Executive Summary

Ensuring our future prosperity

Hong Kong's economy has recovered rapidly from the economic slowdown that it suffered a few years ago. We now need to ensure that our growth is sustainable and that we can continue to compete on the world stage and handle any future sudden economic crisis. Now is the time to put in place the necessary structure to secure our future growth and prosperity.

We cannot take our current good fortune for granted

Our simple, predictable, low-rate tax system, which encourages investment and rewards people for their hard work, is one of the main attributes that has enabled our economy to rebound and flourish so strongly. However, we need to recognise that, notwithstanding its relative strengths, our tax system has some fundamental flaws and weaknesses.

Existing tax base: flaws and weaknesses

Hong Kong's existing tax base is very narrow by international standards. We rely on only a very limited range of taxes and non-tax income to support our public expenditure. Income from these sources varies widely according to economic conditions outside our control. This has greatly constrained the Government's ability to make long-term plans and investment decisions to sustain our growth and development. It also affects our responsiveness to the challenges we increasingly face.

The international trend, especially in the Asia-Pacific region, is towards lower income tax rates as a means of increasing economic competitiveness. Hong Kong needs to respond to this challenge. Only with a broader tax base would we have room to cut our Salaries and Profits Tax rates sustainably, thus enhancing our attractiveness to internationally-mobile talent and capital. This is essential for our continued growth as a knowledge-based, high value-added economy.

The rapid ageing of Hong Kong's population will be accompanied by higher spending pressures on healthcare and services for the aged. At the same time, a large proportion of senior citizens will mean fewer people in the workforce generating Salaries Tax revenue.

We need a new source of secure and steady income

We need a new source of secure and steady income from a broader and growing tax base. With such a tax base, more citizens would become taxpayers and contributors to limited government resources, enhancing our community's sense of civic responsibility.

Why make a change at all?

Were we to do nothing, then in any future economic downturn we might need, as in the past, to increase taxes and cut expenditure on public services. We would also be forced to draw down on our reserves or borrow money from the international market. Possibly we would have to take all of these measures. This might adversely affect our credit ratings. Short-term fiscal responses such as tax increases would undermine our competitiveness in terms of attractiveness to foreign investment and retention of local and overseas talent. This would lead to rising unemployment, and lower incomes for those who were able to keep their jobs. As public spending goes mainly on education, health, social welfare and law and order, drastic cuts would hamper the quality of our services to the community and not be conducive to social harmony.

We cannot afford to stand still: our competitiveness would erode

The present strong recovery of Hong Kong's economy provides us with a respite to address the inherent flaws and weaknesses of our tax system, so that we would be better able to withstand future economic and social challenges. By initiating tax reform during an economic upturn, we are not under pressure to raise the total tax burden; and we could undertake tax reform in a revenue-neutral manner for at least the first five years.

What are the options?

Many options have been suggested by the community and studied by the Government as possible solutions to our tax base problems. Most of these options, such as increasing Salaries Tax, Profits Tax, Stamp Duties or Rates, fail to meet the key requirement to broaden and hence stabilise the tax base. Higher tax rates on our existing narrow base would only exacerbate our fiscal volatility, cause financial instability and undermine our competitiveness. Introduction of a tax on worldwide income or taxation of capital income could, to a limited extent, broaden the tax base. These options would, however, involve a significant cost to our community as they would add complexity to our tax system and weaken our ability to compete.

Only two meaningful options

Only two options can broaden our tax base in a meaningful manner. The first would be a major reduction in personal allowances so that nearly all wage and salary earners would be brought within the Salaries Tax net. This option would also flow on to individuals electing for Personal Assessment. The second would be the introduction of a Goods and Services Tax (GST).

Reduction of personal allowances would cause hardship

Hong Kong has been using its personal allowances as a means to provide financial relief to individuals and households with dependants. A drastic reduction of personal allowances would therefore cause financial hardship. Also, reduction of personal allowances would bring into the tax net those wage and salary earners who currently pay no Salaries Tax. People whose income is not assessed for tax purposes would remain outside the tax net. Although the reduction of personal allowances would bring in a substantial number of new taxpayers, the total amount of their tax contribution would be small: most of the additional revenue would be contributed by current taxpayers through increased tax liabilities.

A substantial reduction in personal allowances would not address concerns over an ageing population as this would still leave our tax base overly reliant on taxation of income.

GST has many advantages

Of all the options available, the Government believes that a low and simple GST, being a general consumption tax, would be the best way to broaden the tax base. A low, single-rate GST would be preferable because:

(a) **it can produce stable and predictable revenue** as it is based on consumption expenditure, which does not fluctuate to the same extent as income or asset values;

(b) **it would be broad based** and thus can be levied at a low rate to produce significant revenue;

(c) **it is fair** as individual consumption determines the amount of tax paid, as the more money one spends, the more tax one pays;

(d) **avoidance is relatively difficult**, due to its multi-stage taxing and crediting mechanism (which means the tax revenue at each "stage" is limited to the value added or margin at that stage);

(e) **everyone who purchases from registered businesses pays the tax** irrespective of their background, income level or other circumstances. Even if a person's income is not assessed for tax purposes, the person will still pay the GST when they spend;

(f) **it is capable of growing in line with consumption** in the economy, even with an ageing population; and

(g) **it would maintain Hong Kong's competitiveness** and our low-tax business environment as a means of attracting foreign investment and talent.

GST would deliver a robust and stable tax base

Tax reform through the introduction of GST would deliver a robust and stable tax base for the future growth and prosperity of our community. There may be alternatives, but these are likely to be less advantageous to Hong Kong's future prosperity and competitiveness.

The GST that is proposed for Hong Kong would have a low rate and be broad based. For illustrative purposes in this consultation document, we have used a GST rate of 5%. The actual rate, once determined, would remain fixed for at least five years.

GST would be a simple tax

GST would have very few exemptions (mainly exports, financial supplies and residential property) and a high turnover threshold for registration by businesses ($5 million annual turnover is proposed), under which most small and medium-sized businesses would not be required to register. Voluntary registration would be available for businesses below the registration threshold.

International experience has shown that exemptions add to complexity and create compliance and revenue-collection problems. To provide simplicity, ensure a robust tax base and avoid inequitable distortions, we would apply the tax to a broad base that would include transport, food, healthcare, education and most other household consumption expenditure.

Rather than complicating the GST system with special exemptions that increase compliance costs and narrow the tax base, we propose to address the cost of living impact of GST on households through reductions to existing taxes and targeted compensation measures, particularly for low-income households.

Some important features of the proposed GST framework include:

(a) **exports of goods, international supplies, and financial supplies, would not be subject to GST**. This approach would be consistent with overseas practice and would ensure our import and export trade, logistics and financial services sectors would remain internationally competitive;

(b) **generous GST postponement schemes would be provided** to alleviate the cashflow issues of importers arising from GST;

(c) **a Tourist Refund Scheme would be included** to allow visitors to obtain a refund of GST on goods they had purchased in Hong Kong and were taking home with them;

(d) **sales and rentals of residential property would not be subject to GST**. This would minimise the GST impact on home-buyers and would be in line with the more common international practice. Sales and rentals of non-residential property would be subject to GST;

(e) **the Government would be GST-registered** and account for output and input tax to provide a level playing field with the private sector; and

(f) **charities would be treated as "taxable persons"** to allow them to reclaim the GST they had paid on purchases.

First five years revenue neutral

It is the Government's intention that the tax reform package would not need to generate additional revenue. It is our plan that, for the first five years after GST introduction, all revenue so generated (after deducting administrative costs) would be returned to the community as tax relief and other compensation measures. We also propose that all key elements of the tax reform, once finalised and introduced, would remain unchanged for the first five years.

Opportunity to reduce existing taxes

Introduction of a broad based GST would provide us with an opportunity to reduce existing taxes and charges, thus relieving the burden on taxpayers and users of government services.

Relief measures for households

Overseas experience is that a relief or compensation package is usually introduced upon the launch of a GST to compensate those affected for the impact on their livelihood through any increased living costs.

The Government is likewise committed to delivering relief to households in Hong Kong as part of our proposed tax reform package. Accordingly, the following measures are proposed alongside the introduction of GST:

(a) **reduced tax rates for all existing taxpayers** including rates for Salaries Tax, Personal Assessment, Property Tax and Profits Tax for unincorporated businesses. These reductions would also enhance our competitiveness in attracting and retaining talent;

(b) **an upfront, one-off supplement equal to the estimated GST impact on the Social Security Assistance Index of Prices (SSAIP) would be provided to households** under the protection of Comprehensive Social Security Assistance (CSSA), with actual price adjustments to follow in subsequent years. This group would be fully compensated for GST's impact on price levels, as the inflationary effect would be fully accounted for;

(c) **for low-income households not in receipt of CSSA, an annual cash GST allowance of $2,000 would be provided** on a per household basis;

(d) **an across-the-board annual "GST credit" of $500 per household** to be used against water and sewage charges for an initial five-year period, which would be subject to review after that; and

(e) **an across-the-board annual "GST credit" of $3,000 per household** to be used against Rates for an initial five-year period, which would be subject to review after that.

Please see Chapter 6 for details.

Business tax relief and other offsets

Our proposed measures include the following:

(a) **Profits Tax rates would be cut** to boost Hong Kong's attractiveness to business;

(b) **Capital Fee would be abolished** to encourage more businesses to incorporate in Hong Kong;

(c) **reductions would be made in Motor Vehicle First Registration Tax and Duties on Liquor, Petrol, Diesel, Aircraft Fuel and Methyl Alcohol**, so that, were GST to be introduced, the total tax level would not increase for these particular items;

(d) **charges for import and export declarations would be cut** to boost the competitiveness of our import and export trade;

(e) **Hotel Accommodation Tax would be abolished** to avoid double taxation together with GST;

(f) **tax deduction limit for charitable donations** would be increased; and

(g) **one-off set-up assistance** (which might be in the form of a subsidy for the purchase of GST-related IT equipment and software) would be offered to small and medium-sized businesses and not-for-profit organisations that were voluntarily to register for GST.

Please see Chapter 7 for details.

Options for remaining funds available

It is estimated that there would be approximately $20 billion remaining after meeting all administrative costs and the costs of providing the proposed household, business and charities compensation measures. There would be many options available to return the remaining balance of funds to the community in the form of tax relief or other alternatives.

Should we aim to devote the remaining balance of funds to Salaries Tax reduction, we could either lower the tax rates or widen the bandwidths, or both.

Alternatively, we could use the funds to reduce the Profits Tax rate to enhance our business competitiveness.

A further option could be to use the funds to increase public expenditure. Additional spending could be directed to education, health, social welfare, law and order or infrastructure so as to enhance public services for our community.

Please see Chapter 8 for details.

Enhancing Hong Kong's competitiveness

Overall, the proposed tax relief and other offset measures have been chosen to relieve the impact of the proposed introduction of GST on individuals and businesses, to enhance the competitiveness of Hong Kong's economy and to reinforce our key objective in undertaking tax reform: to ensure our future prosperity.

Impact of GST

GST would have a temporary, modest (though wide-ranging) impact on household living costs. For example, with a 5% GST, the one-off, short-term price increase is estimated to be approximately 3%.

Now is the time for action

A well-designed tax reform package, with suitable tax offsets and other compensation measures would be capable of addressing the long-standing flaws and weaknesses of Hong Kong's tax system.

The longer we leave these issues unresolved, the worse they will become and the more drastic would be the action required in the event of the next economic downturn.

Consultation is the key to moving forward

As our present economic circumstances and those in the foreseeable future are positive, we have an opportunity through this consultation process to think clearly about this important issue. We do not need to rush into a decision and can take our time to consult, consider and plan the best approach to reform our tax base and manage our public finances.

We seek contribution and debate

As the introduction of tax reform would have implications for the entire community, we shall progress this issue cautiously and meticulously. We welcome your views on this consultation document, in particular on the proposed GST framework, the household compensation package and other tax changes and relief measures. The proposals put forward in this document are not meant to be conclusive, but have been drawn up as the basis for stimulating rational and informed discussion on this subject.

Over the consultation period, which will run from mid July 2006 to 31 March 2007, government representatives will be participating in numerous public meetings and appearing on the radio and television. We encourage the community to join in and make their views known. Every part of this debate will be transparent, and questions and comments are actively sought.

To allow the community as wide an opportunity to contribute as possible, a dedicated website has been established. This will allow for views and comments to be forwarded. We also welcome comments and views by e-mail, by post or by fax at the following addresses and fax number:

Website : www.taxreform.gov.hk

E-mail : taxreform@fstb.gov.hk

Post : Tax Reform
Financial Services and the Treasury Bureau
4/F, Main Wing, Central Government Offices
Lower Albert Road, Central, Hong Kong

Fax : 2868 5641
Attention: Tax Reform

An electronic copy of this document, other relevant reports and information leaflets relating to this consultation are available at the website www.taxreform.gov.hk. Further information will be posted on to this website throughout the consultation period.

As part of the consultation process, we may wish to reproduce and publish your views in whole or in part. Unless you specify a reservation, we shall assume you have given us permission to do so.

Make your opinion count

We will consider all community views carefully before making a recommendation as to whether, and if so, how, Hong Kong should pursue tax reform and introduce GST. We will also take into account your preferences in terms of the mix and value of measures to distribute the balance of surplus funds as additional tax relief, compensation measures or to increase public expenditure to enhance public services for our community.

Please contribute to the debate