CHAPTER 1 IS TAX REFORM REQUIRED IN HONG KONG?

1. Hong Kong is a highly resilient, vibrant and dynamic city. After being in the doldrums for several years, our economy has now recovered strongly. Our ability to sustain the prosperity of our economy, however, is dependent on the attractiveness of a low and competitive tax system, reliable provision of public services and sound government finances. If we allow any of these key attributes to deteriorate for even a short period of time, our continued success will be in jeopardy.

Future sustainable growth will be the key

2. Without sustainable growth we will not be able to withstand international competitive pressures or handle another sudden economic downturn. The consequences for our community will be dire and for many of us individually severe – we will be faced with higher interest rates, business and personal bankruptcies, loss of employment and declining living standards, falling asset prices and an exodus of crucially important investment and skilled labour.

We have low taxes…

3. The rapid recovery of our economy in the last two years is attributable to many factors, one of which is our simple, predictable and low-rate taxation system, which encourages investment and rewards people for their hard work. Our corporate and personal income tax rates are among the lowest in the world. We have an effective and efficient tax collection system. However, notwithstanding its relative strengths, our tax regime is not without its flaws.

… but our tax base is exceptionally narrow

4. We currently rely upon only a very limited range of taxes and non-tax income to generate revenue to support our expenditure. This is not healthy and has greatly constrained our ability to manage our public finances, particularly in times of economic downturn and adversity, which we experienced from the end of 1997 to mid-2003.

Do we have a choice?

5. Hong Kong needs to reform its tax system to establish a steady revenue source to secure our future growth and prosperity. The question is not if we need to do it, but when and how.

Why now?

6. Against the backdrop of the improvement in the economy and the much healthier position of government's finances (with both our Operating and Consolidated Accounts now in surplus), some may doubt whether there is a need to act now to reform the tax system. In fact, not only is there a need, it is also the right time to do so. This is because the present favourable environment allows us to consider reform to our tax system without the pressure to raise the total tax burden. We can undertake tax reform in a revenue neutral manner for at least the first five years.

Future uncertainty

7. Notwithstanding a promising outlook, we are presently faced with many real challenges and uncertainties. These include high oil prices, rising interest rates and global economic imbalances. Moreover, as an externally-oriented economy, Hong Kong is highly susceptible to outside shocks. In view of our narrow tax base, we are very vulnerable to cyclical fluctuations. Our major sources of revenue, such as Profits Tax, Stamp Duties on stocks and immovable property, land premiums and investment returns, all suffer from considerable volatility related to economic conditions. Therefore, factors or major external shocks beyond our control could reverse our recent economic recovery. This would undermine our fiscal position and stifle our future growth and prosperity.

We must address fundamental challenges

8. In addition, we must respond to more fundamental challenges to our economy. These include the need to improve the quality of and access to education and skills re-training for a knowledge-based workforce; increasing demand for elderly care services; addressing environmental, public health and quality of life impediments; and boosting our productivity. All of these challenges will place increasing demands on our public expenditure, and in turn our tax base. These pressures present a very real threat to us.

What's the worst-case scenario?

9. If we do nothing and try to rely on our existing tax system to carry us through any economic uncertainties, then the worst-case scenario is that individually, many of us will ultimately be much worse off. Should we suffer another economic downturn or recession, and if we have not done anything, we will be forced to increase taxes and cut government expenditure on public services, draw down on our reserves and borrow money from the international market. These worst-case scenarios will have a harsher impact on our livelihood and undermine our credit ratings.

Current tax system flaws will undermine competitiveness

10. To make matters even worse during a future economic downturn, the flaws and weaknesses in our existing tax system mean any short-term fiscal responses such as raising taxes will undermine our competitiveness in terms of retaining and attracting local and overseas investment and talent. This will lead to rising unemployment, and lower incomes for those able to keep their jobs. Moreover, any drastic reduction in public expenditure would hamper our level of services to the community and would not be conducive to social harmony.

We cannot afford to stand still

11. Being a modern international city at the forefront of international competitiveness, we have to be vigilant and cannot afford to stand still while our competitiveness is being eroded. We must make good use of the respite provided by the economic recovery to act now so that our public finances will be better able to withstand future economic and social challenges. We must act now to broaden our tax base for the future prosperity of Hong Kong, which will ultimately affect each Hong Kong resident individually.

Tax reform, not tax revenue

12. The main purpose of this proposed tax reform is not to generate additional taxation revenue. It is aimed at broadening our tax base, so that we will be able to rely on a dependable and growing revenue base to maintain our vibrancy, to remain internationally competitive and to be able to meet the challenges arising from the ageing of our population.

How narrow is our tax base?

13. Hong Kong's tax base is very narrow by international standards[1]. We are particularly reliant on income taxes and revenues from land sales and investment earnings to support our expenditure. As income from these sources is very volatile and tends to fluctuate with economic conditions, our ability to manage public finances is very much constrained.

Tax revenue currently volatile and unpredictable

14. One of the most important factors behind Hong Kong's competitiveness is our simple, predictable and low-rate taxation system. It is important to note that the problems with our tax system are not the result of our low-rate policy - a principle we will steadfastly retain - but arise because we rely so heavily on Salaries and Profits Taxes (which are paid by a small proportion of the community) and property-related taxes. This has made our tax revenue exceptionally volatile and unpredictable. By contrast, our expenditure is generally rigid and difficult to adjust in line with increases or decreases in revenue. This is because a large proportion of expenditure goes to education, health, social welfare and law and order.

Limited types of tax, paid by too few taxpayers

15. Moreover, our dependence on one or two types of tax paid by a small number of taxpayers is also inequitable and is not in line with the global norm. Presently, of a working population of 3.4 million in Hong Kong, only some 1.2 million (35%) pay Salaries Tax. Furthermore, the top 100 000 salaries taxpayers contribute 60% of Salaries Tax, while 500 000 pay 95% of the total. For Profits Tax, out of around 750 000 registered businesses, the top 800 companies pay 60% of the total Profits Tax.

Hong Kong's position is weakening

16. In 2001-2002, the Advisory Committee on New Broad-based Taxes established by the Financial Secretary carried out a study to compare the tax base of Hong Kong with those of other developed jurisdictions and in the Asia-Pacific region, and it concluded that Hong Kong:

[1] Findings of the final report of the Advisory Committee on New Broad-based Taxes issued in February 2002. A copy of the final report can be downloaded from the website www.taxreform.gov.hk.

(a) is a low tax jurisdiction that has a narrow tax base whose limited width is contracting;

(b) has a tax base that is narrow in composition because it is heavily reliant upon a limited range of taxes;

(c) is the only developed tax jurisdiction that does not tax general consumption; and

(d) has in the past, and contrary to international norms, often relied on non-tax revenue.

Report identified five tax system defects

17. In addition, the Advisory Committee found that Hong Kong's current tax system suffers from five notable defects:

(a) it has lower revenue productivity during periods of economic downturn compared with tax systems that are broad based;

(b) taxed sectors are small, constraining the ability to raise tax revenue to reflect the changes in the economy;

(c) its narrowness exacerbates economic distortions;

(d) in the main, it taxes income but not private consumption expenditure; and

(e) it is slow to adjust to changing population demographics.

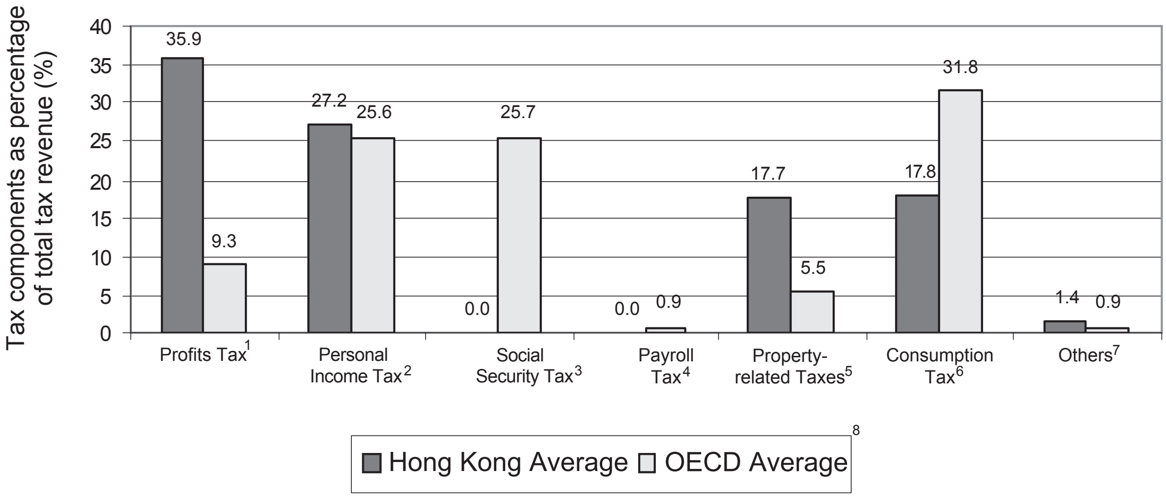
18. These findings are just as relevant today. The same structural tax base problems that were identified by the Advisory Committee continue to exist in Hong Kong.

19. The following section illustrates the current comparison between Hong Kong's tax base and those for countries in the Organisation for Economic Cooperation and Development (OECD)[2].

[2] At the time of this consultation document's publication, the most up-to-date actual OECD tax revenue data available are for 2003. In order to avoid annual fluctuations, the comparison is based on a three-year average of OECD (2001-2003 calendar years) and Hong Kong (2001-02 to 2003-04 fiscal years) tax revenue data.

HK vs OECD — a significantly narrower tax mix

Chart 1 Hong Kong tax revenue mix as a percentage of total tax revenue compared to the OECD economies



[1] Profits Tax includes Profits and Capital Gains Taxes on enterprises.

[2] Personal Income Tax includes Salaries Tax, Personal Assessment and Property Tax.

[3] Social Security Tax includes all compulsory payments that confer an entitlement to receive a future social benefit. Hong Kong has a Mandatory Provident Fund Scheme that provides for retirement benefits. For OECD definitional purposes, this is not considered as a social security tax.

[4] Payroll Tax includes taxes paid by employers, employees or the self-employed which do not confer entitlement to social benefits. There is no such tax in Hong Kong.

[5] Property-related Taxes include Rates, Stamp Duties on immovable property and stocks, and Estate Duty. (Estate Duty was abolished with effect from 11 February 2006)

[6] Consumption Tax includes taxes on all goods and services. In Hong Kong, it includes Duties, Betting Duty, Hotel Accommodation Tax, Air Passenger Departure Tax and Motor Vehicle First Registration Tax.

[7] In Hong Kong, Others refer to income from royalties.

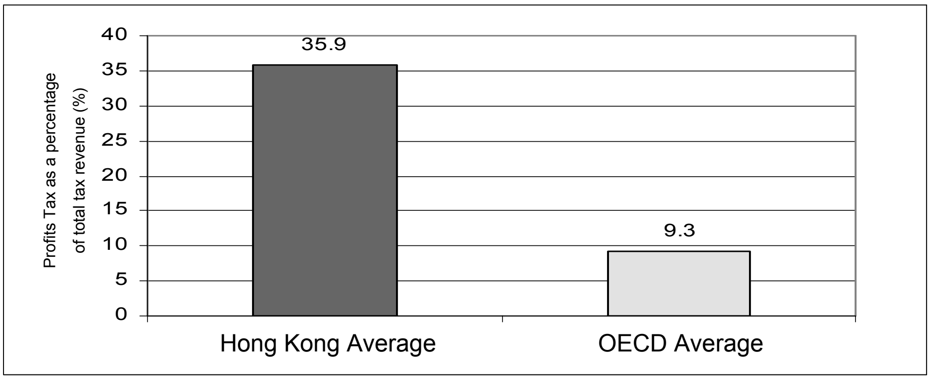
[8] The OECD average does not add up to 100% due to rounding.

20. A simple comparison of Hong Kong's tax revenue base to those of the OECD economies illustrates why Hong Kong's tax mix is significantly narrower than the rest of the developed world (as represented by the OECD).

21. Hong Kong's reliance on Profits Tax is much higher than the OECD average, while our dependence on property-related taxes is more than three times the international average. Heavy reliance on these highly volatile and cyclical forms of tax revenue makes Hong Kong's public revenue unpredictable and unstable.

HK vs OECD – a very high reliance on Profits Tax

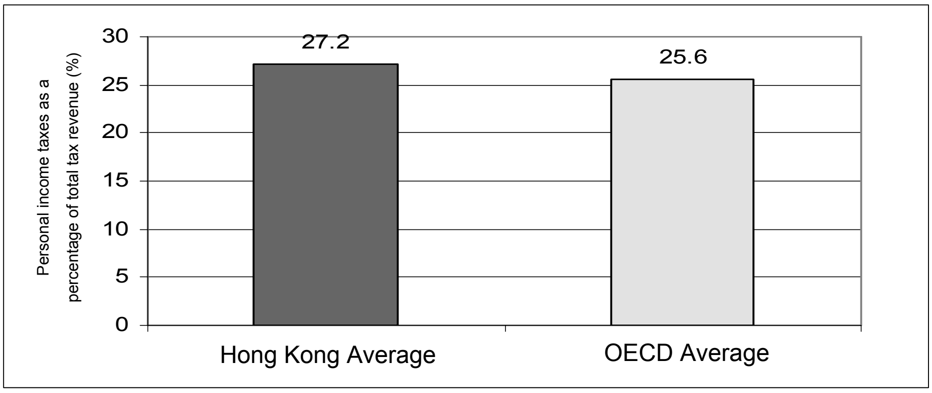
Chart 2 Hong Kong Profits Tax as a percentage of total tax revenue compared to the OECD economies



22. Notwithstanding our low overall tax level, we have a comparatively high reliance on Profits Tax when compared to OECD economies. Hong Kong's comparatively high reliance on Profits Tax means that, unlike other jurisdictions, our public finances are more exposed to variation in global economic cycles and external shocks. This position also means that Hong Kong cannot be as flexible as other jurisdictions in responding to falling corporate tax rate trends, as referred to in paragraphs 28 to 34.

HK vs OECD – personal income tax around average

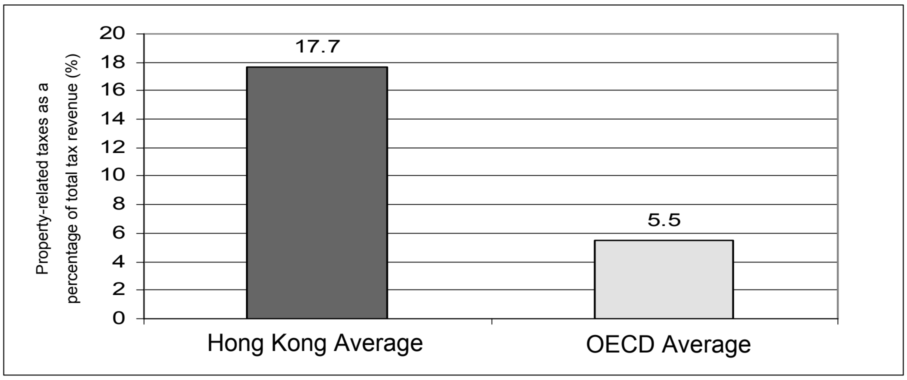
Chart 3 Hong Kong personal income tax as a percentage of total tax revenue compared to the OECD economies



23. Hong Kong's reliance on personal income tax, such as Salaries Tax, as a revenue source is around the OECD average. It should be noted that, while personal taxation remains one of the largest sources of taxation revenue in the OECD, the international trend is towards a lower reliance on this source of revenue (see paragraphs 35 to 38 below).

HK vs OECD – property-related taxes reliance above average

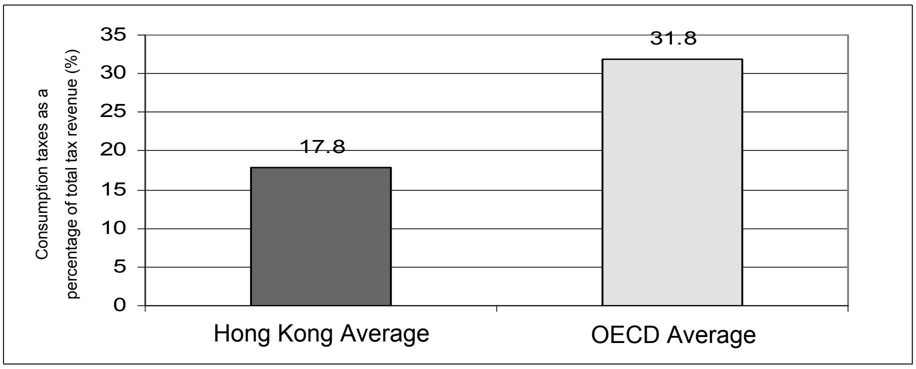
Chart 4 Hong Kong property-related taxes as a percentage of total tax revenue compared to the OECD economies



24. Reliance on property-related taxes in Hong Kong (i.e. Rates, Estate Duty[3] and Stamp Duties on immovable property and stocks) is also well above OECD average. Over the period in question, this form of revenue made up 17.7% of Hong Kong's tax revenue in contrast to 5.5% for the OECD.

HK vs OECD – very low reliance on taxes from goods and services

Chart 5 Hong Kong consumption tax as a percentage of total tax revenue compared to the OECD economies

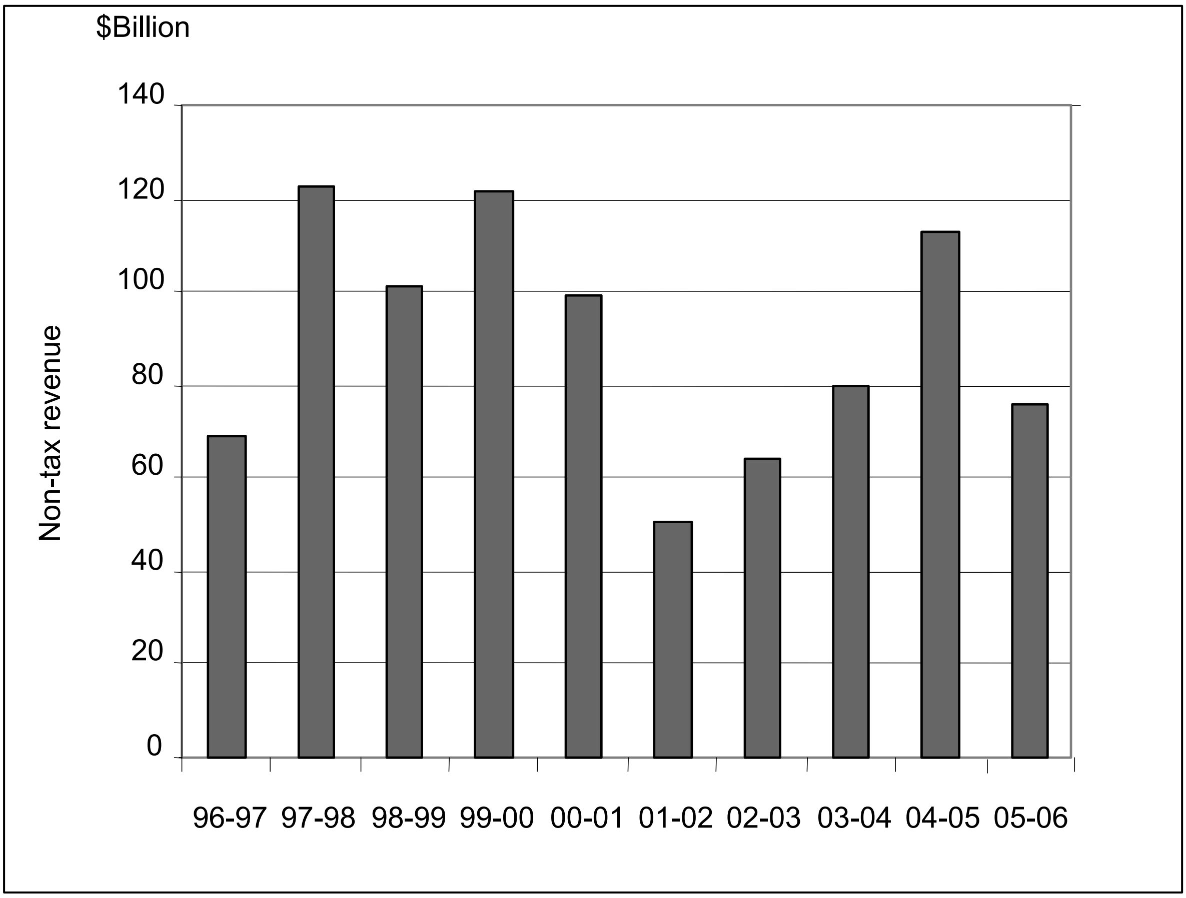


25. Hong Kong's tax base stands out as clearly lacking in its low reliance on taxes from goods and services. Hong Kong's reliance on consumption taxes was 17.8%. This is in contrast to the OECD economies, where consumption taxes accounted for over 31% of total tax revenue. Hong Kong relies principally on Betting Duty and duties on tobacco, liquor, petrol, diesel and aircraft fuel. The international trend is to rely on more broad-based goods and services taxation.

[3] Estate Duty was abolished with effect from 11 February 2006.

HK vs OECD – very high reliance on non-tax revenue

Chart 6 Non-tax revenue of Hong Kong from 1996-97 to 2005-06



26. Hong Kong has traditionally derived one third of its total government revenue from sources other than taxation[4]. By international standards, our reliance on non-tax revenue is very high[5]. Non-tax revenue is primarily derived from land sales and earnings from accumulated reserves. As a share of government revenue over the past decade, the former fluctuated between 3% and 28% and the latter between 0.5% and 18%. With such high volatility, these revenues clearly cannot be relied upon to get Hong Kong over our tax base deficiency. In fact, the surplus forecast for the coming few years is largely attributable to high levels of volatile non-tax revenue. Chart 6 illustrates how volatile our non-tax revenue was over the past 10 years.

[4] From 1996-97 to 2005-06, non-tax revenue represented 39.6% of total revenue.
[5] For the period from 1995 to 2003, OECD's total reliance on non-tax revenue averaged 12.4%.

Fundamental structural problems

27. Our tax base and the nature of public finances present us with a number of fundamental structural problems which have been highlighted by the latest economic downturn. We must not forget that the underlying deficiencies of our fiscal system remain to be addressed, although the immediate fiscal outlook is encouraging.

(I) Erosion of Hong Kong's international competitive edge

28. With its free economy, low tax rates, excellent legal, infrastructural and communications systems, Hong Kong has long been regarded as one of the most competitive jurisdictions in the world, especially in attracting foreign investment. In recent years, however, we have faced more intense global and regional competition. Policy changes in some economies have eroded our competitive edge.

<u>Many economies substantially reducing corporate tax rate</u>

29. The headline corporate tax rate is a powerful symbol of business competitiveness. As a key part of reforming their tax systems, many economies have substantially reduced their corporate tax rates.

30. As shown in Table 1, between 2000 and 2005 the average headline corporate tax rate across the European Union economies was reduced by approximately 10 percentage points (from 35% to 25%) and in OECD economies by around four percentage points (from 33.6% to 29.8%).

31. Among the largest falls were those in Ireland (by 11.5 percentage points from 24% to 12.5%) and in many of the new European Union Member States. Singapore has lowered its corporate tax rate (by six percentage points from 26% to 20%) and offers concessional tax rates as low as 0% or 5% for certain activities. Macau has also lowered its tax rate (by almost four percentage points from 15.75% to 12%).

Hong Kong: Profits Tax increasing

32. In contrast, we have had to raise our Profits Tax rate over the same period, as part of the effort to tackle the budget deficit. Hong Kong increased the Profits Tax rate for incorporated businesses (by one-and-a-half percentage points from 16% to 17.5%) and for unincorporated businesses (by one percentage point from 15% to 16%).

Table 1 Comparing corporate tax rates between Hong Kong and other economies[6]

Jurisdiction	2000 Company Profits Tax Rate	2005 Company Profits Tax Rate	Change in percentage points
OECD	33.6%	29.8% (2004)	-3.8
European Union	about 35%	about 25%	about -10
South Korea*	30.8%	27.5%	-3.3
Austria	34%	25%	-9
Singapore*	26%	20%	-6
Iceland	30%	19%	-11
Hong Kong	**16%**	**17.5%**	**+1.5**
Hungary	18%	16%	-2
Lithuania	24%	15%	-9
Ireland	24%	12.5%	-11.5
Macau*	15.75%	12%	-3.75
Cyprus	15%	10%	-5

* These jurisdictions also offer tax incentives or holidays that can reduce the effective tax rate.

Gap between Hong Kong and competitors is closing

33. Although our existing corporate tax rate is still low, the gap between Hong Kong and competitor economies is narrowing. The clear international trend is to move away from reliance on direct taxes, such as corporate income taxes. In fact, general consumption taxes have been a fast-growing revenue source in many economies over the past decade[7].

[6] Jurisdictions that compete for high value-added services have been selected for comparison. OECD and EU averages are included as a reference point for developed economies.

[7] Source: OECD Revenue Statistics 1965-2003 (2005 edition).

To remain competitive, we cannot ignore international developments

34. Without reforming our tax base and identifying a new broad-based source of revenue, it will be difficult for us to reduce our Profits Tax rate in the future, as any reduction will put pressure on our budgetary position and hamper our ability to achieve sustained fiscal balance, particularly on a continuous basis.

(II) Difficult to attract and retain talent

35. Globalisation has enhanced the mobility of highly-skilled, professional and talented people. As a result, economies with high income tax rates find it more difficult to attract and retain talent than their low-tax counterparts. Moreover, high income tax rates suppress people's incentive to work and discourage initiatives to realise their full potential.

Competitors are cutting tax......

36. In recent years, many economies have cut income tax rates to attract and retain talented people. Since 2000, the average top personal income tax rate in European Union economies has been substantially reduced (a drop of over seven percentage points), as shown in Table 2. Over the same period, the OECD economies dropped their average top tax rate by more than five percentage points. In Singapore, the rate reduction was equally significant (a drop of seven percentage points).

......but Hong Kong Salaries Tax increased

37. Given our persistent budget deficits and against international trends, our standard Salaries Tax rate was increased in 2003 by one percentage point (from 15% to 16%) while the top rate was increased from 17% to 20% over the corresponding period, before this year's budget reduction to 19%. This has undermined our attractiveness to international talent.

Table 2 Comparing top personal income tax rates between Hong Kong and other developed economies

Region	2000	2006[8]	Change in percentage points
Hong Kong	17% (restricted to standard rate of 15%)	19% (restricted to standard rate of 16%)	+2 (standard rate +1)
European Union	51.1%	44%	-7.1
OECD	47%	41.9%	-5.1
Singapore	28%	21%	-7

Hong Kong unable to cut Salaries Tax further

38. Without a broader tax base, it will be impossible for us to cut our Salaries Tax rates significantly in the future, as any such reduction would have an impact on our fiscal position and hamper our ability to continue to achieve budget balance, particularly in the event of an economic downturn. In fact, we might have to increase Salaries Tax rates. This would constrain our flexibility to respond to international trends. This would also likely reduce our ability to attract and retain the talent essential to the continued growth and development of a knowledge-based, high value-added economy.

(III) Narrow tax base unable to cope with an ageing population

39. Another key challenge facing Hong Kong's tax base is the ageing of our population. This is a phenomenon commonly found in developed economies and is one of the problems identified by the Task Force on Review of Public Finances[9].

Hong Kong's population is rapidly ageing

40. Over the past decade, the percentage of persons aged 65 or above increased from 10% of the population in 1996 to 12% in 2005, and is forecast to rise to 27% by 2033. As the population ages, the proportion of working age will, in percentage terms, decrease relative to the total population. With a

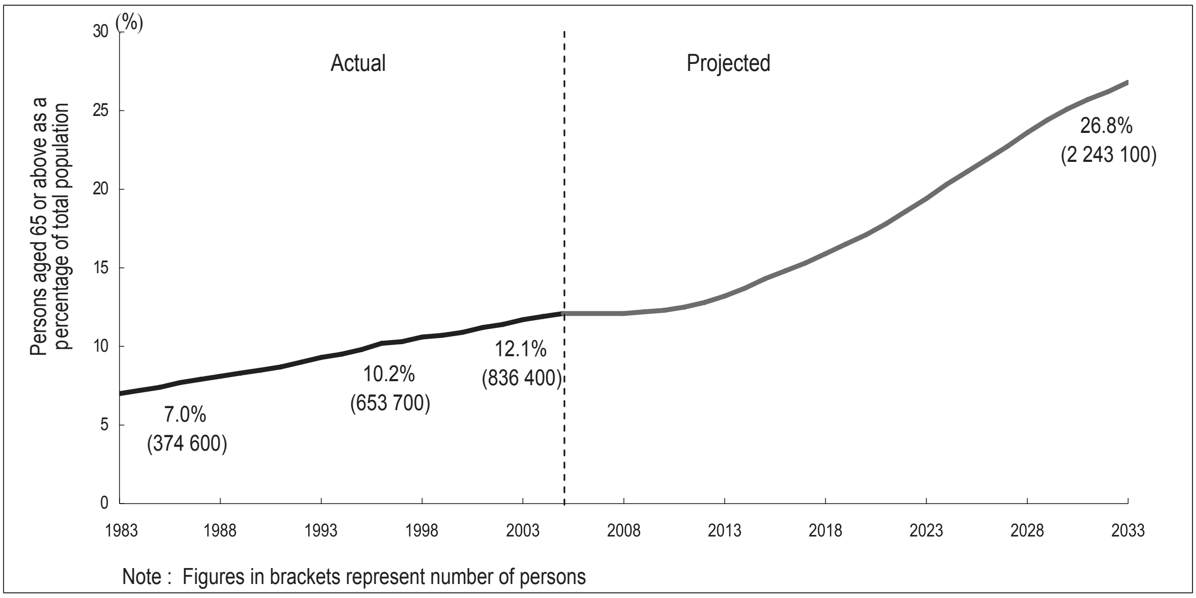
8 European Union and OECD reflect 2004 data.

9 The Task Force on Review of Public Finances was set up by the Financial Secretary in 2000. Its main functions were to identify whether the operating deficits experienced by the Government then were cyclical or structural in nature and to identify solutions to address the deficit problems. The report of the Task Force can be downloaded from the website www.taxreform.gov.hk.

decrease in the size of the working population, the proportion of Salaries Tax revenue will also decrease, further narrowing the tax base.

41. As the International Monetary Fund (IMF) notes in its Article IV Consultation Report for Hong Kong issued in February 2006: "Population ageing could affect Hong Kong's economy and public finances in several ways… growth in revenue from income-based taxes could slow down in line with GDP and shrinkage in the number of labour force participants. ...this will result in lower revenues. …these factors could lead to a significant decline in fiscal reserves… ".

Chart 7 Persons aged 65 or above as a percentage of total population in Hong Kong



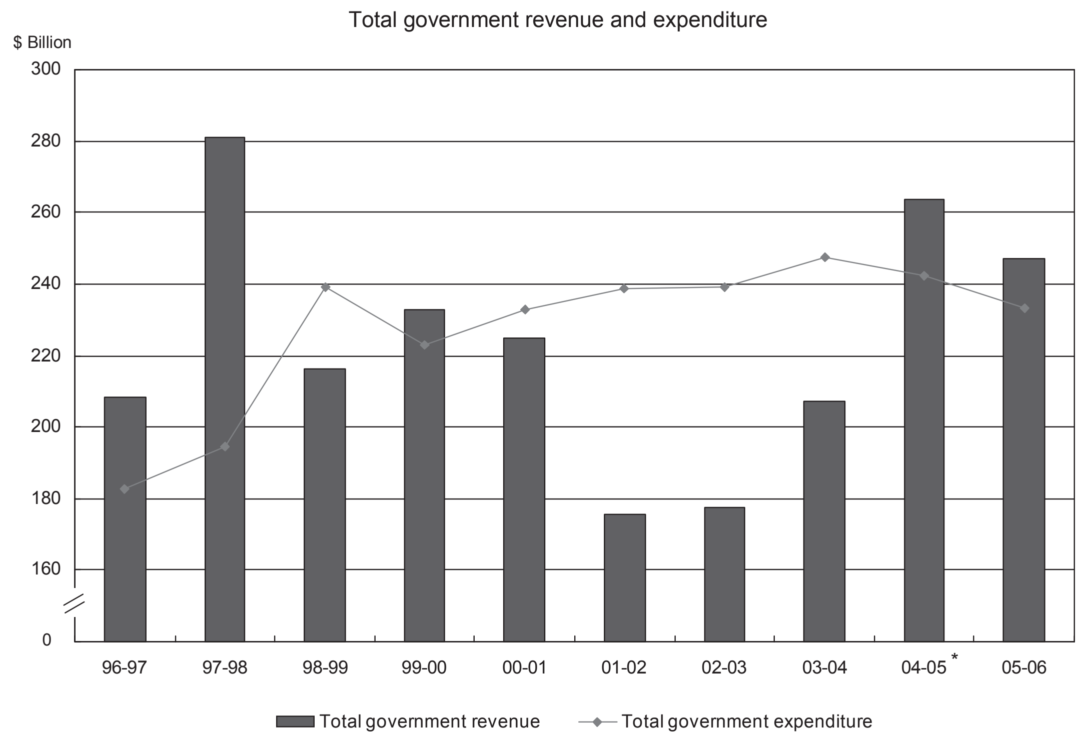
<u>The rapid ageing of our population provides further pressure to reform the tax base</u>

42. As the population ages, tax revenue from Salaries Tax, in relative terms, will fall as the Salaries Tax base shrinks. However, health and social welfare costs associated with the ageing of the population will increase, and mean even greater pressure to increase government expenditure. The current tax base is simply not strong or wide enough to meet these challenges.

(IV) Difficult to match income with expenditure

43. Hong Kong has experienced high volatility in revenue over the past 10 years. This is mainly because we have been heavily reliant on only a very limited range of taxes such as Salaries and Profits Taxes, property-related taxes and non-tax income derived from land sales and investment earnings. As income from these sources is very volatile, and tends to go up and down with economic conditions, we have experienced substantial fluctuations in revenue over the past few years. By contrast, expenditure patterns are far more rigid and inflexible, leading to budgetary mismatches.

Chart 8 Total government revenue and expenditure for the past 10 years



* Revenue income for 2004-05 includes the issuance of a $6 billion Toll Revenue Bond for the securitisation of tolled tunnels and bridges and $20 billion in bonds and notes. If this income is excluded, total government revenue for 2004-05 would be $238 billion, which is $4 billion less than total government expenditure.

44. The narrowness of our tax base thus presents practical difficulties for the Government in matching spending expectations with projected revenue. On a long-term basis, this situation is undesirable as it would undermine our ability to make long-term plans and major investment decisions for the sustained development of the community. The biggest challenge in managing public finances is to keep taxes low while at the same time satisfying the expectations of the community.

Without a broader tax base, we will need to increase taxes

45. Over the past few years, we have implemented rigorous measures[10] to contain expenditure. There is, however, limited scope for further reduction. Revenue volatility is accentuated during economic downturns. The severe shortfall in revenue under adverse economic conditions leads to substantial fiscal deficits, which cannot be sustained for long periods. Furthermore, unpredictability and volatility in non-tax revenue further add to the unpredictability and volatility of total revenue. We cannot afford to continue to expose Hong Kong to this risk. Many of our revenue items are heavily dependent on the performance of our economy. In times of future economic downturn, the risk of budget deficits will re-emerge. Hence, there is a need to broaden the tax base so that stable streams of income will be available to meet our expenditure needs.

(V) Enhancement of civic responsibility

46. As stated in the preceding paragraphs, Hong Kong's tax base is exceptionally narrow as only some 35% of our working population needs to pay Salaries Tax. As a citizen, while one has the right to enjoy the services and facilities rendered by the Government, one also has the obligation to bear a fair share of the cost of these services and facilities. Through the broadening of the tax base, more of our citizens can contribute to limited government resources, enhancing the community's sense of civic responsibility.

Time to make a change?

47. Hong Kong has long been reliant on a very limited range of taxes and non-tax income to meet its expenditure needs. Without a robust tax system and a reliable stream of revenue, we could not be certain of our ability to meet our expenditure requirements, particularly in the areas of education, health, social welfare and law and order. While in good times we can expect to meet such needs through windfalls from Salaries and Profits Taxes and property-related revenue, our ability to keep our finances balanced in years of economic downturn is constrained.

[10] These measures include cutting civil service salaries, reducing civil service establishment, reprioritising the provision of public services, reorganising the structure of government departments and re-engineering procedures to optimise the use of scarce resources.

What if we were to experience another economic downturn?

48. When a downturn occurs again, we may have no choice but to cut the provision of services to the public even though we have already implemented rigorous measures to contain expenditure. Alternatively, we might have to raise funds through international borrowing, even though we still have outstanding borrowings of around $24 billion from financial markets[11]. Additionally, we might have to draw down on our fiscal reserves to cover deficits, as we did in the recent past. We can only resort to these options on a short-term basis, and to a limited extent, otherwise we risk undermining our competitiveness and downgrading our credit rating.

What has been guiding our decision making?

49. As a responsible government, we have long been guided by the principle of prudent fiscal management: to strive to keep our expenditure within the limits of our revenue and avoid deficits. To do this, we need tax reform to broaden the tax base. Hong Kong needs a tax base where revenue is generated from diversified sources, and is not so susceptible to external shocks and cyclical economic conditions. A broader tax base will also allow us to reduce Profits and Salaries Taxes and hence improve both the sustainability and competitiveness of our low-rate and simple tax system.

Is doing nothing an option?

50. If we fail to take action now, our fiscal structural problems will remain and it would be more difficult for us to meet the challenges ahead when confronted with another economic crisis. We need to be vigilant and far-sighted. We cannot keep putting off a decision and taking action, as we have done before due to adverse conditions at the time. The longer we leave the problem unaddressed, the greater the pressure for reform, and the more drastic the action that will need to be taken. We must have the fortitude to make tough, but necessary, decisions.

We have time to consult, consider and plan

51. As the present economic circumstances and those in the foreseeable future are positive, we have been provided with a respite. We have an opportunity to consider and think carefully about this important issue,

[11] Government bonds ($20 billion) and Toll Revenue Bonds ($6 billion) were issued in 2004-05. Since then, around $2 billion has been repaid.

and do not need to rush into a decision. We can take our time to consult, consider and plan the best approach to reform our tax base and manage our public finances. We welcome your views to assist us in taking this important issue forward.

Questions

- ✧ Do you think that our existing tax base is too narrow?
- ✧ 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?
- ✧ Do you think the Government should take action to reform the tax base to ensure our future growth and prosperity?