

LEGISLATIVE COUNCIL BRIEF

Public Consultation on Tax Reform Interim Report

INTRODUCTION

The purpose of this brief is to report to Members on the interim review of the tax reform public consultation.

BACKGROUND

2. In July 2006, we launched a public consultation on how we should reform our tax system. In the Consultation Document, we explain in detail why we need to broaden the tax base, the flaws and weaknesses of our existing tax base, and the various challenges that we are facing. In addition, the document seeks to consult the public on whether the introduction of a Goods and Services Tax (GST) is an appropriate option to broaden the tax base and proposes various tax relief and compensation measures to offset the likely impacts of GST on the economy and low-income households.

3. Since this issue has far-reaching implications for the community, we have allowed a nine-month consultation period to run from mid July 2006 to 31 March 2007, so that the public can have sufficient time to express their views. Now that the consultation has run half its course, we consider that it is an appropriate time to conduct an interim review of the public's views in order to determine the focus of consultation for the remaining part of the exercise.

4. The Interim Report of Public Consultation on Tax Reform (the report) is at Annex. The executive summary of the report has provided an overview of the public opinions collected and the focus for the remaining part of our consultation exercise. Members are requested to refer to the report for details.

ENQUIRY

5. 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
5 December 2006

Public Consultation on Tax Reform

Interim Report

December 2006

Financial Services and the Treasury Bureau

The Government of the Hong Kong Special Administrative Region

Executive Summary

Since the launch of the tax reform consultation exercise, we have participated in over 260 meetings and seminars to listen directly to views from different sectors of the community. We have so far received about 2 200 written submissions from the public. In addition, we have conducted regular opinion surveys on whether we should broaden the tax base and introduce a Goods and Services Tax (GST). Different community organisations have also conducted opinion surveys on the tax reform proposals.

Now that the nine-month consultation period has run half its course, we consider that it is an appropriate time to conduct an interim review of the public's views.

Over the past few months, through a variety of methods, we have discussed with the community the problems of our public finances and narrow tax base, as well as our tax reform proposals. The public generally has gained a better understanding of the problems of our narrow tax base. They understand that the current tax system is over-reliant on limited types of tax and a small number of taxpayers, thus rendering government revenue highly susceptible to the ups and downs of the economic cycle. The public is also aware that rapid ageing of our population and the effects of globalisation pose challenges to Hong Kong that will affect our economy and public finances. They agree that we should not ignore these problems nor avoid discussing them. They share the view that the Government should stabilise its revenue by broadening the tax base so as to enhance our fiscal health and competitiveness. They also support the position that the Government should discuss the

issues with the community and listen to their views on the various ways of broadening the tax base.

As to whether GST is an appropriate option, we have explained in the Consultation Document that this tax could 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. During consultation, the community has expressed concern over this tax on a number of issues, including whether GST would complicate our tax system, widen the wealth gap and adversely affect our economy.

To maintain a simple tax system, we have proposed a single tax rate with few exemptions, as well as a high registration threshold. We have also pointed out that, according to overseas experience such as in Singapore, which has a GST framework similar to the one we have proposed, GST would not complicate the tax system nor would the administrative and compliance costs be high.

As regards the impact on the wealth gap, we have proposed a package of relief and compensation measures, such as cash allowances and GST credits on Rates and water and sewage charges so as to ensure that low-income households will not be affected. We have stated that these proposals are just a starting point to facilitate discussion and we welcome views from the public on these measures in order to ensure that the livelihood of low-income households would not be affected. Moreover, in our plan, part of the revenue raised by GST could be used to provide services to disadvantaged groups.

On the issue of economic impact, we have provided a considerable amount of data and information, including overseas experience, to demonstrate that introduction of GST has only a minimal and short-term impact on the economy and, in the long term, would enhance our competitiveness.

Despite our having given explanations to the community on various occasions in order to address their concerns, we are still unable to remove their worries. Having regard to views collected through the different channels, it is clear that the public is strongly against GST. We consider that at this point in time there is insufficient public support nor are the conditions right for the introduction of GST.

In contrast, the community generally agrees that the Government should continue public consultation on how to broaden the tax base. We hope that the public will continue to provide their views on other viable options. The Government will listen carefully and participate in the discussion, so that we can come up with a conclusion for the Government of the next term to consider when the consultation exercise ends in March next year.

(I) Introduction

1. In July 2006, we launched a public consultation on how we should reform our tax system. In the Consultation Document, we have explained in detail why we need to broaden the tax base, the flaws and weaknesses of our existing tax base, and the various challenges that we are facing. In addition, the document seeks to consult the public on whether the introduction of a Goods and Services Tax (GST) is an appropriate option to broaden the tax base and proposes various tax relief and compensation measures to offset the likely impacts of GST on the economy and low-income households.

2. Since this issue has far-reaching implications for the community, we have allowed a nine-month consultation period to run from mid July 2006 to 31 March 2007, so that the public can have sufficient time to express their views. Now that the consultation has run half its course, we consider that it is an appropriate time to conduct an interim review of the public's views in order to determine the focus of consultation for the remaining part of the exercise.

(II) Public Views

3. Since the launch of the tax reform consultation exercise, we have participated in over 260 meetings and seminars and attended meetings of the Legislative Council (LegCo) and 11 District Councils to discuss the tax reform proposals with Councillors and the community and to listen to their views on these proposals.

4. Up to 30 November 2006, we had received about 2 200 written submissions from the public. In addition, we have commissioned an independent organisation to conduct regular opinion surveys. At the same time, different community organisations have also carried out opinion surveys on the tax reform proposals and provided their views to the Government.

5. Since this is an important and complex issue, we need different sectors of the community to participate in the discussion. We are grateful to the public and various organisations for contributing their views over the past five months. We also appreciate that a number of organisations have arranged various kinds of activities, such as briefings, seminars and opinion surveys to stimulate public discussion and assist the Government to hear their views more clearly on tax reform and broadening the tax base.

6. We have conducted an analysis of the views collected from the above-mentioned channels. Our observations are summarised below.

Is there a need for tax reform and broadening of the tax base?

7. The majority of the public agrees that the current tax base is too narrow and that there is a need to explore ways to broaden it. Most of the 11 District Councils that have already discussed the tax reform proposals support the Government's conduct of the study and public consultation on how to broaden the tax base. Our opinion surveys have also indicated that around 60% of the public consider that the current tax

base is too narrow and over half support reform of the tax system and broadening of the tax base. Opinion surveys conducted by various organisations have come up with similar results.

8. Of those who are supportive of broadening the tax base, the major views are summarised below:

- (a) the current tax system is over-reliant on limited types of tax and a small number of taxpayers;
- (b) the majority of the Government's tax and non-tax revenue is closely related to the property market and so government revenue is very susceptible to property market fluctuations;
- (c) Hong Kong is an externally-oriented economy which is vulnerable to outside economic conditions. The limited types of tax that we rely on are also susceptible to economic ups and downs. Hence, even though our economy has now recovered, we have to plan and save for a rainy day;
- (d) the rapid ageing of our population will result in increasing pressure on government expenditure and will further shrink our tax base; and
- (e) due to our narrow tax base, it is difficult for us to lower the rates of our direct taxes in order to maintain competitiveness in the face of challenges posed by

globalisation.

9. Of those who do not consider that there is a need to broaden the tax base, the major views can be summarised as follows:

- (a) if indirect taxes are taken into account, we already have a large number of taxpayers and hence our tax base is not narrow;
- (b) we have already achieved fiscal balance, so there is no imminent need to broaden the tax base;
- (c) we already have very strong fiscal reserves. Moreover, the Government can increase the investment return from the Exchange Fund and change the method of sharing the investment income in order to increase government revenue; and
- (d) the Government should reduce its expenditure further before considering ways to increase revenue.

10. During consultation, we have provided a considerable amount of information and data to the public to explain why there is a need to broaden the tax base. As globalisation intensifies, we need a broad tax base to generate stable streams of revenue and give us room to lower the rates of direct taxes to enhance our competitiveness and attract foreign investment and talent.

11. The further economic integration of the Mainland and Hong Kong is posing challenges to our workforce. To meet these challenges, we need to allocate additional resources to education and training to enhance the competitiveness of our workforce. We therefore need to have stable sources of revenue to support such investments.

12. As regards increasing the investment return from the Exchange Fund and changing the method of sharing investment income, we review these issues with the Hong Kong Monetary Authority from time to time, having regard to the need to defend the Hong Kong dollar and maintain the stability of our financial markets.

13. As for reducing expenditure, we reduced government expenditure for two consecutive years from 2003-04, with a total reduction of \$16.7 billion. Reduction in government expenditure has rarely happened in other parts of the world. This has demonstrated our determination to curb expenditure.

Whether GST is an appropriate option to broaden the tax base?

14. The majority of the public is not supportive of introducing a GST at this stage. Our opinion surveys have revealed that some 60% of the public are opposed to the introduction of a GST while some 30% support its introduction. Opinion surveys conducted by other organisations have also indicated that the majority of the public is against GST. On 19 October 2006, LegCo passed a motion, following a debate, that “this Council opposes the introduction of a Goods and Services Tax”. Those District Councils that have discussed the tax reform proposals are

generally opposed to the introduction of a GST at this stage.

15. Of those who are supportive of GST introduction, the main views are summarised as follows :

- (a) GST can bring stable revenue to the Government, and can help solve the problems of an ageing population and rigid public expenditure;
- (b) GST is a tax on consumption. Those who consume more have to pay more tax. Hence, it is a fair tax;
- (c) under the existing tax system, those Hong Kong residents who work outside Hong Kong on a long-term basis do not have to pay Salaries Tax, while their family members can enjoy a variety of public services in Hong Kong. Introduction of a GST can bring these people who have the ability to pay tax into the tax net;
- (d) under the existing tax system, those who earn high income from dividends and interest do not have to pay Salaries Tax. Introduction of a GST can bring such people into the tax net; and
- (e) paying tax is a civic responsibility. Citizens can fulfill such an obligation according to their ability through the payment of GST.

16. Of those who do not support the introduction of a GST at this stage, the main concerns are as follows:

- (a) GST is regressive in that people with different income levels are charged at the same rate. This would widen the wealth gap;
- (b) GST would cover most goods and services and would be collected at each stage of production or distribution. Hence, it would complicate our simple and low-rate tax system and undermine its competitive edge;
- (c) it would dampen consumption and detract from our status as a “shopping paradise”, thus hampering the development of tourism;
- (d) it would complicate the goods declaration system and undermine the competitiveness of our logistics industry; and
- (e) government administrative costs and business compliance costs would be high.

17. During consultation, we have responded proactively to the concerns raised by the public. As to whether GST would widen the wealth gap, our primary concern, at the time of drawing up the GST framework, was in fact to ensure that the livelihood of low-income households would not be affected. For these households, we proposed a package of relief measures, such as a \$2,000 cash allowance and \$3,500

in GST credits on Rates and water and sewage charges. As to how to allocate the revenue raised by GST, the public in fact holds two differing views. While some consider that the Government should use part of the revenue in areas such as social welfare, education and health services to enhance the well-being of the community, others hold the view that the Government should not use the revenue to increase expenditure, but use it to provide tax relief.

18. We have clearly stated that all these proposed measures are just a starting point to facilitate discussion and we welcome views from the public on these measures in order to ensure that the livelihood of low-income households would not be affected. For instance, we have proposed a limited number of exemptions to keep the system simple, and provision of direct relief would ensure that low-income households were not affected. During consultation, many people suggested that basic necessities should be exempted. We have said that we would consider exempting public education, transport and health services. In addition, in our plan, part of the revenue raised by GST could be used to provide services to disadvantaged groups.

19. The proposed GST framework is simple. We have proposed a low, single tax rate and a high registration threshold that would not require most small and medium-sized enterprises to register. According to overseas experience such as in Singapore, which has a GST framework similar to the one we have proposed, business compliance costs are not high. Hence, GST would not undermine our simple and low-rate tax system. According to our study, the impact of GST on the economy would be minimal and short-term. In the long term, it could provide room for the Government to reduce the rates of direct taxes in

order to enhance our competitiveness.

Other options to broaden the tax base

20. Some of those opposing GST introduction have suggested other options to broaden the tax base. These options include:

- (a) introducing a progressive Profits Tax and increasing the progressive element of Salaries Tax;
- (b) introducing a capital gains tax;
- (c) introducing a tax on dividends or interest;
- (d) introducing a tax on luxury goods;
- (e) introducing a land departure tax; and
- (f) introducing a green tax such as a tax on plastic bags or electricity.

21. The Advisory Committee on New Broad-based Taxes (Advisory Committee), which was established in 2000, has already conducted a thorough study on most of these options and its conclusion was covered in its Final Report submitted to the Government in February 2002. The public may visit the Tax Reform Website www.taxreform.gov.hk to download the report.

(III) Assessment and Way Forward

22. Over the past few months, through a variety of methods, we have discussed with the community the problems of our public finances and narrow tax base, as well as our tax reform proposals. The public generally has gained a better understanding of the problems of our narrow tax base. They agree that we should not ignore these problems nor avoid discussing them. They share the view that the Government should stabilise its revenue by broadening the tax base so as to enhance our fiscal health and competitiveness. They also support the position that the Government should discuss the issues with the community and listen to their views on the various ways of broadening the tax base.

23. As to whether GST is an appropriate option, we have explained in the Consultation Document that this tax could 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. During consultation, the community has expressed concern over this tax on a number of issues. Despite our having given explanations to them in order to address their concerns, we are still unable to remove their worries.

24. Having regard to the views collected through the different channels, it is clear that the public is strongly against GST. We consider that at this point in time there is insufficient public support nor are the conditions right for the introduction of GST.

25. In contrast, the community generally agrees that the Government should continue public consultation on how to broaden the

tax base. We hope that the public will continue to provide their views on other viable options. The Government will listen carefully and participate in the discussion. We will make reference to the options considered by the Advisory Committee in its 2002 report on broadening the tax base and those suggested by the public in the course of consultation in our continued discussion with the public. In considering different options, we will take into account various factors, such as the need for the tax system to be fair and comply with the “capacity to pay” principle; not to widen the wealth gap; to maintain the simple and low-rate tax system and our competitiveness; and to be effective in stabilising our revenue to cope with future challenges. We hope that we can come up with a conclusion for the Government of the next term to consider when the consultation exercise ends in March next year.