

Response to the Consultation Document Questions

Chapter 1

Do you think that our existing tax base is too narrow?

On the whole, we believe the tax base is too narrow. However, there are different ways of measuring breadth, and we believe it would be useful to distinguish between them. First, a tax base may be narrow in the sense that revenues are derived from too few *sources*, such as salaries or profits. For Hong Kong, this does not seem to be the case. The second measure looks at the *number* of taxpayers as compared to the population as a whole, and here there can be no question: only 18% of the population pays tax on a portion of their income, a ratio which is the lowest in the developed world.

Do you believe that Hong Kong needs a tax base where revenue is generated from diversified sources that are less susceptible to external shocks and cyclical economic conditions?

The events of the first half of this decade clearly indicate that the existing tax base is insufficiently robust to withstand major external shocks. However, it should be noted that the 1998-2005 deflation was an extremely rare occurrence, and is unlikely to be repeated at regular intervals.

With that in mind, we believe expanding the number of people paying taxes – and not necessarily the means by which taxes are paid – would be useful. The very deep decline in both salaries and profits taxes suggest that these are not suitable, in and of themselves. Hence, a broader and less vulnerable tax base is needed.

Do you think the Government should take action to reform the tax base to ensure our future growth and prosperity?

Framed as it is, this question can only be answered in the positive. However, what is missing from this question, the consultation paper and all discussion of reforming the tax base is any consideration whatsoever of the level of operating expenditure. We firmly believe that operating expenditure needs to be reduced to somewhere near the 11% of GDP level that prevailed before the depression. This should be achieved through headcount reduction, delayering, rationalizing civil service compensation and greater use of public-private partnerships.

Chapter 2

Do you agree that there are only two viable options?

Within the context of the question –broadening the tax base through either a GST or lower personal allowances – we would agree with this assertion. However, once again we note that no consideration is given to reducing expenditure.

Other options were discussed in the 2002 report by the Advisory Committee on New Broad-Based Taxes. Briefly, our views are as follows:

Taxation Options	Effectiveness at broadening tax base	Ability to raise useful revenue	Impact on competitiveness	Conclusion
G S T	Strong	Strong	Insignificant	Ideal, if done right
Billboards, phones	Moderate	Modest	Modest	Acceptable
Capital gains taxes	Moderate	Moderate (homes)	Highly damaging	Unacceptable
Departure tax	Strong	Poor	Modest	Acceptable
Dividends taxes	Moderate	Poor	Highly damaging	Unacceptable
General Rates	Strong	Strong	High	Unsuitable
Interest taxes	Moderate	Poor	Highly damaging	Unacceptable
Luxury goods tax	Poor	Poor	Modest	Unsuitable
Personal allowances	Strong	Moderate	Modest	Acceptable
Worldwide income	Poor	Poor	Highly damaging	Unacceptable
Green taxes	<i>Green taxes should be considered on environmental rather than fiscal grounds.</i>			
- Electricity	Poor	Poor	Significant	Unsuitable
- Plastic bags	Poor	Poor	Insignificant	Unsuitable

Hong Kong's extremely light regulatory regime forbids consideration of world-wide income, capital gains, interest or dividends taxes, which would rapidly undermine our competitiveness and likely raise little or no revenue from segments of the economy that are not already taxed. The single exception, which we do not believe to be a wise choice, would be a capital gains tax on family homes.

Higher General Rates taxes would significantly broaden the tax base and likely raise useful revenue for off-setting other taxes. However, as we are already one of the most expensive cities on earth, increasing the cost of living and doing business here would be extremely unwise. Similarly, taxing luxury goods sales would quickly reduce our attraction to tourists, and as a result raise little revenue. Hence, we believe these taxes to be unsuitable for Hong Kong.

Green taxes, which we support, are uniquely unsuitable for the purposes of this tax base broadening exercise. Such levies are not intended to raise revenue; rather, their objective is to change behaviour, much like so-called sin taxes. If green taxes (or, sin taxes) are successful, revenue will drop as behaviour changes. While there would be a brief broadening of the tax base, once behaviour changes, the tax base would again narrow. We therefore are opposed to using green taxes as a means of broadening the tax base.

Do you agree that a reduction in personal allowances is not a preferred option?

On this point we disagree. Hong Kong has the highest personal allowances, in comparison to incomes, of any developed economy in the world. We believe that the personal allowance rate should be reduced steadily, without regard to revenues, over a period of several years. A 50% reduction over five years, for example, would bring our personal allowance into line with that of the OECD economies.

Our conclusion is that, when the political circumstances permit, the consultation on broadening the tax base through a revenue-neutral Goods and Services Tax is the best option for Hong Kong. However, the right timing may be several years away, and we need solutions sooner, rather than later. Hence, a combination of significant spending reductions coupled with a steady reduction in personal allowances and perhaps some modest additional measures such as departure taxes would provide the most reasonable and useful near-term solution.