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**HONG KONG SAR**

**POLICY AND ADMINISTRATIVE ISSUES IN INTRODUCING  
A GOODS AND SERVICES TAX**

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## EXECUTIVE SUMMARY

Hong Kong SAR has one of the lowest overall tax burdens in the world and its tax base is remarkably narrow by any standard. Indeed, it is the only major territory in the Asian and Pacific region that does not have some form of a broad-based tax on consumption. However, none of these facts, in and of itself, constitutes a sufficient basis for introducing a new tax in the territory, broad-based or otherwise. Therefore, the mission welcomes the fact that the impetus for considering a broad-based consumption tax in Hong Kong SAR has arisen not based on any of these facts, but in the context of assessing the necessity of meeting possibly rising revenue needs that are of a structural nature with minimum distortions, and obtaining a more cyclically stable tax base than the present one.

The focus of the present report is not on whether Hong Kong SAR should or should not introduce a broad-based consumption tax—that decision will presumably be made by the authorities after the release of the findings, expected by end-2001, of the recently formed task force charged with the responsibility of looking into the existence of any structural budget deficits in the territory. The report's focus is, instead, on issues that are largely technical in nature. Specifically, it addresses policy issues related to the design, and administrative issues related to the implementation, of a broad-based consumption tax in Hong Kong SAR—should an eventual decision be taken to introduce it.

Given sufficient preparation time and the necessary administrative resources, almost any country—let alone a territory of Hong Kong SAR's level of economic development—can introduce a broad-based consumption tax. Nevertheless, introducing such a tax in Hong Kong SAR does pose formidable administrative challenges. (It may also pose political challenges, about which the mission does not have the competence to render an informed assessment.) Most notably, effective controls over cross-border flows of goods are currently lacking on account of Hong Kong SAR's status as a free port; and key revenue departments (i.e., the Customs and Excise Department (CED) and the Inland Revenue Department (IRD)) have no experience in administering broad-based consumption taxes. Overcoming these challenges would require the political will to reorient the mode and focus of the operations of both the CED and the IRD in a fundamental way, as well as careful and advance planning to execute such a change.

In considering broad-based consumption taxation, it is the mission's understanding that the authorities have in mind a goods and services tax (GST), otherwise known as a value-added tax, of the credit-invoice type—this being the overwhelmingly dominant practice around the world and that Hong Kong SAR has little desire to deviate from the international norm. Furthermore, in keeping with the authorities' commitment to safeguard Hong Kong SAR's competitiveness in part by keeping its tax system simple and tax burden low, the mission takes as given that the prospective GST in the territory—if introduced—would: (1) contain few exemptions, zero ratings, and special concessions; and (2) have a low single rate, presumably in the range of 3–5 percent (a rate below 3 percent could raise questions about the cost-effectiveness of introducing a GST at all). It is worth underscoring that

administrative and compliance costs could rise significantly if the design of the GST were to deviate materially from these two attributes.

### Policy issues

Issues of GST design are by now quite familiar, as a large number of countries have already implemented it with minor variations. Nevertheless, the mission has singled out four issues for the authorities' special attention, on account of their particular relevance to Hong Kong SAR's circumstances.

- **Destination vs. origin principle.** Almost all countries that have a GST implement it on the basis of the destination principle (i.e., imports are taxed but exports are zero-rated). Clearly, applying such a principle requires carrying out border tax adjustments and, therefore, effective border controls—which Hong Kong SAR does not, as noted earlier, currently have. An alternative would be to implement the GST on an origin basis, taxing exports but exempting imports. While not requiring border tax adjustments, the origin principle has some major disadvantages, most notably exports will bear the GST burden, which could hardly bode well for maintaining Hong Kong SAR's competitiveness (in view of Hong Kong SAR's linked exchange rate). Other problems associated with the origin principle include import and export valuation, as well as transfer pricing issues. On balance, the mission is of the view that a destination-based GST would be in the best long-run interest of the territory, and efforts should be directed to securing effective border controls.
- **Treatment of financial services.** Financial services pose some of the most difficult problems for a GST, because they are often rendered with no explicit charges. Since such services play an important role in Hong Kong SAR's economy and face a highly competitive environment in the region, care should be given to how they are to be treated under the GST. The mission advises that Hong Kong SAR should consider adopting one of two possible approaches. It could follow Singapore's approach, which taxes most financial services for which explicit fees are charged (except those exported), and exempts all others. To reduce cascading when financial services are purchased by taxable businesses as inputs, financial institutions—notwithstanding the fact that most of their outputs are exempt—are nevertheless allowed to recover a substantial proportion of the GST they paid on their purchases. As an alternative, Hong Kong SAR could take Singapore's approach one step further and allow financial institutions to recover their input tax fully, thus eliminating cascading completely. The mission has estimated that the revenue consequence of taking the latter approach, relative to Singapore's, is of only marginal significance. Either approach is conceptually superior, and administratively simpler to adopt, than the European Union's (EU) approach of exemption with no recovery of input tax allowed.
- **Treatment of immovable properties.** The importance of the real estate sector in Hong Kong SAR's economy also necessitates a careful consideration of its GST treatment. The approach favored by the mission can be stated in fairly simple terms.

The sale and use of commercial properties, whether new or existing, should be fully taxable. This will not impose a burden on taxable businesses, since the GST so paid by them on such transactions is recoverable. Rental payments on residential properties should be exempt to avoid creating a distortion between rental and owner-occupied housing. However, the sale of new residential properties supplied by the private market should be taxed—which tax could be considered as imposed on the stream of future housing services provided by the properties. The above approach is one that is broadly followed by most countries in the region, but stands in contrast to the EU’s approach, which largely exempts the sale and use of immovable properties, commercial or residential.

- **Treatment of small businesses.** Given the great number of small businesses in Hong Kong SAR, the success of introducing a GST in the territory hinges crucially on setting a small business exemption threshold specified in terms of annual turnover. Businesses whose annual turnover is below the threshold are not required—but could optionally elect—to be registered. This approach, which is almost a universal practice, reduces substantially the administrative and compliance costs of the GST at relatively minor revenue costs. This is so because small businesses, though large in number, collectively contribute relatively little to an economy’s total value-added. Moreover, those who are exempt because of the threshold still pay tax on their purchases. Industry survey data on the distribution profile of business establishments by annual turnover indicate that the appropriate threshold in Hong Kong SAR would most likely be between HK\$1 million and HK\$5 million. More detailed data are required, however, to set the exact level of the threshold.

The mission has calculated that, based on available national income accounts data and CPI basket weights, a broad-based GST would have a base of about 38 percent of Hong Kong SAR’s GDP and produce only a moderate price impact—provided that the GST rate is low. These estimates are, however, largely indicative in nature; they should, therefore, be used with caution.

### **Administrative issues**

The typical timeframe for introducing a GST in a developed economy is around two years from the date a decision to implement the tax is taken. For Hong Kong SAR, however, given its present limitations with customs and tax administrations, as noted earlier, the necessary timeframe could stretch to three years. Since the decision on the GST is still far into the future, the present report does not address the details of GST implementation; rather, it focuses on contingency planning for both the CED and the IRD—identifying tasks that each of these departments can usefully do now in anticipation of a possible eventual affirmative GST decision. The mission suggests that the authorities consider requesting further technical assistance from the Fund, if and when such a need arises after the decision to introduce the GST is made.



- **Planning focus for the CED.** An essential first step for the CED to establish an acceptable border control environment in Hong Kong SAR would be to implement with some urgency a number of recommendations put forward by a recently completed consultancy study on customs cargo clearance requirements and services. These recommendations have to do with ensuring that the CED has timely information on the movements of goods into and out of the territory through early lodging requirements of cargo manifests, and securing better physical control of public cargo working areas, especially with respect to river trading vessels. While this step alone is not sufficient to support the effective collection of GST at the borders, it would provide a strong platform for the CED to effect further necessary changes with the advent of the GST.
- **Planning focus for the IRD.** The contingency tasks that the IRD should perform are more varied, including: (1) developing and maintaining a database—including a review of the adequacy of the present system of taxpayer identification numbers—that would capture more complete information on active businesses than is available now to better ascertain the potential GST taxpayer population and set the exemption threshold, and to facilitate information exchange between the IRD and the CED; (2) accelerating the shift to a full self-assessment system; (3) developing shorter and more targeted audits, upgrading the skills of field inspection staff, and promoting a culture of field checks at business premises that the IRD does not currently have; (4) maintaining a strong focus on improving business record-keeping standards and practices; and (5) enhancing the consultation process between the IRD and relevant private-sector business and professional groups to identify and resolve existing and/or potential tax issues in a cooperative environment. Undertaking these tasks in a timely manner would place the IRD in a better position than it is now to begin preparation for the GST's introduction.