant Secretary General 1 responded that she would discuss Miss LAU's request with the Research and Library Services Division (RLSD) of the Secretariat to explore if such information was available, and would present the available information to the Panel in an appropriate format to facilitate further discussion.

36. The Chairman suggested that since the Report had just been published, members would need more time to peruse its content. In the meantime, the Secretariat would collect further relevant information as requested by Miss Emily LAU for the Panel. Follow-up sessions to further discuss the subject of new broad-based taxes for Hong Kong would be arranged, if required, in due course.

37. The Chairman thanked the Administration and the Advisory Committee for attending the meeting.

II Any other business

38. There being no other business, the meeting ended at 12:55 pm.

Legislative Council Secretariat
29 April 2002