CHAPTER 9 ECONOMIC AND INDUSTRY SECTOR IMPLICATIONS

Economic implications

206. International experience generally shows that the introduction of a GST would have some impact on the economy. However, in Hong Kong the extent of the impact would very much depend on the details of the GST package and the timing of its introduction (i.e. whether the economy at the time of introduction was in a period of upswing or consolidation). Since the main purpose of our tax reform would not be to raise revenue, but to broaden the tax base so as to enhance our fiscal health, we would expect the overall macroeconomic impact of GST introduction to be short-lived and mild.

Empirically, all economies share a common experience that GST impacts are generally short term, with no adverse impact in the long term

207. It is reasonable to expect that Hong Kong would share a similar experience. GST is generally regarded as an economically efficient tax that causes minimal distortion to business. In this respect, GST, being a tax on consumption expenditure within the domestic economy, is far more advantageous in terms of competitiveness, productivity and investment than increases in income taxes or narrow-based indirect taxes, such as Stamp Duties or excise duties. These conclusions have been supported by the IMF[56], the Advisory Committee on New Broad-based Taxes, the Singapore Ministry of Finance[57], and the Australian Treasury[58] in their analysis and assessment of the economic impacts of GST.

208. As our proposed tax reform would shift the tax burden away from income taxes and narrow-based indirect taxes towards a broad-based GST, the overall efficiency, competitiveness and robustness of our tax base would be enhanced. In undertaking tax reform, we would improve the prospects for our future growth and prosperity.

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[56] "The Modern VAT", IMF 2001; "IMF Report to HKSAR", January 2001.

[57] "GST in Singapore: Policy Rationale, Implementation Strategy & Technical Design", Asian Development Bank Conference, October 2004.

[58] "Preliminary assessment of the impact of *The New Tax System*", Australian Treasury Quarterly Economic Round-Up, Autumn 2003.

Inflation implications

209. The most noticeable and easiest-to-predict impact of GST would be on inflation. The imposition of GST would push up the retail price of most expenditure items. Assuming a GST rate of 5%, our modelling suggests that the Composite Consumer Price Index (CCPI) would be expected to rise by only around 3% immediately after GST introduction. The GST-related CCPI increase would be on top of the underlying prevailing inflation rate at the time. However, it would be a one-off spike and be expected to dissipate quickly.

Economic growth implications

210. International experience generally shows that GST itself would not materially alter economic growth trends. In the short term, GST would not be anticipated to have any material effect on economic growth. Over the long term, GST would be expected to underpin economic growth by reducing the risk and uncertainty stemming from structural fiscal problems and significant fluctuations in fiscal income. Creating a broad-based, steady source of growing revenue would lessen the reliance on other taxes, fees or charges that impact adversely on Hong Kong's competitiveness. Furthermore, we could expect the other business tax reductions and relief measures to deliver noticeable benefits to the overall profitability and competitiveness of our business sector.

Private consumption expenditure implications

211. In the run up to commencement of a GST, consumers might bring forward some discretionary purchases of goods and services that could be expected to increase in price. Thus, in the short term, after an initial increase in spending just prior to GST commencement, there could be a drop in private consumption demand as a result of perceived and actual price changes resulting from GST introduction. Private consumption in the economy would, however, be unlikely to change much with a low-rate GST as consumption expenditure patterns, according to overseas experience, would return to normal within a short period of time, and corresponding tax offset and relief measures would boost household disposable incomes.

Private investment implications

212. GST is not a tax on investment. There would be no increase in the cost of investment by business, as registered businesses would be entitled to immediate and full input tax recovery on capital expenditure. At the same time, some existing taxes on investment would be lowered by the offset package. A reduction in the Profits Tax rate would especially enhance investment returns and should encourage future investment.

Export implications

213. At a macroeconomic level, GST is fully creditable for exports. Under our proposed broad definition of "export", export-related logistics and ancillary services would also be regarded as such and would accordingly be zero rated. Moreover, exporters would enjoy small savings arising from the proposed reduction in Trade Declaration Charges. The business relief measures would have a positive, albeit modest, impact on operating costs for exporters.

Business GST compliance cost implications

214. A common concern of business is the compliance cost associated with a GST. International experience shows that a simple broad-based GST with few exemptions keeps compliance costs at a low level. Furthermore, with our proposed high business registration threshold, most small and medium-sized businesses would not be required to register for GST. Therefore, a large number of unregistered businesses would not incur any GST compliance costs.

215. The experience from Singapore, which has a tax base similar to that proposed for Hong Kong, illustrates that compliance costs for businesses represent less than 0.01% of turnover for large businesses or an average of S$1,000 a year per registrant[59].

216. The Australian experience, where the GST is more complex and has a much larger number of small turnover registrants, shows an average compliance cost per registrant of A$1,300 a year. According to a 1994 OECD

[59] "Survey Research Singapore, Survey on Compliance Costs of GST", 1996.

study[60], the international average annual cost per registrant is around US$500.

217. Registered businesses might also be able to enjoy a small cashflow advantage[61] by holding their GST receipts prior to remitting them to the tax authority. In some cases, the cashflow advantage might outweigh the compliance costs.

Industry sector implications

218. In addition to analysing the impact, which we would expect to be minor and transitional in nature, of the GST package on the economy, we have assessed its impact on important industry sectors.

Trade, transport and logistics

219. Under the destination principle, exports of goods and international supplies are zero rated. 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 facilities such as DGPS, provision of BWs and implementation of a QES would be expected to be helpful to importers in relieving possible cashflow concerns.

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

221. 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.

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[60] "The Modern VAT", IMF, 2001.

[61] Reference in the Regulatory Impact Statement for the 1998 GST Bill in Australia estimated this to average A$200 per registrant a year.

Tourism and hospitality

222. While the price of consumer goods would increase marginally following the introduction of GST, the impact would only be on a one-off basis. 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.

223. We would therefore not expect the impact of GST introduction on these industries to be significant. In fact, as mentioned earlier, 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.

Financial services

224. Financial institutions would benefit from the proposed zero-rating approach towards financial supplies as they would be allowed to reclaim full refund of their input tax. Moreover, financial supplies under the proposed scope would not be subject to GST. This approach would place them in a more competitive and advantageous position in relation to their international counterparts in other GST systems. Apart from enjoying zero rating, our financial institutions would also benefit from Profits Tax reductions and other proposed business offset measures. Hong Kong's position as an international financial centre would thus be further strengthened following the implementation of GST.

Property and construction

225. Although sale and rental of non-residential property would be subject to GST, the tax so incurred would be a business input tax which could be reclaimed by GST-registered businesses. Hence, we would expect GST's impact on non-residential property to be negligible.

226. Residential property, on the other hand, is proposed to be exempt from GST. That means the purchase or rental of residential property would not be subject to GST. However, the exemption of residential property from GST would also mean that developers and property owners would not be

able to reclaim any GST on their related inputs, e.g. the materials used for the construction of these properties.

227. As residential property would not be subject to GST, we would not expect the overall price effect on new residential premises to be significant. As experienced by Singapore (which has a similar GST treatment to that proposed), the imposition of GST would not be expected to have a material impact on this sector either in the short or long term.

Question

- What are your views on the economic and industry sector impacts of a GST in Hong Kong?