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POLICY AND ADMINISTRATIVE ISSUES IN INTRODUCING A GOODS AND SERVICES TAX : FURTHER CONSIDERATIONS

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EXECUTIVE SUMMARY

This report takes as its point of departure the 2001 mission report that covered a range of policy and administrative issues related to the possible introduction of a goods and services tax (GST) in Hong Kong SAR. The present report provides elaborations on those issues, as well as advice on a number of new issues, that have been sought by the authorities.

The estimated revenue yield of a broad-based GST (i.e., with minimal exemptions and zero-rating limited to exports) in Hong Kong SAR would be about 0.37 percent of GDP (HK\$ 4.6 billion) for every percentage point of the GST rate—a figure that is comparable to the observed performance of the GST in other countries of the region. The base of such a GST would come very close to the combined base of the existing salaries and profits tax. Thus, the argument for introducing a GST in Hong Kong SAR could rest on two grounds: (1) revenue—having a GST would lessen the need to raise salaries and profits taxes for mobilizing needed budgetary resources; and (2) equity—to the extent that there are salaries tax evaders, the GST provides an alternative instrument to bring them into the tax net.

Concerns about possible revenue leakage of introducing the GST on the destination basis are valid—since the customs administration is not experienced in the collection of duties and taxes on imports on a broad scale—but should not be exaggerated. Much of the value of imports destined for domestic consumption in Hong Kong SAR would be recaptured in the tax base even if it escapes taxation at the import stage. However, a significant change in customs practices should still be undertaken to minimize border leakage. Such a change would involve the implementation of largely audit-based modern customs control practices, which include requiring importers to post adequate financial security.

Policy issues

The GST is first and foremost an instrument of revenue generation in the most neutral manner possible; it is ill-suited to be used to achieve other economic and social objectives for which other and superior instruments could be found. Hence, it would not be advisable to burden the GST with features largely designed to address equity concerns, such as food exemptions. Such features would not be cost-effective and have a tendency to proliferate over time, thus mitigating much of the inherent revenue productiveness of the tax. Concerns about the impact of the GST on the vulnerable should preferably be addressed through a suitably designed offset package that would, at a minimum, compensate for its initial but one-off price effect. The mission has estimated that a GST at the rate of 5 percent would probably increase the cost of the consumption basket of the poor by about 3.3 percent. A commensurate upward adjustment in the benefits available under Hong Kong SAR's comprehensive social security assistance scheme could be an effective means to protect the vulnerable.

The GST treatment of financial services and immovable properties remain major issues under deliberations, due to the importance of these two sectors in Hong Kong SAR's economy. The mission's views on these issues are the same as those stated in the 2001 mission report. In

short, it would be important for Hong Kong SAR to ensure that the competitiveness of its financial sector would not be adversely affected by the GST's introduction. The merits and limitations of practices found in Australia, New Zealand, and Singapore are elaborated in the report, and the mission continues to take the view that the financial sector should either be zero-rated, or exempted but with provision of partial input tax recovery. As regards immovable properties, the report reiterates the preferred GST treatment: the sale and use of commercial properties, whether new or existing, should be fully taxable, while only the sale of new residential properties should be taxed. Residential rental payments should be exempt to preserve neutrality between rental and owner-occupied housing services.

Revenue administration issues

In respect of revenue administration, the Inland Revenue Department (IRD) has asked for advice on management issues such as the organizational structure of a GST office, training needs of new and existing staff, the appropriate consultation activity, process design, and a checklist of the preparatory work required. The mission noted that there are both similarities and major differences between the administration of the GST and of other revenues collected by the IRD. While the functions required to administer a GST are identical to those required for the profits tax, and the two taxpayer registration bases are likely to have much in common, the differences meant that quite different approaches are needed for taxpayer audit and that, in general, a greater speed of operation is required for the GST. In organization terms, the mission noted that traditionally the GST is administered by the same department as that which collects income taxes and that structurally, at least in the medium term, a separate GST division is a sensible approach. The mission also noted that it sees no reason why the IRD could not handle the GST.

The mission identified the key tasks likely to be required in the lead-up to the GST's implementation but, in view of the uncertainty about the implementation date, did not attempt to lay down a timeline. A number of key implementation issues are identified, including the fact that it will be necessary to allocate funds to the implementation team prior to the passage of the GST law and that a lengthy period (preferably 6 months between the passage of the law and the implementation date) should be allowed for final taxpayer and administrative preparation. The mission also noted the importance of adopting a logical sequence to the implementation tasks. In relation to consultation, the mission noted a low level of understanding of the impact and operation of a GST within the business community. It was therefore seen as being necessary, in the next round of consultation, for the government to address not only the budgetary needs, the options for meeting them, and the justification for a GST, but also to illustrate clearly how the tax would operate, discuss its practical impact on all key sectors of the community, and to give an indication of the implementation timeframe and program. Finally, the mission outlined the needs of a comprehensive staff training plan for the GST administration.

Customs administration issues

The liability of imports into Hong Kong SAR to pay the GST will require a major change in the operations of the Customs and Excise Department (CED). At present its revenue interest is limited to only four types of excisable goods on importation. Closer control will become necessary when all imports become liable to pay the GST. Attention will also have to be given to transshipment goods, for they should have to pay the GST if they are diverted to domestic use. The importance of international trade to the economy makes it of paramount importance that existing port operations are not distorted, disrupted, or delayed by the new requirements. The mission has, therefore, outlined the type of new controls that will be needed to achieve the correct balance between customs control and trade facilitation. They will not affect the present control of excisable goods and goods subject to outward processing, or current intelligence-based operations in the port. If carefully implemented, the new controls should have minimal impact on the work of the port.

Operators of existing unloading premises will be required to give financial security (bond) to cover the GST on goods for which they are responsible if the goods are released without CED clearance and the GST is not paid. Importers and transshippers should be required to give information about their consignments to the CED before they take possession of their goods. A new computer system will be required to process the information, charge GST when appropriate, assess the revenue risk, and decide on any action to be taken by the CED. Special advance arrangements need to be made available for imports by road to avoid delay at the border. Payment of the GST on goods for re-export should be suspended if the importer guarantees payment in default of re-export. The movement of transshipment goods should be covered by bond to avoid payment of the GST on arrival. The CED needs to check on the exportation of goods on which GST payment has been suspended. The risk of goods being illicitly imported without payment of GST may require some increase in the presence of the CED in the port and closer cooperation with the Marine Department.

The mission also noted that a low-rate GST probably would not necessitate the introduction of tourist relief schemes. Should such schemes be offered, it would be important to set a suitably high refund threshold, and possibly restricting them to only sea and air departure points.