<u>LC Paper No. CB(1)2319/05-06(02)</u>

<u>Reply</u>

LegCo Panel on Financial Affairs
Special meeting on 18 July 2006

List of follow-up actions to be taken by the Administration

1. <u>General views and concern</u>

(a) While Members in general have no objection to the Administration's initiative to examine how the tax base could be broadened, some Members oppose to the introduction of a Goods and Services Tax (GST) and some query whether GST is the appropriate option for Hong Kong.

Response: We consider that GST is an appropriate option for broadening Hong Kong's tax base because, according to the experience of those jurisdictions which have implemented GST, this tax:

(i) can help to provide a much more stable source of public revenue in comparison with other sources of revenue; and

(ii) provides room for reducing existing direct taxes such as Salaries Tax and Profits Tax, and thus would help to maintain Hong Kong's international competitiveness.

Over the past years, the Administration has considered a wide range of options to broaden the tax base. As an example, the Advisory Committee on New Broad-based Taxes (the Advisory Committee) has considered as many as 14 options, including introducing capital gains tax, tax on dividends, tax on worldwide income of businesses and individuals as well as reduction of personal allowances under salaries tax. The Advisory Committee recommended that GST would be the best option for broadening the tax base, because "GST is the only new tax with the long-term capacity to broaden the tax base which is not incompatible with Hong Kong's external competitiveness."

(b) Introduction of GST to broaden the tax base is a move in the wrong direction, as this will radically alter the renowned simple taxation system and the low tax rate of Hong Kong, which will in turn undermine the competitiveness of Hong Kong.

Response: The proposed GST for Hong Kong would have a low tax rate, a broad based tax net with few exemptions or special concessions and a high registration threshold in order to make it consistent with our present business-friendly low and simple tax system.

(c) Overseas experience (e.g. Singapore and Japan) show that the introduction of GST has brought about strong blow to the local economy.

Response: In developing the proposed GST framework as stated in the Consultation Document, the Government made reference to the experiences of Singapore and Japan, as well as Australia, Canada and New Zealand. The allegation that the introduction of GST brought a "strong blow" to the economies of either Singapore or Japan is not consistent with facts since in the year of GST's introduction, their economies in fact grew by 11.6% (1994) and 5.3% (1989) respectively.

(d) While the Corporate Profits Tax Rates in a number of jurisdictions have been reduced (Chart 5 of the presentation material provided by the Administration), it should be noted that the reduction from about 35% in 2000 to about 25% in 2005 in the European Union was achieved by a high GST rate of 17.5%. As regards Ireland, the reduction from 24% in 2000 to 12.5% in 2005 was not caused by the introduction of GST.

Response: Chapter 1 of the Consultation Document discusses the challenges facing our present tax system. One of those important issues is the heightened threat of tax competition from other jurisdictions for lowering their corporate profits tax rates, regardless of whether the reductions of such taxes in those jurisdictions were associated with the introduction of GST. Table 1 in the Consultation Document is illustrating this point by highlighting this global tax development.

(e) The Administration’s proposed compensation packages for different household groups, together with the options for utilizing the additional revenue from GST to increase public expenditure in areas like education, health and social welfare, may attract diverse views from different sectors of the community, thus having a divisive effect for the community as a whole.

Response: The proposal to offer compensation packages and to increase public expenditure on major policy areas is to demonstrate Government’s commitment that the purpose of introducing GST is not to raise additional revenue, but to broaden the tax base so as to improve the health of our fiscal system. The options provided in the Consultation Document are not meant to be conclusive but are drawn up as the basis for stimulating rational and informed discussion on the subject. We welcome the community’s views on what their preferred options are. We believe that this is an important part of our consultation exercise so that we can reflect the community’s views to the Government of the next term to decide how to take the matter forward.

(f) The Administration’s claim that the introduction of GST is “revenue neutral”, together with its proposed offsetting measures such as tax reduction and GST credits, are just publicity gimmicks for soliciting public acceptance of GST.

Response: With strong economic growth, moderate inflation and a low unemployment rate, there is no immediate need for us to generate additional tax revenue. The primary objective of this public consultation is to find out the best solution for broadening the tax base through tax reform. Therefore, we could consider a revenue-neutral approach, at least for the first five years, to return to the community the remaining revenue so generated from GST after deducting administrative costs. In fact, undertaking tax reform in a revenue-neutral manner can minimise its impact on the economy. Australia has successfully adopted this model in introducing GST.

The Government has proposed a series of measures to offset the likely impact of GST on low-income households. Overseas experience is that a relief or compensation package is usually introduced upon the *launch of a GST to compensate those affected for the impact of the tax on their livelihood.*

(g) The introduction of GST may affect the consumption ability and quality of life of the retired citizens, and may not help resolve the problem of an ageing population. The Administration should consider providing retirement protection to address the problem of an ageing population instead of introducing GST.

Response: With respect to addressing the ageing of the population, a GST would provide a more stable tax base, which could better stabilise revenue with an ageing population that will erode the Salaries Tax base. The Government recognises that while GST can help stabilise revenue, it is not a cure to the problems of an ageing population which can best be dealt with through social, medical and health measures.

(h) Whether the Administration has in mind a benchmark level of public acceptance/objection against which it will decide whether GST should be introduced in Hong Kong? If so, what is the benchmark level?

Response: The Government will listen to the views of the community very carefully before making a recommendation to the Government of the next term as to whether Hong Kong should pursue tax reform with GST.

2. <u>Proposed GST framework</u>

(a) While the proposed GST rate is low by international standards in the initial launch, the Government may increase the rate after its introduction, as in some other jurisdictions.

Response: The Government has stated that it would not change the GST rate for a period of at least five years after its introduction. Overseas jurisdictions have mixed experiences with respect to their GST rates. The most recent rate change was in Canada where the GST rate was reduced from 7% to 6% on 1 July 2006. In Hong Kong, if GST were introduced, we envisage that any adjustment of its rate would require the approval of the Legislative Council. It is also relevant to note the budgetary *principles enshrined in the Basic Law. In managing public finances, the Government must comply with Article 107 of the Basic Law which stipulates that "The HKSAR shall follow the principle of keeping expenditures within the limits of revenues in drawing up its budget, and strive to achieve a fiscal balance, avoid deficits and keep the budget commensurate with the growth rate of its gross domestic product."*

(b) The proposed high registration threshold of $5 million annual turnover, whilst excluding most small and medium-sized enterprises (SMEs) from GST collection, may be unfair to large-sized enterprises, such as the chain stores. This may be a disincentive for business operation in the form of large-sized chain stores.

Response: GST is a consumption tax, it is to be borne by final consumers. Businesses which have registered for GST would be allowed to claim back their GST paid on purchases whereas those which have not registered could not. Indeed, many SMEs may find it in their interests to register voluntarily.

We understand that registered businesses would have to incur additional costs for GST compliance but, according to international experience, the increase in cost would be marginal if the GST is broad-based and with few exemptions. The experience from Singapore is that, with a tax base similar to that proposed for Hong Kong, compliance cost for businesses, based on a survey done in 1996, an average of S$1,000 a year per registrant.

3. Impact on the problem of disparity between the rich and the poor

(a) Given that Hong Kong already ranks high in the Asian region and among the developed economies in the problem of disparity between the rich and the poor, the impact of GST in this respect should be carefully assessed. In this connection, the Administration is requested to provide information on overseas jurisdictions in this regard.

Response: According to the information released by the government of

Australia and Canada, with introducing a GST in conjunction with a compensation package, GST does not lead to worsening of living standards for the vast bulk of the population.

Australia is the most recent developed economy to introduce a GST in year 2000. At the time of introduction the Government proposed a compensation and tax offsets package to ameliorate the impact of GST on household livelihoods. According to a study conducted by the Australian Treasury[1] *to assess the impact about one year after the GST commenced, using Australian Bureau of Statistics Survey of Income and Housing Costs unit record data, all groups of household were found to have greater real disposable income. The study made particular mention of the fact that working families in the lower-income households experienced greater proportional increases in their disposable incomes than those in the highest income households.*

Canada implemented its GST back in 1991. The nature of compensation and offsets for households in Canada took two major forms. First, tax brackets and government allowances are indexed automatically for CPI movements, hence ensuring they remain the same in real terms after any GST inflationary effect. Second, a refundable GST credit was used aimed especially at low to middle income households and those with children, such that according to the Federal Government all families with annual income below C$30,000 were expected to be effectively better off (i.e. paying less federal tax - income and indirect tax - than before the changes).

(b) Taxing the large number of low-income households which do not meet the threshold for Salaries Tax through the introduction of GST will only widen the gap between the rich and the poor.

Response: Introduction of the proposed GST accompanied by a package of tax relief and offset measures will not adversely affect the quality of life of low-income people while some high-income people may have to pay more tax.

---

[1] Economic Roundup, Autumn 2003

The Government has proposed a series of measures to offset the likely impact of GST on low-income households. Our target is to ensure that the quality of life of low-income households will not be adversely affected by GST.

Also, with a broader tax base brought about by GST, the Government would have a more stable stream of revenues, thereby providing more room for improving the delivery of public services further to assist those who are in genuine need.

(c) GST, which is a regressive tax making the low-income households to pay tax of a higher percentage of income compared with the high-income households, is in a way "robbing the poor to help the rich". This regressive tax is inconsistent with the taxation principles of "higher earnings, higher payment" and "fair redistribution of income". GST is not suitable for Hong Kong given the special income structure in Hong Kong (with the high-income households earning over ten times of the low-income households), which is unlike other jurisdictions with more even distribution of income.

Response: The proposed GST is based on consumption. The more money one spends, the more tax one has to pay. As such, this tax is in line with the principle of affordability. Moreover, the proposed GST introduction would be accompanied by a package of tax relief and offset measures which would mitigate the price impact of the tax on the community, particularly the low-income households. The Government is committed to compensate in full the Comprehensive Social Security Assistance (CSSA) households and households that are not in receipt of CSSA, but with income at commensurate levels, for the GST impact on their cost of living.

4. <u>Households: impacts and offsets</u>

(a) GST as a tax on consumption will include the whole population within the tax net and cause hardship to Comprehensive Social Security Assistance (CSSA) households and low-income households. The adverse impact could hardly be alleviated through the proposed compensation measures.

Response: The proposed GST introduction would be accompanied by a package of tax relief and offset measures which would mitigate the price impact of the tax on the community, particularly the low-income households. The package proposed in the consultation document was designed to offset in full any impact of GST on low-income households, including Comprehensive Social Security Assistance (CSSA) households and households that are not in receipt of CSSA. We welcome comments and suggestions on the proposed relief measures.

(b) The well-being of the middle class households will also be greatly affected by GST as only limited offsetting measures will apply to them and their burden of expenses on areas such as health and education may not be relieved given that the Administration has not made any commitment to increase the expenditure on these areas upon the introduction of GST.

Response: The Government has proposed measures to alleviate the price impact of the GST on all households, i.e., a GST credit of $500 for water and sewage charges and a GST credit of $3,000 for Rates. Moreover, the Government would return to the community the remaining balance of funds generated from the proposed GST after meeting all administrative costs and the costs of providing the proposed compensation and offset measures. We welcome views on the preferred options as to how the revenue generated from the proposed GST should be returned to, and benefit, the community.

(c) The Administration is requested to provide further information on the proposed compensation measures for households, as follows:

(i) Methods for computation of the one-off supplement to be provided to CSSA households;

Response: Cash supplements would be provided to CSSA households on the basis of the estimated and real GST impact on them were GST to be introduced. They would be fully compensated for any loss of purchasing power due to introduction of GST.

(ii) Definition of non-CSSA low-income households; and

Response: For the purposes of this consultation exercise, we assume that non-CSSA low-income households would be those households not drawing CSSA, but with income within the lowest 20% income group households in Hong Kong.

(iii) Whether any other offsetting measures will be provided for households which do not have to pay Rates and therefore will not be able to use the $3,000 annual GST credit for the payment of Rates.

Response: Assuming a 5% GST rate is set, the cost of living of a non-CSSA low-income household (with a monthly expenditure below $8,000) might increase by approximately $3,144 a year. The Government realizes that some low-income households, however, pay water and sewage charges of less than $500 a year[2]*, while many lower-income households in private and public housing pay Rates of less than $3,000 a year. Therefore, to ensure lower-income households receive compensation that could at least make up for the impacts of GST, the Government has proposed to make available to such households a special "GST allowance" in cash direct. Currently, we propose to set the annual GST allowance at $2,000 per household.*

(d) The proposed compensation measures for the three household groups based on household income may not be fair as they fail to cater for differences in household size (e.g. the difference in consumption between households with two members and four members).

Response: The proposed relief measures are based on household units instead of household size in order to simplify the application and approval procedures and therefore enhance operational efficiency and minimize administrative cost. We welcome views and suggestions on these proposed measures.

---

[2] *Based on 2006 actual water and sewage charges, around 15% of households using these services were not charged.*

(e) The Administration is requested to provide figures to illustrate in detail the impact of GST on different income groups, including information on the amount of additional expenses and/or savings for these groups taking into account the cost of GST and the savings from various proposed compensation measures.

Response: To assist in understanding the impacts of an assumed 5% GST rate on household spending, examples of the impact of the GST on spending of different households are included in the Consultation Document at examples 1, 2 and 3 after paragraph 152. In sum, increased cost of living per month due to GST will be $262 for non-CSSA low-income household, $507 for middle-income household and $1,053 for high-income household. Until the allocation of the remaining $20 billion of funds is determined it is not possible to calculate the total value of offsets or tax relief to different households. We welcome your views on how these funds should be allocated.

5. <u>Various industries and sectors: impacts and offsets</u>

(a) Despite that tourists will be able to claim a GST refund under the proposed "Tourist Refund Scheme", the procedures involved for the claim may have adverse impacts on the city's reputation as a "duty-free shoppers' paradise" and the tourist industry. The GST may also discourage tourists from spending in Hong Kong, thus affecting the retail and service industry and creating unemployment.

Response: We appreciate that the TRS would be an important element of our proposed GST framework for Hong Kong. In this respect, we seek input on how to ensure the proposed TRS (as outlined in paragraphs 98 to 106 of the Consultation Document) could be made appropriate for our circumstances.

In terms of the impact on the tourists' spending, it is expected to be only one-off as the price of consumer goods would increase marginally following the introduction of GST. Moreover, tourists would be able to take advantage of the TRS to claim a refund of GST for goods purchased in

Hong Kong, hence experiencing no GST price rise. The proposed abolition of Hotel Accommodation Tax would also reduce the effects of GST on the tourism and hospitality industries. In addition, the proposed Profits Tax relief and adjustments to some of the indirect taxes, such as the excise duties on liquor, petrol, diesel and aircraft fuel would help reduce some of the operating costs of these businesses and, to some extent, enhance their competitiveness. We would therefore not expect the impact of GST introduction on these industries to be significant.

(b) With the introduction of GST, Hong Kong residents may choose to purchase goods and services across the border more frequently. The Administration should assess the impact of GST on the consumption habit/pattern of Hong Kong residents across the border and the resulting impact on the local retail and service industry.

Response: Though the imposition of GST would be expected to push up the retail prices of most expenditure items, it would be a one-off increase and be expected to dissipate quickly. Assuming a GST rate of 5%, our modelling reveals that the Composite Consumer Price Index (CCPI) would be expected to rise by only around 3% immediately after GST introduction.

While it is possible that the implementation of the GST might, on the margins, induce some Hong Kong residents (particularly those living in northern part of New Territories) to do more shopping in the Mainland, the overall impact is unlikely to be significant. Given the relatively slight increase in local prices, and particularly when weighted against the time and transport costs involved in travelling across the boundary to make more purchases, it is unlikely that in overall terms the implementation of the GST would affect the business volume of the local retail trade in any significant way.

In the context of the GST impact, the consumption expenditure of Hong Kong residents in Shenzhen would be the most relevant. Given the much higher time and transport costs involved in travelling to other parts of the Mainland, the incentive of Hong Kong residents to travel to places other than Shenzhen specifically for purchasing daily necessities and the like due to the implementation of GST in Hong Kong is low.

According to a survey conducted by the C&SD in 2005, the total consumption expenditure in respect of personal travel in non-package tour mode to Shenzhen by Hong Kong residents was about $6.6 billion[3], which was equivalent to about 0.8% of the total consumption expenditure by Hong Kong residents[4] in that year. In addition, Hong Kong residents when travelling in Shenzhen, spent most of their money on meals, entertainment and other services rather than shopping. In fact, shopping accounted for only around 15-20% of Hong Kong residents' spending in Shenzhen.

(c) Given the close economic ties between Hong Kong and the Pan Pearl River Delta Region, the import/export trade and logistics sector are important to the development of the local economy. As such, the Administration should examine in detail the impact of GST on the import/export trade and logistics sector and be mindful that the possible adverse impact may out-weight the benefits of broadening the tax base.

Response: For the sake of facilitating trade and maintaining the competitiveness of Hong Kong, the Government has proposed that exports of goods and international supplies be zero rated under the proposed GST framework. To this extent, there would be no GST cost on these goods or services and the competitiveness of these trades should therefore not be affected. Indeed, in considering the definition of international supplies, we have deliberately proposed a generous definition so as to include for zero rating as many ancillary and supporting services related to exports as possible. In addition, the proposed schemes and facilities such as Deferred GST Payment Scheme, provision of Bonded Warehouses and implementation of a Qualifying Exporters Scheme would be expected to be helpful to importers in relieving possible cashflow concerns.

It is acknowledged that, under the proposed GST regime, importers and exporters would have to follow additional requirements such as lodgement of goods declarations. We propose that, apart from a reduction in declaration charges, importers and exporters would be

---

[3] *Figures from Hong Kong Monthly Digest of Statistics May 2006*

[4] *Total consumption expenditure by Hong Kong residents refers to the total consumption expenditure of Hong Kong residents in the domestic market, overseas and the Mainland of China. The figure is about $828 billion in 2005.*

allowed to lodge goods and trade declarations simultaneously to reduce their workload.

In this context, we will work closely with the trade and relevant business chambers with a view to understanding their concerns and, if appropriate, developing further trade facilitation measures to minimise any negative impact of the proposed GST.

(d) Whether and what measures will be put in place by the Administration to assist SMEs in coping with the additional resources required for the collection of GST and in tiding over the difficulties of cost increase to maintain their competitiveness?

Response: We would propose to offer set-up assistance to help businesses meet compliance costs associated with GST introduction. Our intention would be to provide this one-off assistance to small and medium-sized businesses and other organisations that voluntarily register for GST. The assistance might take the form of a subsidy for the purchase of GST-related IT equipment and software. We propose to set aside $200 million for this purpose. Furthermore, the proposed Profits Tax reduction would benefit these businesses.

October 2006