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HONG KONG SAR

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

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Preface

In response to a request from the Hong Kong SAR authorities for further advice on policy and administrative issues in introducing a goods and services tax, a mission comprising Messrs. Howell H. Zee (head), Graham Holland (FAD), and Michael Welling (FAD expert) visited Hong Kong SAR during April 19-May 3, 2004. This report contains the mission's main findings.

During its stay in Hong Kong SAR, the mission held discussions with, at the Financial Services and the Treasury Bureau: Mr. Frederick Ma, Secretary; Mr. Alan Lai, Permanent Secretary (Treasury); Mr. Tony Miller, Permanent Secretary (Financial Services); Mr. King-chi Au, Deputy Secretary (Financial Services); and Mr. Martin Glass, Deputy Secretary (Treasury); at the Economic Development and Labor Bureau: Mr. Raymond Fan, Deputy Secretary (Economic Development); at the Inland Revenue Department: Ms. Alice Lau, Commissioner; at the Customs and Excise Department: Mr. Lawrence Wong, Deputy Commissioner; at the Census and Statistics Department: Mr. Hing-wang Fung, Deputy Commissioner; and other senior officials. The mission also met with various interested private sector business and professional associations.

The mission is grateful to the authorities for their hospitality; and to Mr. Paul Gruenwald, IMF Resident Representative, and his staff for their assistance.

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 transhipment 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 transhippers 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 transhipment 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.

I. Introduction

The need to broaden Hong Kong SAR's tax base has not lessened—indeed it has been heightened if anything by recent budgetary developments—since an FAD mission in 2000 provided advice to the authorities on designing and implementing a goods and services tax (GST) in the territory.[1] Hence, the introduction of such a tax remains high on the authorities' policy agenda.

A. Background

As is well known—and clearly noted in the 2001 mission report, Hong Kong SAR has one of the lowest tax revenue/GDP ratios in the world (about 10¼ percent in 2003/04), stemming largely from its extraordinarily narrow tax base. About 60 percent of the tax revenue is usually derived from taxes on salaries and profits (at statutory rates of 15½ percent and 17½ percent, respectively, in the same year),[2] with the rest largely derived from excise duties on a few goods and services and stamp duties on transfers of immovable properties, shares, and leases. There are no broad-based consumption-type taxes. Nontax revenue, the most notable components being land sales and investment income, is generally a major source of budgetary resources (amounting to about 6¼ percent of GDP in 2003/04). Table 1 provides the structure of tax revenue in 2003/04.

While low taxes bring obvious economic benefits, they also pose inevitable difficulties for the public finances: the narrow tax base has proved problematic for addressing rising structural budget deficits in recent years (reaching about 5½ percent of GDP in 2003/04—the overall budget deficit was about 1½ percentage points of GDP lower for the same year), and the reliance on nontax revenue has rendered budgetary revenue highly volatile over business cycles. These drawbacks prompted the government in 2000 to seriously explore options of broadening the tax base and reducing the volatility of budgetary revenue, and form an Advisory Committee on New Broad-Based Taxes (ACNBT) to consider the suitability of new types of broad-based taxes for introduction in Hong Kong SAR.

Subsequent to the issuance of the 2001 mission report, the government commissioned a *Tax Base Study* that assessed the merits and limitations of alternative options. This study, prepared by KPMG, recommended the introduction of a GST in Hong Kong SAR. This recommendation was formally endorsed by the ACNBT in its final report to the government

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[1] The findings of the 2000 mission are contained in the report prepared by Howell H. Zee, *et al.*, *Hong Kong SAR: Policy and Administrative Issues in Introducing a Goods and Services Tax* (FAD, 2001). This report is available in its entirety without modification on the Hong Kong SAR's government website.

[2] The indicated statutory rates of the salaries tax and the profit tax refer to the standard rate and rate on corporate profits, respectively. Profits of unincorporated businesses were taxed at 15½ percent in 2003/04. Both the standard rate on salaries and the rate on unincorporated profits are being increased to 16 percent in 2004/05, while the rate on corporate profits will remain unchanged.

in 2001, which explicitly called for introducing a GST that is designed along the lines suggested by the FAD mission. In his 2003/04 budget speech, the then Financial Secretary announced that the government had taken the position that a GST would be necessary for Hong Kong SAR, although the timeframe for its introduction was left unspecified. He also announced that the government would carry out a detailed study to consider issues of GST implementation. The current Financial Secretary reaffirmed these announcements in his recent 2004/05 budget speech. In the event, an internal interdepartmental Goods and Services Tax Study Committee (GSTSC) has been set up to conduct the study, which is to be completed by end-2004.[3]

B. GST and the Income Taxes

A GST is a tax on the consumption-based value-added of the economy (i.e., the value-added after excluding investment expenditure). In most countries, the combined base of the personal income tax (PIT) and corporate income tax (CIT) is much broader than this value-added, largely because interest income, capital gains, and a significant share of investment expenditure are included in the income tax base. In Hong Kong SAR, however, the combined base of its salaries tax and profits tax actually comes very close to the consumption-based value-added, since neither interest nor capital gains is taxable, and a generous initial write-off is allowed for most investment expenditure (some can even be fully expensed). Hence, technically, a GST, if introduced, would target almost the same tax base as the existing salaries and profits taxes, but through a different collection mechanism. This point, though mentioned in the 2001 mission report, seems to be little understood so far in most discussions about the GST in the territory.

The practical significance of the above point is that, for raising budgetary revenue, introducing a GST and raising income taxes (either through increasing rates or reducing salaries tax allowances) are close substitutes of one another from an economic (but obviously not administrative) point of view. It is sometimes argued that having a GST would broaden the tax base because a significant number of wage earners who are currently outside the salaries tax net would have to pay the GST. Yet, a substantially similar result could be achieved by reducing the current generous levels of salaries tax allowances that have led to the narrow coverage of the salaries tax in the first place.[4] Thus, the argument for introducing a GST in Hong Kong SAR could rest on two grounds: (1) revenue—having a GST would

[3] The GSTSC is chaired by the Permanent Secretary for Financial Services and the Treasury (Treasury), and comprises the Commissioner of the Inland Revenue Department; the Commissioner of the Customs and Excises Department; the Government Economist; a representative of the Commerce, Industry, and Technology Bureau; the Deputy Secretary for Financial Services and the Treasury (Treasury); and the Deputy Commissioner for the Census and Statistics Department. The Principal Assistant Secretary for the Financial Services and the Treasury (Treasury) serves as the secretary for the GSTSC.

[4] At present, there are less than 1.2 million payers of the salaries tax, out of a work force of about 2.2 million. Reducing salaries tax allowances is also a recommendation noted in the ACNBT's final report.

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.

C. Scope of the Report

The present report takes as its point of departure the 2001 mission report and addresses specific GST policy and administrative issues that have been raised by the GSTSC with the mission as it begins to complete its mandated GST study. Issues that were already addressed in the earlier report are given further elaborations here, although an attempt has been made to minimize duplication.

The report is organized under three major headings: policy issues (Chapter II), revenue administration issues (Chapter III), and customs administration issues (Chapter IV).

Table 1. Structure of Tax Revenue, 2003/04 1/

	In percent of	
	Total tax revenue	GDP 2/
Taxes on income and profits	61.4	6.3
Profits	36.9	3.8
Salaries	21.6	2.2
Rents	0.7	0.1
Personal assessment 3/	2.1	0.2
Excise duties	16.6	1.7
Hydrocarbon oil	2.8	0.3
Tobacco	1.8	0.2
Alcoholic beverages	0.6	0.1
Methyl alcohol	--	--
Betting	9.2	1.0
Motor vehicles (first registration)	2.1	0.2
Hotel accommodation	0.1	--
Stamp duties	7.8	0.8
Property tax (general rates)	8.7	0.9
Estate duty	1.2	0.1
Air passenger departure tax	0.6	0.1
Miscellaneous taxes	3.7	0.4
Total tax revenue	100.0	10.3
Memorandum items:		
Nontax revenue		6.2
Of which: asset sales		1.3
Investment income		2.1
Total revenue		16.5

Source: Data provided by the authorities.

1/ Fiscal year April/March.
2/ 2003 calendar year figure.
3/ Individuals taxed, at their own election, on the sum of profits, salaries, and rents at the same progressive rates of, after deducting personal allowances available under, the salaries tax. Personal assessment is considered a tax concession.

II. Policy Issues

The 2001 mission report identified four major aspects of GST design that would warrant Hong Kong SAR's close attention: (1) the treatment of financial services, (2) the treatment of immovable properties, (3) the treatment of small businesses, and (4) the applicable tax principle (destination vs. origin). It also employed the working assumption that the prospective GST rate would fall within the range of 3–5 percent. The authorities have sought elaboration on all of the foregoing issues, as well as a number of new issues, including the design of an offset package and necessary transitional arrangements. Each of these issues is discussed below. However, before addressing them, the mission would like to first tackle briefly an emerging issue of importance in the authorities' GST policy deliberations: the treatment of food.

A. Treatment of Food

The mission understands that exempting selected food items is a policy option under consideration by the authorities. In this connection, the mission simply wishes to underscore that the GST is first and foremost an instrument for 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).

The fundamental problem with exempting food items is that few of them, if any, can be differentiated clearly on the basis of the income levels of those who consume them. In a number of countries where food items are exempted (or taxed at a reduced rate), studies have shown that a significant share of the tax benefit has gone to the relatively well-off at a high cost to the treasury. The high revenue cost follows partly from the fact that the GST is ultimately a tax on consumption of which food typically accounts for a significant share (over 26 percent in Hong Kong SAR), and partly from the tendency of the exemption to expand in scope over time. The true cost of yielding to pressures for exemption at any point in time—however few the number of targeted food items may be initially—lies in the difficulty the government, having yielded once, will find in resisting pressures to exempt additional food items in the future.

Exempting food may also give rise to significant administrative cost because of boundary problems. For example, if instant noodles are exempt but other types of noodles are not, then a definition of "instant" would be required. If all noodles are exempt except when consumed on restaurant premises, then the treatment of take-away orders would have to be ascertained. Other similar examples abound. Thus, to address equity concerns of introducing the GST, an appropriately-designed offset package (further discussed in Section G below) may well be a better alternative to exempting food for providing assistance (if necessary) to the vulnerable.

B. Treatment of Financial Services

The treatment of financial services, which accounted for about 11.6 percent of GDP (inclusive of about 1.3 percentage points of GDP in insurance services) in 2002, is an important GST design issue for Hong Kong SAR as these services are highly mobile and face a fiercely competitive environment in the region. As is well known, taxing financial services under a credit-invoice GST is problematic because a significant share of such services is rendered without explicit fees, and is thus difficult to tax on a transaction-by-transaction basis. Recognizing this difficulty, the European Union (EU) decided to exempt most financial services. This exemption approach has been followed by most other countries that subsequently introduced a GST (or an equivalent value-added tax (VAT)). The scope of this exemption is generally broader in developing than in developed countries.[5]

Problems of exemption

It soon became clear, however, that the exemption approach—by breaking the credit-invoice chain—would lead to cascading. The nature and severity of the exemption-induced cascading is often not well understood by those not familiar with the mechanics of the GST. Often, cascading is simply referred to as a "tax on tax," but such a characterization is misleading and understates its distortive consequences. The numerical example below illustrates the issue involved, assuming the GST rate is 10 percent.

	GST-exempt business	GST-registered client	Final consumer
Value of inputs (exclusive of GST)	100	190	190
GST on inputs	10	0	0
Value-added	80	50	0
Value of output (exclusive of GST)	190	240	0
GST on output	0	24	0
Total GST revenue to government	10	24	0

The GST-exempt business purchases 100 in inputs, pays 10 in GST, contributes 80 in value-added, and sells 190 in output on which no GST is collected. If this output is purchased by a GST-registered client whose value-added is 50, the value of the output of the client would be 240, on which 24 in GST would be collected. The total GST revenue to the government as a result of the combined activities of the GST-exempt business and GST-registered client is thus 34, which exceeds 10 percent of the correct GST base of 230 (the sum of the value-added of the two parties plus the value of inputs purchased by the GST-exempt business) by 11. Only 1 of this 11 is technically attributable to the consequence of tax-on-tax (10 percent of the 10 in GST on inputs purchased by the GST-exempt business); the remaining 10 actually results from taxing the value of purchased inputs by the GST-exempt business twice. Hence, *each* exemption in the credit-invoice chain would lead to the *double taxation* of the *total value* of a good or service purchased at the stage prior to the exemption stage. The distortive impact of this cascading clearly far exceeds the mere tax-on-tax outcome.

Note that cascading would not result if the GST-exempt business sells to the final consumer. Indeed, the final consumer is undertaxed: it pays 190 for the output that has an embedded

[5] Developed countries, including those in the EU, tend to tax at least some fee-based financial services (the EU's 6th directive allows member countries to optionally tax financial services, except insurance).

value of 180, thus bearing a tax burden of only 10 rather than 18. The loss of 8 in GST revenue corresponds to the 10 percent of the 80 in value-added of the GST-exempt business.

The above example nicely brings out two problems of exempting a financial institution: its services would be (1) overtaxed if purchased by GST-registered clients but (2) undertaxed if purchased by final consumers. There is, however, a third problem in exempting financial institutions: the difficulty in ascertaining the share of their creditable input tax if they also provide fee-based—and hence taxable—services. This apportioning problem is present for any business that produces both taxable and exempt supplies, but it is particularly acute for financial institutions where attributing inputs to different supplies is inherently more difficult. It is, in fact, the cause of frequent disputes between financial institutions and revenue administrations.[6]

Alleviating measures

The 2001 mission report mentioned two alternative approaches Hong Kong SAR could adopt to alleviate the problems stemming from exempting the financial sector. While neither approach is capable of addressing completely all of those problems, either is preferable to the straightforward exemption approach.[7]

Fixed partial input tax recovery

Even if financial institutions are formally GST-exempt, they could be allowed to recover a part of the GST paid on their inputs. If the recovery percentage(s) is(are) fixed in advance, the problem of apportioning input tax credits would not arise. Australia and Singapore are two countries that have adopted such an approach, although each determines the recoverable input tax percentages(s) based on different conceptual considerations.

Australia

One consequence of the exemption-induced cascading is that an incentive is created for exempt businesses to "self supply" taxable services that they would have otherwise purchased from third parties had they been taxable. Australia's partial input tax recovery

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[6] In most countries, the apportioning procedure involves two separate steps: (1) identifying inputs directly attributable to producing taxable supplies—the GST on such inputs is creditable; and (2) attributing the remaining inputs to exempt supplies based on a formula such as the share of exempt supplies to total supplies—the GST on such inputs would not be creditable. Financial institutions and revenue administrations are prone to disagree on the first of these steps.

[7] The EU itself, as noted in the 2001 mission report, is considering replacing the exemption with a cash-flow approach to taxing the financial sector. The cash-flow approach would deliver the correct theoretical result but entail formidable administrative complications.

scheme (known as reduced input tax credits) has been designed to neutralize the self-supply bias. The following example illustrates the concepts involved.

Suppose an exempt bank requires a new software platform that has been estimated to cost (exclusive of the GST) 250 in materials and 750 in value-added (wages and profits). The difference in the GST-inclusive costs of self-supplying and outsourcing the platform is illustrated below, assuming a GST rate of 10 percent.

	Outsource	Self-supply
Materials (exclusive of GST)	250	250
GST on materials	--	25
Value-added	750	750
Cost of platform (exclusive of GST)	1,000	1,000
Cost of platform (inclusive of GST)	1,100	1,025

The outsourcing option is clearly more expensive for the bank because it has to incur 100 in non-creditable GST if it purchases the platform from a third party rather than 25 in non-creditable GST if it develops it in-house. In the example, if the bank is allowed an input credit of 75 (or 75 percent of its total input tax), the self-supply bias would be neutralized. Note that this neutrality would also be achieved if the outsourced supplier of the platform is itself exempted, since in that case it would simply have passed on the 25 in GST on materials to the bank but without charging the bank any GST on the platform.

Hence, if the objective is to neutralize the self-supply bias, the critical factor to consider would be the value-added of the potential outsourced supplier as a percentage of its total sales. Of course, this percentage would be different for different financial institutions using different suppliers. Australia has settled on a fixed partial input tax recovery of 75 percent based on the average of industry statistics.

Singapore

Singapore has also adopted a fixed partial input tax recovery approach—motivated not so much by the concern about the self-supply bias as by the desire to mitigate cascading when supplies of exempt financial institutions are purchased by GST-registered businesses. To illustrate the situation involved, consider an exempt bank that provides 1,000 in total services comprising 200 in purchased inputs (exclusive of the GST) and 800 in value-added. It also pays 20 in GST on the inputs, assuming the GST rate is 10 percent. Suppose its services are supplied to a GST-registered business and to a final consumer in the ratio of 70 percent and 30 percent, respectively. In the absence of input tax credits, cascading would have resulted on that part of its services supplied to the former, as shown below. The extent of the cascading is 15.4, representing the sum of 14 (which equals 70 percent of the bank's purchased inputs doubly taxed at 10 percent) and 1.4 (which equals the tax on tax). This cascading would be completely avoided if the bank is allowed to recover an input tax credit of 14 (70 percent of its GST of 20 on its inputs) that is targeted for removing the GST burden embedded in the services supplied to the GST-registered business. The final consumer in this case would remain undertaxed, as its consumption of the bank's services bears only the share of the GST on the bank's inputs (30 percent of 20); the final consumer's share of the bank's value-added is free of the GST altogether.

	Exempt bank	
	No input credit recovered by bank	Input credit recovered by bank
Value of inputs (exclusive of GST)	200	200
GST on inputs	20	20
Value-added	800	800
Value of output (exclusive of GST)	1,020	1,020
GST on output	0	-14
Total GST revenue to government	20	6

	GST-registered business		Final consumer
	No input credit recovered by bank	Input credit recovered by bank	
Value of inputs (exclusive of GST)	714	700	306
GST on inputs	0	0	0
Value-added	300	300	0
Value of output (exclusive of GST)	1,014	1,000	0
GST on output	101.4	100	0
Total GST revenue to government	101.4	100	0

In reality, it would of course be a burden on the bank to differentiate its customers on the basis of their GST registration status. Hence, Singapore uses industry statistics on the proportion of total services supplied by an exempt financial institution to GST-registered businesses to set the average percentage of recoverable input taxes for each of the 7 types of financial institutions (full banks, merchant banks, restricted banks, offshore banks, finance companies, life reinsurance companies, and nonlife reinsurance companies). While the use of these industry norms—which are revised yearly—eases their administration, they can clearly impact individual financial institutions differently. Indeed, even if a financial institution is representative of the industry (i.e., it matches the industry norm), cascading would not be completely eliminated. This can be seen by continuing with the above numerical example: if the bank does not differentiate its customers, a part of the input tax credit would actually go to benefit the final consumer, leaving the GST-registered business still burdened with cascading—albeit at a reduced level. Since the final consumer was already undertaxed before, the problem has worsened with the granting of input tax credits to the bank.

	Exempt bank	
Value of inputs (exclusive of GST)	200	
GST on inputs	20	
Value-added	800	
Value of output (exclusive of GST)	1,020	
GST on output	-14	
Total GST revenue to government	6	
	GST-registered business	Final consumer
Value of inputs (exclusive of GST)	704.2	301.8
GST on inputs	0	0
Value-added	300	0
Value of output (exclusive of GST)	1,004.2	0
GST on output	100.42	0
Total GST revenue to government	100.42	0

At first glance, it may also seem curious that life and nonlife reinsurance companies are included in the group eligible for partial input tax recovery scheme, since nonlife insurance is taxable just like a fee-based service and life insurance is exempt but has no cascading consequences (see further discussion below). However, as reinsurance transactions are conducted between insurance companies, it has been found that it is administratively simpler to exempt such transactions. To prevent exempt reinsurance increasing the cost of insurance (stemming from reinsurance companies passing on the burden of their input taxes through higher reinsurance premiums), fixed partial income tax recovery has also been extended to life and nonlife reinsurance companies, as determined by the industry average of the share of their total premiums from reinsurance.

Zero-rating

To prevent the benefit of any allowable input tax recovery granted to exempt financial institutions from flowing to final consumers (or to other GST-exempt businesses—including financial institutions themselves—that also purchase financial services as inputs), recoverable input taxes could be restricted only to financial services supplied to GST-registered businesses. This restriction is equivalent to zero-rating such supplies, and is known as business-to-business zero-rating of financial services in New Zealand (targeted for implementation in 2005).

New Zealand

The New Zealand approach is, in fact, conceptually identical to Singapore's approach, except that exempt financial institutions are required to ascertain the GST status of their customers, rather than apply the industry norm, to determine the extent of creditable input taxes. Continuing with the earlier numerical example, only the services supplied by the exempt bank of 700 to the GST-registered business would be zero-rated; the remaining 300 of services supplied to the final consumer/exempt business would remain exempt. As expected and illustrated earlier, the above outcome would be equally achievable by the Singapore approach if the latter mandates the financial institutions to target their recoverable input taxes only to remove the GST element in their supplies to GST-registered businesses.

<table>
<tr><td></td><td colspan="2">Exempt bank</td></tr>
<tr><td>Value of inputs (exclusive of GST)</td><td colspan="2">200</td></tr>
<tr><td>GST on inputs</td><td colspan="2">20</td></tr>
<tr><td>Value-added</td><td colspan="2">800</td></tr>
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<tr><td>Total GST revenue to government</td><td colspan="2">6</td></tr>
<tr><td></td><td>GST-registered business</td><td>Final consumer/GST-exempt business</td></tr>
<tr><td>Value of inputs (exclusive of GST)</td><td>700</td><td>306</td></tr>
<tr><td>GST on inputs</td><td>0</td><td>0</td></tr>
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<tr><td>Total GST revenue to government</td><td>100</td><td>0</td></tr>
</table>

Clearly, the New Zealand approach is capable of addressing the cascading problem, but at the price of administrative complexity. Since a GST-registered business typically produces a mixture of taxable and exempt sales, as a practical matter New Zealand allows the zero-rating of financial services supplied to a GST-registered business so long as the latter's taxable supplies are equal to or exceed 75 percent of its total supplies in a 12-month period. Details on the administrative procedures the financial institutions would have to follow to categorize their customers on the above basis are yet to be determined. One possibility would be to base the categorization on some reasonable assumptions for a set 12-month period that is subject to periodic reviews.

Modified New Zealand

Since the New Zealand approach is untested, its enforcement and compliance costs are unknown. However, a slight modification of the New Zealand approach—by removing its restriction on zero-rating—would completely overcome any potential administrative complications associated with its adoption. In essence, the modification, first mentioned in the 2001 mission report, calls for the zero-rating of all services supplied by a financial institution,[8] regardless of the GST status of its customers. The outcome of this approach is illustrated below based on the same numerical example used earlier.

	Exempt bank	
Value of inputs (exclusive of GST)	200	
GST on inputs	20	
Value-added	800	
Value of output (exclusive of GST)	1,000	
GST on output	0	
Total GST revenue to government	0	
	GST-registered business	Final consumer/GST-exempt business
Value of inputs (exclusive of GST)	700	300
GST on inputs	0	0
Value-added	300	0
Value of output (exclusive of GST)	1,000	0
GST on output	100	0
Total GST revenue to government	100	0

Aside from removing the potential administrative complications of the New Zealand approach, the modified New Zealand approach also addresses an implicit conceptual problem that can arise with the former: if a GST-exempt business that has purchased exempt financial services makes supplies to a GST-registered business, cascading would be re-introduced. It is unclear how the New Zealand approach would be able to address this problem—a problem that cannot arise with the modified New Zealand approach.

There is, of course, a price to the modified New Zealand approach: the revenue cost. As the numerical example clearly shows, this approach leads to a loss in GST revenue of 6 that

[8] Fee-based financial services should remain taxable.

arises entirely from letting the final consumer's purchases of financial services completely free of the GST. Based on 2002 data, intermediate consumption (i.e., inputs consumed) by the financial sector amounted to about 5.1 percent of GDP.[9] Thus, zero-rating the financial sector would lead to a *theoretical* maximum revenue loss in Hong Kong SAR of about 0.05 percent of GDP for every percentage point of the GST rate. In reality, as indicated earlier, the actual revenue loss would probably amount to only a small fraction of the indicated figure, as much of the value of the financial services would be recaptured in the GST base when such services are supplied to GST-registered businesses.[10]

Summary comparison

As noted earlier, none of the above approaches is capable of producing a perfect solution, but all are preferable to the exemption approach. The following table provides a summary assessment of the different approaches.

	Distortion on businesses	Distortion on final consumers	Revenue cost	Administrative complexity
Exemption	· Overtaxation	· Undertaxation	· Small, due to cascading	· In apportioning input tax credits
Fixed partial input tax recovery				
Australia	· Overtaxation is lessened but not eliminated	· Undertaxation is worse than exemption	· More costly than exemption	· Minimal
Singapore	· Overtaxation is lessened but not eliminated	· Undertaxation is worse than exemption	· More costly than exemption	· Minimal
Zero-rating				
New Zealand	· Overtaxation is largely removed · Problem with exempt-to-exempt transactions	· Undertaxation is same as exemption	· More costly than exemption	· Untested and potentially worrisome
Modified New Zealand	· Overtaxation is completely removed · Solves exempt-to-exempt transactions	· Undertaxation is somewhat worse than New Zealand	· Somewhat more costly than New Zealand	· Minimal

As can be seen, none of the approaches is capable of addressing the problem of undertaxation of final consumers. However, to the extent that these consumers face few close substitutes of financial services, the adverse impact on economic efficiency of this distortion is likely to be small.

[9] This compares with the figure of 3.9 percent of GDP based on 1997 data as indicated in the 2001 mission report.

[10] The separation of business and final consumer consumption of financial services is not ascertainable as input-output tables are as yet unavailable in Hong Kong SAR.

Insurance

The above discussion of financial services excludes insurance. The 2001 mission report addressed the GST treatment of insurance services. Some elaboration is provided below.

Life insurance

Life insurance is universally exempted under a GST or VAT. There are two compelling reasons for this treatment: (1) there is a significant savings element in life insurance, which should not be taxed under a GST that is supposed to be a tax on consumption; and (2) exempting life insurance produces negligible cascading, as almost all life insurance policyholders are final consumers. Of course, exempting life insurance means that some GST element is present in life insurance premiums as a result of taxable inputs purchased by life insurance companies. This burden should not, however, be a particular concern since some services are provided by life insurance companies to policyholders to undertake savings in the form of life insurance.

Nonlife insurance

While the EU exempts nonlife insurance, it is subject to tax in a number of countries as a fee-based financial service, including Australia, New Zealand, and Singapore. The New Zealand approach to taxing nonlife insurance is noteworthy because it corrects a problem that would arise if the GST is simply applied on the premiums of such insurance. Specifically, nonlife insurance would be overtaxed because the premiums include indemnity payments that do not represent considerations for services rendered. The New Zealand approach, which involves grossing up the indemnity payments by a deemed GST, is described in the 2001 mission report. It is summarized in the table below assuming an indemnity payment of 1,000 and a GST rate of 10 percent. This approach ensures that no GST is imposed on the indemnity payment component of nonlife insurance premiums.

	Insurer	
Indemnity payment (exclusive of deemed GST)	1,000	
Deemed GST	100	
Indemnity payment (inclusive of deemed GST)	1,100	
Deemed GST as input tax	100	
Net cost of indemnity payment to insurer	1,000	
Net GST revenue to the government	-100	
	Policyholder is GST-registered	Policyholder is GST-exempt
Gross indemnity payment received	1,100	1,100
Deemed GST on insurance policy as output tax	100	0
Replacement cost	1,000	1,000
GST on replacement cost	100	100
Net GST remission to the government by policyholder	0	0
Net GST revenue to the government	100	100

A similar approach is adopted in Australia with a minor variation: if the policyholder is GST-registered and so notifies the insurer, no grossing-up would be necessary and the policyholder would not report any output tax on the indemnity payment.

C. Treatment of Immovable Properties

While the real estate sector has been on a declining trend in recent years (accounting for only about 5.3 percent of GDP in 2002, compared to an average of over 10 percent during 1993–98) due to the general downturn in economic activities, it remains an important sector whose GST treatment needs to be carefully designed. The conceptual issues and country practices involved in taxing this sector have been well laid out in the 2001 mission report and need not be repeated here. However, a concise summary of the preferred GST treatments and their underlying rationale of various real estate transactions would probably be useful as a reference for policy makers.

The first category of real estate transactions is associated with the letting or leasing of residential and commercial properties. Exempting residential rents from the GST is usually justified on grounds that the implicit rental value of owner-occupied housing is infeasible to tax. In contrast, commercial rents should be taxed to avoid cascading. Even if the latter are to be exempt (say, because it is difficult to differentiate between the two types of properties), optional taxation should be provided if both the owner and tenant agree and are GST-registered. These considerations are summarized below.

	Preferred GST treatment	Reason
Residential	Exempt	To ensure neutrality between rental and owner-occupied properties.
Commercial	Taxable 1/	To avoid cascading.

1/ If exempt, provide optional taxation if both the owner and tenant agree and are GST-registered.

The second category of real estate transactions involves the sale of new or existing buildings. New buildings, whether residential or commercial, are no different from any other goods and services and should, therefore, be taxed. Taxing new residential buildings is particularly important to compensate for the subsequent exemption of rental payments (the price of a new building can be thought of as the present value of the future stream of rental payments that it can generate). Existing residential buildings should generally be exempt, as there is no justification to tax the same building multiple times under a consumption-type tax like the GST and let the tax burden on it to accumulate over time. However, at the time of the GST's introduction, many existing residential properties would not have been previously taxed, so an option exists to tax the first sale of such properties. Existing commercial properties should be treated in the same way as commercial rentals. These considerations are summarized below. An adjustment to the stamp duty rate on the transfer of immovable properties should be examined at the time of the GST's introduction.

	Preferred GST treatment	Reason
New		
Residential	Taxable	To compensate for rental exemption.
Commercial	Taxable	To avoid cascading.
Existing		
Residential	Exempt 1/	To avoid multiple taxation.
Commercial	Taxable 2/	To avoid cascading.

1/ If desired, existing residential properties could be taxed on a first-sale basis.
2/ If exempt, provide optional taxation if both buyer and seller agree and are GST-registered.

D. Small Business Exemption Threshold

Based on the 1998 annual surveys of various economic sectors in Hong Kong SAR, the 2001 mission report suggested setting a small business exemption threshold close to HK$ 5 million in annual business turnover. At that level, the number of potential GST registrants would be about 65,000. The authorities' own recent investigation produced a comparable figure of about 60,000.

The distribution profile of businesses by turnover as revealed by the 2002 economic surveys indicates that the above threshold remains broadly appropriate, as can be seen below.

Annual turnover	Cumulative number	Cumulative value-added
(In millions of Hong Kong dollars)	(In percent of total)	
< 1	48.4	2.0
1 – 4.99	77.2	8.9
5 –9.99	85.7	14.0
10 – 19.99	91.8	20.5
≥ 20	100.0	100.0
Memorandum items:		
Total number of business establishments	271,449 1/	
Total value-added		
In millions of Hong Kong dollars	651,059	
In percent of GDP	51.7	

1/ The figure does not include 260 storage facilities, 2,260 insurance companies and agents, and 143 banks. The distribution of these establishments by turnover is not available.

With an exemption threshold of HK$ 5 million, the above distribution data imply that there would be about 62,000 potential GST registrants contributing almost 90 percent of the total value-added. A breakdown of these establishments by type of business is given below.

	Establishments		Value-added
	Number	In percent of total	
Import and export trade	37,889	61.3	36.5
Transport	4,485	7.3	13.7
Wholesale	4,112	6.7	1.6
Building and construction	3,041	4.9	7.6
Manufacturing	2,885	4.7	8.3
Restaurants	2,739	4.4	2.7
Retail	2,495	4.0	3.8
Business services	1,595	2.6	5.7
Nonbank finance	1,228	2.0	3.7
Real estate development	780	1.3	9.6
Architecture and engineering	234	0.4	1.1
Communications	193	0.3	4.3
Hotels	96	0.2	1.4
Total	61,772	100.0	100.0

It is interesting to note that import and export trade would account for more than 60 percent of the number of potential GST registrants and contribute over a third of the value-added. However, much of this value-added probably will not be in the GST tax base.

Some updated comparative information on the threshold levels in Australia, New Zealand, and Singapore is given below (see the 2001 mission report for a larger set of countries).

	Annual turnover GST exemption threshold	
	National currency	Equivalent U.S. dollars 1/
Australia	50,000	35,811
New Zealand	40,000	24,687
Singapore	1,000,000	586,441
Hong Kong SAR 2/	5,000,000	641,042

1/ Based on exchange rates prevailing on April 30, 2004.
2/ Indicative.

E. Destination Principle and Revenue Leakage

As is now well appreciated by the authorities, introducing a GST on a destination basis in Hong Kong SAR would present formidable challenges because the territory is tariff-free and the customs administration has little experience in collecting duties and taxes on imports (only four excisables are currently assessed duties upon importation). Moreover, the border between Hong Kong SAR and China is porous and would require a significant tightening of controls to prevent excessive abuse and leakage—especially by river trade vessels (RTVs)—if and when all imports (except transhipment goods and imports eligible for special relief schemes) become taxable under the GST. Concerns about revenue leakage at the import stage are, therefore, understandable. While such concerns are valid and should be addressed (see Chapter IV), they should not be exaggerated. The 2001 mission report contains a lengthy footnote on this issue that should perhaps warrant further elaboration. The footnote (on p. 19 of that report) is reproduced below in its entirety:

"In theory, a destination-based GST can be implemented without border controls through the use of the so-called reverse charging system. Under this system, all businesses, whether registered or exempt for GST purposes, are required to account (reverse charge) for the GST on their imports. If the importing business is GST-registered, the reverse charge is creditable against its output tax, thus producing no net revenue effect. If the importing business is GST-exempt (typically because of the small business exemption threshold), it would be required to file GST returns and remit the reverse charge to the tax authorities. Such a system of reverse charging is already being applied on imported services in many countries; it is also applied—often referred to as a postponed accounting system—on imported goods on intra-European Union (EU) trade as a transitional measure, as fiscal borders within the EU have disappeared. The basic problem with this system is that the leakage is likely to be severe. For example, there would be little incentive for GST-exempt businesses to account for the GST on their imports. If administrative resources have to be devoted to enforce it, it would negate much of the rationale for having the exemption threshold in the first place."

While leakage would indeed likely be severe if the collection of GST on imports were to rely entirely on a reverse-charging system—not recommended by the mission—instead of the more conventional system under which the GST is due immediately upon importation, the basic implication of the passage quoted above is that not all imports that manage to escape taxation at the import stage would necessarily result in a revenue loss. A revenue loss from such "leaked" imports would come about only if they are imported by GST-exempt businesses whose products or services do not get purchased by GST-registered businesses. An examination of the nature of imports into Hong Kong SAR destined for domestic use would provide a sense of the scope of possible GST leakage at the border. Imports that represent transhipments or are later re-exported are not relevant for determining the quantitative significance of the likely revenue loss.

Based on the 2003 trade statistics, the follow table shows the structure of retained imports by end-use category in that year.

Category of retained imports	In percent of	
	Total	GDP
Foodstuffs	9.1	3.7
Consumer goods	24.3	9.7
Raw materials and semi-manufactures	36.4	14.6
Fuels	6.8	2.7
Capital goods	22.5	9.0
Others	0.9	0.4
Total	100.0	40.0

Total retained imports in 2003 amounted to 40 percent of GDP. Of these, foodstuffs and consumer goods—the two categories of imports that most likely would make up the bulk of importation by GST-exempt businesses—accounted for only about a third of total retained imports, or only about 13.4 percent of GDP. Hence, even if a share of these imports crosses the border into Hong Kong SAR without paying the GST, the extent of the revenue loss would be limited.

The extent of possible revenue leakage could be assessed from a different perspective. There are four main modes of transport associated with imports into Hong Kong SAR. In 2003, the distribution of imports among these modes is as follows.

Mode of transport	Value of imports in percent of total
Air	34.5
Land	33.2
Ocean	27.9
River	2.9
Others	1.4
Total	100.0

The mode of importation that is the most problematic for the customs administration to exercise effective control—the RTVs—in fact accounted only for less than 3 percent of total imports. The foregoing observations are not intended to minimize the revenue risks associated with introducing a GST in Hong Kong SAR on a destination basis. They do suggest, however, that such risks, while certainly exist, should not be exaggerated.

F. Rate of the GST

The setting of the GST rate is ultimately a policy decision based on revenue considerations. In the Asia-Pacific region, the lowest observed GST/VAT rate at present is 5 percent, which can be found in Japan and Singapore. Too low a rate not only will raise inadequate net revenue, it would also not produce much of a stabilizing impact on budgetary revenue over business cycles. The 2001 mission report estimated that, based on 1999 national accounts data, a broad-based GST (i.e., a GST with few exemptions and with only exports zero-rated) in Hong Kong SAR would yield about 0.38 percent of GDP in revenue for every percentage point of the GST rate—a figure in line with the regional experience.

The present mission has taken the opportunity to re-estimate the GST base on the basis of the more recent 2003 national accounts data. As shown below, the updated estimated GST base is about 37 percent of GDP, which is, as expected, close to the earlier estimate.

	In billions of H.K. dollars		In percent of GDP	
Domestic consumption in domestic market 1/		723.9		58.6
Less likely GST-exempt consumption: 2/				
Rent, rates water, and household maintenance	- 130.7		- 10.6	
Household operation and personal care	- 22.7		- 1.8	
Medical and health care	- 30.5		- 2.5	
Education	- 17.1		- 1.4	
Total		- 201.0		- 16.3
Taxable domestic consumption in domestic market		522.9		42.3
Expenditure of nonresidents in domestic market		55.8		4.5
Private sector residential buildings 3/		36.0		2.9
Potential GST base		614.7		49.8
Less likely leakage 4/		- 153.7		- 12.4
Estimated GST base		461.0		37.3

1/ Includes government purchases of goods and services.
2/ Based on 2002 weights for components of domestic private consumption in domestic market.
3/ Based on the decomposition of private sector building and construction component (inclusive of costs of ownership transfer) of gross domestic fixed capital formation by the share of gross value of residential construction in total construction.
4/ Assumed to be 25 percent of potential GST base.

G. Offset Package

In most countries, a GST/VAT is introduced to replace existing sales-type taxes, so the need for an offset package for equity reasons is usually not particularly compelling. Nevertheless, a number of these countries (e.g., Australia, New Zealand, and Singapore) decided to introduce the GST as part of a broader tax reform package that also included reductions in the CIT or PIT (or both). The argument for an offset package is more compelling for Hong Kong SAR, as there are no existing sales taxes to be replaced by the GST.

The extent of any offset package depends in part on the policy maker's notion of the appropriate trade-off between budgetary revenue needs and equity considerations, and in part on an assessment of what is politically necessary to secure legislative passage of the eventual GST law. These are matters that can only be resolved by reference to the policy maker's value and political judgment. To assist the authorities' policy deliberations, the mission briefly discusses a few factors below that are relevant for the design of an offset package.

Protecting the vulnerable

A minimalist approach would be to assign to the offset package the sole objective of compensating the price impact of the GST on the vulnerable. The 2001 mission report estimated that a broad-based GST at the rate of 3 percent would lead to a largely one-off increase in the composite CPI by 1.9 percent (the increase ranged from 1.7 percent to 2.1 percent with respect to the CPI (C) and CPI (A), respectively).[11] The present mission has re-computed the price impact using the re-based CPI weights and the results are shown in Table 2 for a GST rate of 5 percent. In this case, the composite CPI is estimated to increase by 3.1 percent (the increase ranges from 2.9 percent to 3.3 percent with respect to the CPI (C) and CPI (A), respectively).[12] Hence, a minimal offset package could comprise a commensurate upward adjustment in the basic benefits of government welfare programs.[13] In Hong Kong SAR, this adjustment could be carried out through its comprehensive social security assistance scheme, which is a means-tested, non-contributory cash assistance social safety net program.[14]

Compensating taxpayers broadly

A more costly offset package could include reductions in the salaries and/or profits tax rates. However, other countries that have included such reductions in their offset packages generally had relatively high PIT and CIT rates; such reductions were, therefore, justified as measures to enhance savings, investment, and work effort. The current salaries and profits tax rates in Hong Kong SAR are already comparatively low by both regional and international standards. Hence, the argument for a general reduction in income taxes—much of the benefit of which could actually flow to the rich—does not seem persuasive.

Instead of reducing rates, consideration could be given to lowering salaries tax liabilities over a fixed period (including a one-off reduction). Should the authorities decide to adopt such a measure, it would be preferable to effect the reduction through a tax credit, which would

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[11] See Table 2 for an explanation of the nature of the different CPI indices.

[12] These estimates tend to understate the price impact somewhat because the GST may well increase the prices of the GST-exempt components of the consumption basket, because exemption does not remove the entire GST burden embedded in such components.

[13] The 1986 tax reform package in New Zealand that contained the GST's introduction included among many elements an increase in basic benefits by 5 percent to compensate for the price impact of the GST.

[14] This observation was also made in the ACNBT's final report.

provide the same tax benefit to all taxpayers, rather than a tax deduction, which would benefit taxpayers in the upper rate brackets more than those in the lower rate brackets.

Assisting small and medium enterprises

Another dimension of introducing a GST that could be taken into account in the offset package is the provision of some form of financial assistance specifically targeted at small and medium enterprises (SMEs) at the start-up of the GST. In Australia, as mentioned in the 2001 mission report, such assistance included immediate tax deductibility for SMEs of the costs of acquiring new equipment and software associated with preparing for the GST, as well as a AU$ 200 certificate that could be redeemed for purchasing GST preparation-related goods and services. The necessity and extent of financial assistance to SMEs would clearly depend inversely with the small business exemption threshold.

H. Transitional Arrangement

In countries where a GST is introduced to replace other sales-type taxes, there are usually two aspects to the design of a transitional arrangement: (1) the treatment of stocks and inventories that have already borne the taxes that are to be replaced; and (2) long-term contracts that traverse the date on which the GST becomes effective. Since Hong Kong SAR has no existing sales-type taxes, the first aspect is irrelevant.

The transitional arrangement for long term contracts is fairly straightforward. Two crucial dates should be taken into account: the date the GST legislation is enacted (date L), and the date the GST becomes effective (date E). For contracts entered into after date L, it can be assumed that the contractual parties have taken fully into account the impending GST in the terms of the contracts, thus requiring no special treatment. Under such contracts, supplies made after date E would be taxable as usual. For contracts entered into before date L, it should be assumed that the contractual parties are ignorant of the GST and would not have taken it into account in the terms of the contracts. Hence, it would be appropriate to zero-rate such contracts either for their duration (if they contain no review dates) or until their first review dates that occur after date L.

I. Miscellaneous Issues

The authorities raised a number of other miscellaneous issues that will be addressed only briefly in this report. The preferred GST treatment of ***supplies provided by governmental bodies and nonprofit organizations*** is to subject them to taxation if similar supplies are produced in the private sector. This ensures that the GST would not have a distorting impact on such supplies. ***Digitized services provided by nonresidents*** located outside Hong Kong SAR are equivalent to services imported into the territory. The GST treatment of imported services is clearly problematic. Many countries impose a reverse charge on such services to level the playing field between domestically-produced and imported services.[15] Under it, importers are required to account for the GST on the services upon importation. Of course, reverse charges are practically unenforceable if the importer is GST-exempt.

As a general principle, the ***rates of existing excises*** and excise-like taxes should not be changed when the GST is introduced. This would preserve the tax wedges that existed before the GST's introduction between excisables and non-excisables. The GST on the excisables should include the excises in its base.

[15] New Zealand has recently enacted such a reverse charge. However, the reverse charge in Singapore's GST has been suspended at present.

Table 2. Price Impact of GST 1/

	Composite CPI weights		CPI (A) weights 2/		CPI (B) weights 3/		CPI (C) weights 4/	
	Basket	GST exempt	Basket	GST exempt	Basket	GST exempt	Basket	GST exempt
Food	26.67	–	31.88	–	25.94	–	21.38	–
Housing	29.91	29.91	29.13	29.13	29.68	29.68	31.22	31.22
Electricity, gas, and water	2.98	0.31	3.99	0.43	2.81	0.29	2.02	0.21
Alcoholic drinks and tobacco	0.94	–	1.50	–	0.86	–	0.39	–
Clothing and footwear	4.13	–	3.36	–	4.47	–	4.55	–
Durable goods	6.24	–	4.96	–	6.93	–	6.73	–
Miscellaneous goods	5.70	–	5.25	–	5.58	–	6.43	–
Transport	9.01	–	8.23	–	9.05	–	9.94	–
Miscellaneous services 5/	14.42	7.55	11.70	5.25	14.68	7.77	17.34	9.99
Total	100.00	37.77	100.00	34.81	100.00	37.74	100.00	41.42
Memorandum items:								
Increase in price level 6/								
Composite CPI	3.1 percent							
CPI (A)	3.3 percent							
CPI (B)	3.1 percent							
CPI (C)	2.9 percent							

Source: *Monthly Report on the Consumer Price Index* (Census and Statistics Department, Hong Kong SAR), February 2004; and mission calculations.

1/ October 1999–September 2000 = 100.

2/ Based on households with average monthly expenditure of HK$ 4,500–18,499.

3/ Based on households with average monthly expenditure of HK$ 18,500–32,499.

4/ Based on households with average monthly expenditure of HK$ 32,500–65,499.

5/ Service in this category considered to be GST-exempt correspond broadly to those assumed exempt consumption items in estimating the GST base.

6/ Based on a GST rate of 5 percent. The change in each of the CPI index is computed as 0.05 multiplied by (100 – GST-exempt weights).

III. Revenue Administration Issues

As noted in Chapter I, no political decision has yet been on the GST's introduction, let alone the time frame for its implementation. Even if the decision on the GST is affirmative following the second round of public consultation to be launched next year after the GSTSC issues its report, the authorities are contemplating a preparation period of three to four years. This would put the GST's introduction date around 2008 at the earliest. Hence, it would be premature at this stage to attempt to lay out a detailed GST implementation path. Instead, the mission has decided to focus on a framework that will assist the Inland Revenue Department (IRD) in preparing for the planned public consultation and for GST implementation once the necessary political decision on its introduction is taken.

A. Impact of GST on IRD

Since the IRD has no significant experience with the management of indirect taxes, it may have difficulty in developing the operational requirements of a GST. One way of increasing the understanding of the way in which a GST operates is to evaluate the points of similarity and difference between the GST and a more familiar tax, such as the profits tax. It is then possible to draw some conclusions about the impact that those similarities and differences would have for the administration of the GST. A comparison between a typical GST and the current profits tax is given below.

Similarities

Common functions. The administrative functions required for both the GST and profits tax are very similar with respect to registration, taxpayer services, return and payment processing, audit, and debt collection. The weight given to each varies, but the basic structure and processes are similar.

Similar registration base. One of the implications of adopting a high threshold (as proposed) is that it is likely that virtually all taxpayers liable for the GST will already have been registered with the IRD and have had a business registration number (BRN) issued to them. In relation to the registration of new businesses, it seems that the processes for both taxes would be identical and that a person applying for a BRN will simply have to provide the IRD with an estimate of taxable sales and if they are over the threshold, a GST registration will also be recorded. The same number will be used for both the GST and profits tax.

Common legislative procedures. Some of the provisions of the Inland Revenue Ordinance (IRO) could be applied equally to a GST. While the mission has not attempted to review the entire IRO, it is clear from even a brief review that many of the definitions could be shared as well as a number of administrative issues such as those relating to the keeping of business records, appeal rights, certain penalty provisions, official secrecy and general powers to make rules and prescribe forms. However, most of the technical aspects of the GST would differ.

Self assessment.. For both the GST and profits tax, self assessment is the preferred operating system as it results in lower compliance costs for taxpayers, reduced administrative cost for the government, and at the same time can achieve a good compliance level. The IRD has commenced moving towards self assessment for the profits tax.

Verification of financial flows for compliance checks. Liabilities for both the profits tax and the domestic component of the GST are calculated by reference to financial transactions and commercial documentation. For both taxes verification at the audit stage is also conducted primarily by a review of the financial records, including books of account, bank account records, invoices, and statements of assets and liabilities. In some GST cases, the financial checks need to be backed up by physical checks of the assets (e.g., refund verification) but this is also quite usual for certain profits tax purposes (e.g., checks of repairs and maintenance or depreciation claims).

Differences

GST generates greater tax liabilities. While the relationship between a firm's GST and profits tax liabilities will depend on a number of factors (such as the relative tax rates, business profitability, and the sales mix between taxable and exempt or zero-rated supplies), it will often be the case that the GST will generate a far greater liabilities than the profits tax. Businesses in a loss position with no profits tax liabilities will still face GST liabilities. Even at the low rates being considered for Hong Kong SAR, these liabilities can be relatively significant. For example, at a 5 percent GST rate a business in the service sector with a turnover of just above the possible threshold of HK$ 5 million could have an annual GST liability approaching HK$ 125,000, assuming its value-added is 50 percent of total sales. As a result, incentives to evade differ between the GST and profits tax both because of the size of the liabilities and because loss-making businesses will still incur GST liabilities.

GST has higher levels of administrative activity. A monthly GST return filing cycle is likely to be appropriate for all taxpayers if the threshold is as high as HK$ 5 million. Clearly, this indicates that for the GST the number of returns filed, payments made, enquiries handled, and process actions required will be up to 12 times that of the profits tax. Not only are activity levels higher, the shortness of the filing cycle means that actions in respect of non-filers and late payers have to be completed more quickly than for the profits tax if the IRD is to avoid multi-period compliance difficulties.[16] Operationally, the GST has more in common with the high volume, fast turnaround requirements of a PAYE system than the profits tax.

[16] In this regard, it should be noted that the standard tax administration plan to complete all income or profits tax work in relation to a particular tax year before the following year ends has a direct counterpart in the GST. For the GST, the aim would be to complete the follow-up action on non-filers or non-payers within the month before the next return is due.

GST has higher refund claims. Unlike the profits tax, the GST will inevitably lead to a relatively large number of claims for refunds. These will arise in a number of situations, such as: (1) a significant proportion of supplies are zero-rated exports; (2) a significant capital expenditure has been undertaken and a claim is therefore made for an unusually large input credit; and (3) a business that is building up stocks either in the ordinary course of trading or at its commencement. Verification procedures not normally associated with the profits tax will be required, including, for example, highly targeted and very fast audits and more sophisticated risk management models.

GST legislative provisions are different and less complex. Some provisions apply equally to the GST and profits tax, but these are mainly related to the administrative and procedural issues. The core technical aspects of the GST and profits tax laws will differ markedly, as the former is primarily concerned with the timing, nature, and value of input and output supplies, while the latter is primarily focused on profits, deductions, and allowances. In many countries, the GST legislation is less complex than that required for income taxes. It is unclear whether this will be the case if Hong Kong SAR decides to introduce the GST. This is both because the existing profits tax legislation is simple and because many aspects of GST design have not yet been decided.

GST has simpler operational processes. Because there are fewer variables involved in the calculation of the GST than that of the profits tax, many parts of the process are simpler. For example, fewer forms are required and those that are needed are simpler, data capture is quicker, legal interpretations are less frequently required and, in general, are less complex. If the GST has a simple design, it will have fewer disputes than the profits tax.

Implications for GST administration

In view of the above similarities and differences between the GST and profits tax, some broad conclusions can be drawn about the design of GST administration.

Integrating the GST with profits tax management is relatively easy. Primarily because of the similarity of functions, it is relatively easy to incorporate the GST into the IRD. In addition, the registration task is relatively straightforward because generally, in a well managed and mature system, all of the potential GST payers should already be paying the profits tax.

A separate GST law will be required. The GST differs sufficiently from the profits and salaries taxes to warrant a separate legislation.

A different audit strategy is necessary. Several factors point to the need for a different approach to taxpayer audit than is appropriate for the profits tax. The frequency with which returns and payments are lodged, the level to which deficiencies can rise in a short time, and the demands for a speedy refund all require a greater frequency of audit. This implies that, when compared to direct taxes, in a GST system both a higher proportion of total staff are allocated to audit and a greater audit frequency is achieved. At present, the IRD devotes about 8 percent of total staff to audit and the average audit rate is about 1 percent (i.e., on average a profits tax payer can expect to be audited once in 100 years). In a typical GST system about 1/3 of all staff would be auditors and the audit ratio would be between 25 percent and 40 percent.

Accountability for the GST is shared. In almost all GST systems, accountability is shared between customs and the IRD. Customs generally has some form of physical control of goods at the time of importation and this provides an ideal (and particularly secure) opportunity to collect the GST before the goods are released into the domestic economy. The inland revenue responsibilities are limited to collecting the GST on domestic transactions and to verifying and paying all refunds, including those related to exports. A result of this shared collection is that almost invariably customs tends to collect a significant share of the net GST—in many countries this share is greater than that collected by the IRD. The share of GST collection by customs is positively related to imports as a share of GDP, and that by the IRD is inversely related to exports as a share of GDP.

A different staff mix is required for the GST. The generally lower level of complexity of a GST—in legal, operational, and process terms—means that the average educational qualifications of staff recruited for this tax could be lower than the profits tax. In practical terms, this means that fewer professional grade staff need to be recruited and that most of the work (including audit) can be performed by technical grade staff.

B. Major Organizational Considerations

Choice of department to administer the GST

An early decision on the department to administer the GST is necessary for a number of reasons, including:

- departmental staff are less likely to be fully committed to development activities if there are doubts about whether their organization will be responsible for the new tax;
- funding needs have to be identified and allocated to a specific department;
- the business community needs to know who it will be dealing with so that it can begin the informal consultation and discussion process; and
- management structure, staff size, financial requirements, and operational design cannot commence in any meaningful sense until the administering department is identified.

Traditionally, there are three options which the authorities can consider. The GST could be administered by: (1) the customs department, (2) the IRD, or (3) a new GST department.

The choice between the options will involve a consideration of three basic issues:

- the ease with which the GST can be integrated with the responsibilities of each of the existing departments;

- the capacity of each of the existing departments to take on a major new responsibility; and

- the operating costs associated with each option.

The decisions taken in a range of countries on the choice of the department to administer the GST is provided below.

	Administered by IRD or equivalent department	Administered by Customs department	Administered by separate GST department
EU	10	1	2
Non-EU European	14		1
BRO 1/	15		
Latin America	18	1	3
Africa	18	1	5
Asia-Pacific	13		
Middle East	1	1	2
North America	1		
Total	90	4	14

1/ Baltic States, Russia, and other states of the former Soviet Union.

Customs department

As the above table indicates, few countries have selected the customs department to administer the GST. The reasons for this are basically that customs almost always has less experience at revenue collection than the IRD and that what experience it does have is with taxes or duties where compliance is primarily achieved through physical controls rather than the financial controls required for a GST.[17] In Hong Kong SAR, customs has virtually no experience of revenue collection (apart from a few excises) and it would be a major stretch for them to collect the GST on domestic activities. Customs will always be responsible for the collection of GST at the import stage and preparation for this is already a formidable task.

IRD

Generally, the administration of the GST finds a natural home with the department collecting income-based taxes because of the similarities of function and the fact that liabilities for both taxes are calculated from the same financial records. GST payers will generally already have been registered with the IRD and taxpayer agents are familiar with its practices. While audit

[17] Despite these factors, there have been some good successes where customs has administered a GST—the United Kingdom being the best example.

strategies may differ, as noted earlier, there is scope for joint investigation where fraud is suspected. The mission has not conducted an assessment of the capacity of the IRD to manage the GST, but on the basis of discussions with its senior staff, its observed commitment to GST preparation, and the good state of its operating processes, the mission has no reason to doubt its capacity to take on the GST administration.

New GST department

If there are serious doubts about the capacity of the existing departments to take on the new GST responsibility, an option would be to create a new department to administer the GST. In countries where such a decision is taken, it is generally a part of a broader modernization effort to amalgamate the responsibilities of the existing departments targeted for reform with those of the modern GST department after the latter's operation has matured sufficiently. This is an inherently more expensive option than using either the customs or IRD as it would duplicate a number of the management and support functions of the existing departments and, therefore, the benefits of economies of scale are lost. In addition, it is probably also a riskier option, as inevitably untried management teams are involved in the development and the scarce skilled resources in all existing departments could be diluted. Such risks would be worth taking if the existing IRD is performing poorly, but unnecessary if otherwise.

Organization of resources for administering the GST

Once the decision on the department to administer the GST is made, the next important organizational issue is how best to deploy the resources of that department for the new tax.

Customs. If Customs were to be selected, the task would be sufficiently different from its traditional role to require the creation of a separate division within the department. New sections would be required to deal with registration, taxpayer services, return and payment processing, and audit. Senior management and major services would be provided to the division by customs headquarters.

IRD. If IRD were to be allocated the task, it would have two options to consider. It could either integrate the GST functions within its current structure or it could elect to establish a separate division to handle them.

The riskier option is the integration approach as it would divert the attention of profits tax staff towards the new function at a time when it is important to ensure that the current revenue base is maintained. In addition, immediate integration would deny the organization the opportunity of developing the specialist approaches required for the new functions, such as refund management and a revised approach to audit. Finally, there are two other important prerequisites for the successful integration of the GST into the present IRD structure: the prior existence of a functional organizational structure and the absence of significant changes to that structure. Adopting the integration approach in Hong Kong SAR might be unnecessarily risky as: (1) the IRD does not currently have a functional structure; (2) it is part way through the introduction of a self assessment system; and (3) it is likely to take on some additional responsibilities as part of any offset package associated with the introduction of the GST.

Hence, the safer option is for the IRD to establish a separate division for the GST. If this option is followed, the GST division would be responsible for the principal operation functions, but would rely on the rest of the organization to provide services such as management oversight, personnel management, planning, policy development, and IT design and delivery. A separate division ensures that the rest of the revenue administration activity is largely insulated from the new activity and it is therefore less likely that problems with implementing the GST would spill over into the profits tax. In addition, creating a separate division provides enhanced opportunities for the development of specialized GST skills and also simplifies the establishment of activities which have no parallel in the profits tax, such as GST refund controls. The creation of a separate division does not preclude the eventual absorption into the core of the department once the GST operation has fully matured. Australia and New Zealand both established a new division to manage their GSTs. New Zealand ultimately absorbed the unit into the rest of the department and now has no separately identifiable GST structure.

New GST department. A new department would, of course, require the establishment of a completely new revenue administration structure, including all management, operational, and service functions.

C. GST Implementation

It is normally possible for a well managed revenue administration to complete the GST development tasks within a period of 18–24 months. As already noted, the GST's introduction in Hong Kong SAR is still in the study and consultation stage. There is, therefore, little point in the mission providing a detailed timeline for implementation. Instead, this section (1) discusses key issues that need to be considered when implementation commences; (2) identifies an indicative list of key implementation tasks; and (3) provides advice on two specific issues raised by the authorities—the consultation process and staff training needs.

Key implementation issues

Many of the world's GST systems have been introduced relatively recently and it is possible to identify some key features of the more successful implementation programs. The following are the main features.

Implementing department will require assistance. The GST implementation is a large activity that will severely stretch the resources of the administering department. That department will most likely not have the numbers or mix of specialist skills required for the task. Often, the GST implementation is seen as being a broader public sector responsibility and assistance is afforded by other departments providing officers to work with the GST development team. For example, if the IRD were to administer the tax, its development team could be supplemented with officers on loan from the Customs and Excise Department, the Financial Services and Treasury Bureau, and the Census and Statistics Department. Additional assistance might be provided by other departments to assist with the large recruitment task.

Funding will be required before the law is passed. It is likely that the implementation team will incur quite significant expenditure before the law is passed and the best practice has, therefore, been to provide a special financial allocation to the administering department. Examples of the expenditure likely to be incurred prior to the passage of legislation are:

- departmental costs to backfill the vacancies created by seconding staff to the implementation team;
- accommodation costs for the implementation team and the initial staff recruitment;
- IT development costs for applications completed prior to passage;
- consultancy expenditure on specialized issues, such as IT development and law drafting;
- printing costs of consultation materials; and
- advertising costs associated with consultation.

Full time development team will be required. As soon as the decision to introduce the GST is taken, a full time team will need to be established. It needs to be headed by a senior member of the administering department. While it is impossible to forecast the size of the team, the mission notes that one country with a staff size similar to the IRD initially allocated 8 people to the team and saw that number grew to a core of about 20 within 6 weeks, expanded to nearly 100 at the peak development period (when members were working at the same time on writing manuals, developing the IT system, and preparing training materials), and fell back to about 20 for the final period.

Development time should be short. The development period should be kept as short as possible. Most countries, as noted earlier, took 18–24 months. The reasons for keeping it short are to (1) avoid the building-up of pressures from lobby groups for special GST treatments of their sectors; (2) to maintain focus of both management and staff on the task at hand; and (3) to reduce development costs and avoid delays in revenue collection.

Passage of the GST law should precede application date by a reasonable period. It is necessary to allow a period of about 6 months between the passage of the legislation and the commencement of the GST to enable the administration and the business community to complete their preparations with knowledge of the final shape of the tax. More specifically, time needs to be given to enable the following to be done with the benefit of the certainty of the GST law:

- initial registration of GST taxpayers and completion of taxpayer education;
- final printing of forms and issuance of first tax returns to registered taxpayers before the first return date;
- completion of the IT system so that it reflects the final statute; and
- provision of time to the business community to amend their computer systems, redesign processes, train staff—tasks many will be reluctant to undertake until the law is passed.

Key implementation tasks

Implementing a GST is a complex and large project. It is complex because it requires careful coordination of policy decisions, legislation, design of operating structures, development of IT, recruitment, staff training, and taxpayer education. It is large because its scale involves hundreds of staff, many thousands of taxpayers and millions of transactions. Appendix I sets out the principal tasks that the mission envisages will need to be carried out during the implementation phase.

Although it is impossible at this stage to indicate the timing and likely duration of each of these tasks, it is important for management to appreciate that there is a general sequence which will need to be broadly followed during the implementation phase. This is presented in Appendix II. While this chart oversimplifies the process somewhat, it indicates that there are at least two interrelated flows of activities.

One flow of activities relates to the organization design and deals with issues such as choosing the department to administer the tax, ascertaining the size of the workforce, determining the structure of the GST division, and recruitment of staff. A prerequisite to dealing with this type of issues is a decision to proceed and the making of the broader policy decisions on issues such as the nature of the GST (credit-invoice or subtraction method) as well as issues that affect its complexity such as the level of the small business exemption threshold, the number of tax rates, and the scope of exemptions.

The second flow of activities is the more detailed operational stream that requires not only the major policy decisions, but also the lower level decisions on issues such as the definition of supply and time of supply, setting valuation rules, the treatment of groups and branches, return cycles, and the treatment of special areas such as auction sales and agents. These decisions are needed to enable operational tasks to be designed in a logical sequential order: (1) design processes, (2) develop the IT system, (3) produce manuals, (4) prepare staff training packages, (5) train staff, and, finally, (6) educate taxpayers.

Specific issues raised by the authorities

The mission has been asked to provide advice on the required consultation process and on staff training needs.

Consultation process

The consultation process adopted during both the lead-up to making a decision on the GST's introduction and the ensuing period following the decision is very closely tied to political realities. It is, therefore, difficult to draw detailed conclusions as to what is appropriate for Hong Kong SAR. However, some observations can be made.

Often, a clear distinction is drawn between (1) the political task of marketing the need for a change in the tax system, and (2) the essentially administrative tasks of preparing for the implementation of the tax and educating businesses and taxpayers in their responsibilities under it. From this perspective, there are three different phases that can be identified.

Marketing phase. A senior politician is generally responsible for presenting to the public and the business community the need to introduce the tax, together with an explanation of the options considered and an assessment of the costs and benefits of each. Often, this will involve a broad publicity campaign, including television advertisements, letter drops of explanatory pamphlets, and a series of government media releases. It is common for this phase to be managed by a special appointee with standing in the business community who would report to the Financial Secretary. The appointee would often lead a steering committee established to receive feedback from society and provide a report back to the government on public attitudes to the proposed tax. The GST administering department's involvement during this phase would be limited to assisting with the preparation of the materials, providing technical advice, and assisting with the evaluation of any submission from the public and the business community from a technical and policy development perspective. Funding for its activities during this phase would be provided to the appointee's office, not to the administering department.

Post-decision consultation phase. At this stage, it is likely that the department selected to administer the GST would be heavily involved in the development of a consultation document which would provide the first real detail on the key policy decisions and information on how the GST will operate. An independent GST review committee could well be established and a formal process developed under which submissions from the public and the business community are received and hearings held. The administering department is likely to be asked to form a secretariat to assist the committee. The output from this phase will be a review report to the Financial Secretary that would form the basis for the final decisions leading to the presentation of the GST legislation to the legislature.

Taxpayer education phase. The administering department would be responsible for educating taxpayers to ensure that all businesses are aware of the GST's registration requirements and to provide operational advice and assistance to those who do register. In effect, this is the standard administrative responsibility to inform taxpayers, although it is likely to differ from other similar activities because of the level of the assistance required. During this phase, many countries have undertaken one-on-one advisory visits to all newly registered businesses, as well as issued special registration pamphlets, GST guides, and industry specific materials. The activity level is intense during the period between the passage of the legislation and the completion of the first return cycle.

Hong Kong SAR's situation. One round of public consultation has already been conducted (in 2001), and the normal expectation would be for the government to take the next step of announcing the GST decision to allow detailed preparatory work to begin. However, the government has decided to undertake a further round of public consultation upon the completion of the report by the GSTSC.

Assessing the information needs of society and, therefore, the shape of any consultation document, would require more research and analysis than has been possible during this mission. However, the mission has met with members of the business community and, although their information needs were not discussed in detail, it was clear that there is a low level of appreciation of what a GST is, how it would operate, and what its impact would be. Hence, for the next round of public consultation, the mission believes that it should be used as an opportunity to provide a lower level of detail than in the past and to present as complete a package as possible of both the likely policy design and the operating model for the GST. The consultation might, therefore, contain elements of both the marketing and consultation phases identified above. This is not ideal as it will mix different themes targeted at quite different audiences, but it would nevertheless be a useful way of advancing the real understanding of the tax.[18]

If the above approach is taken, the process could involve (1) the publication of a consultation paper,[19] (2) appointing a consultation committee to review submissions on the paper, and (3) submission of a formal report with recommendations from the consultation committee to the Financial Secretary.

The mission has given some consideration to the content of such a paper. Our view is that it should include:

- an outline of prospective budgetary developments and the need for reforming the revenue system;

- an assessment of alternative options, laying out the merits and limitations of each;

[18] However, it should be noted that the mission does not consider that such an approach would overcome the need for a fuller technical consultation process once the final GST decision has been taken and announced.

[19] Because the paper would be quite a technical document, it would be necessary to produce a simplified version using plain language understandable by the general public.

- an explanation of the basis on which the GST option is chosen, together with an outline of the principal features of the tax, including a reasonable set of major policy parameters with respect to exemptions, zero-ratings, the small business exemption threshold, and the GST rate;

- an illustration of the way the tax operates, providing numerical examples of the credit-invoice mechanism and calculation of tax liabilities;

- a discussion of the impact of the tax on key taxpaying groups, such as (1) large businesses, (2) SMEs, (3) importers; (4) exporters, (5) service industries, (6) the financial sector, (7) the real estate sector, (8) charitable organizations, and (9) consumers at large; and

- an indication of the timeframe and program for introduction identifying further consultation opportunities.

Staff training needs

Although there is a broad similarity between the GST and profits tax with respect to procedural activities, it can be assumed that all staff of the GST division or department, as well as many of the existing IRD staff, will require training. Developing a training strategy, preparing training guides and other materials, and delivering or overseeing the delivery of training will be one of the largest tasks of the implementation team.

The training needs will differ significantly from those handled on an ongoing basis by any government department for the following reasons:

- most of the staff requiring detailed technical training will be new to the GST division or department, having no prior experience from which they can draw;

- the numbers requiring detailed training are likely to be greater than other training exercises previously undertaken by any governmental departments; and

- the available time for training may be limited.

The above reasons are likely to call for the adoption of new training approaches. Classroom training will not be appropriate for most topics and the newness of the issues will limit the capacity of managers and supervisors (the principal trainers in a modern system) to take on this task unaided. The likelihood is that the best results for the bulk training will be achieved through the centralized development of detailed training guides, linked to operational manuals, and self-paced on the job training. Some tasks will be suitable for computer-based training while other more specialized issues might need to be handled through classroom-type training.

Identification of the precise relevant training topics will need to await the full design of the tax and the selection of the management structure and operating processes, but it is likely that the following topics will be needed:

- all GST staff, irrespective of their function, will require basic GST training—at least to a level which will permit them to provide a general taxpayer education service to newly registered businesses;

- auditors will need specific training in GST audit techniques. Some auditors may be completely new to this function and may also require basic bookkeeping training if they do not have a relevant qualification. Some profits tax audit awareness training should be included so that GST auditors are equipped to recognize a need for a combined GST and profits tax audit;

- all return and payment processing and debt collection staff will need to be trained in the processes, including the operation of the IT system from a user perspective;

- staff who are new to the department (probably a large proportion) will require a basic induction course;

- all existing staff of the department (e.g., all IRD staff if that department is to administer the tax) will require at least a basic understanding of the GST concept and of the way in which the department would administer it; and.

- staff new to management or supervisory positions (of whom there will be many) will need training in basic management or supervision as appropriate.

IV. Customs Administration Issues

The introduction of GST in Hong Kong SAR will necessitate greater changes in the customs administration than in other places where it has been introduced. In other countries the necessary controls and procedures for levying charges on imports are already in existence, but in Hong Kong SAR only a very limited range of (excisable) goods is dutiable. However, as a hub port, the importance of trade to the economy cannot be overemphasized. Hence, it is essential that the necessary changes to customs procedures do not adversely impact on the work of the port. In particular, they should not lead to the imposition of additional storage charges, delay the loading of vessels, or disrupt the movement of transhipment goods. The need is for greater facilitation wherever possible.

Future requirements under the operation of a GST are dealt with in the following sections, emphasis being placed on those measures that could be introduced in Hong Kong SAR with the least disruption and with minimal changes to the existing situation. Account is taken of the Kyoto Convention[20] that customs control systems shall include audit-based controls. The time available to the mission has not permitted detailed consideration of all procedural issues that will have to be studied by the Customs and Excise Department (CED) prior to the introduction of a GST. This report does not propose detailed control procedures; rather it deals with the application of basic principles and how they might be applied with a light touch to produce minimum disturbance to the existing situation. It does not specifically address intelligence based anti-smuggling operations, the present procedures for charging excise duties, or customs control of goods subject to outward processing. The nature of these operations would not necessarily change with the introduction of a GST. While issues related to the organization, staffing, and IT needs of the CED are not discussed in this report due to the mission's time constraints, the GST will certainly have an important impact in these areas. The CED would be well advised to pay close attention to them.

A. General Implications of GST for CED

The CED is in need of information on customs control methods used in other countries. The following practices that are widespread elsewhere may be of relevance in designing new control procedures. In many countries, imports are not cleared at the border. They are often taken under seal to an inland clearance depot (ICD, or "dry port"). Similarly, exports may be checked at an inland point and taken under seal to the place of exportation. This facilitates the flow of goods by reducing congestion at border crossing points and is preferred by many traders who consider clearance nearer to their premises as more convenient. Deferred payment of import charges is also allowed in many countries, e.g., monthly payment within 10 days of the month end.

[20] References in this chapter to the Kyoto Convention are to the *International Convention on the Simplification and Harmonization of Customs Procedures* (WCO, 1999).

The CED currently runs an anti-smuggling risk assessment program on advance information about the arrival of aircraft and ocean-going vessels. To increase its effectiveness, it wants advance cargo manifest information. The assessment will continue to be done before arrival and before detailed information about import consignments is available. The CED does not envisage delaying the procedure for the inclusion of consignment information. Risk assessment of import consignments based on information provided in a pre-clearance import declaration would therefore run separately at a later stage, i.e., immediately prior to clearance.

Since there are no charges on goods imported (except the few imported excisables) into or exported from Hong Kong SAR, close customs control of unloading and loading locations and storage areas for revenue reasons is therefore currently unnecessary. It is not required for the present type of intelligence-based preventive activity which targets suspect areas. Interest in imports and exports is mainly statistical, and the checking of trade (goods) declarations against manifests to ensure that there is a declaration for every consignment is done by the Census and Statistics Department (CSD). Their objective is 100 percent check on existence of a declaration, but the description of the goods is compared only on a selective basis. Import and export trade declarations are not required for transhipment goods, so tonnage but not value is available for transhipped goods.

Revenue interest in all goods will arise when a GST is chargeable on all imports. Customs control of all arriving goods will be necessary until they have paid the GST or account has been taken of their liability to pay. The CED will need to be satisfied that transhipment goods have not been improperly diverted to the home market.

The CED has started to draft new import procedures drawing largely from its present practices with respect to the few excisables, but some of the contemplated control features will not be necessary for control of a low rate GST. For example, the mission does not consider that extension of the existing system of dutiable goods permits to all imports will be necessary. Documents and/or notifications equivalent to the permits issued for excisables will be required, but on a less formal basis. In most cases, their issuance would be automatic without need for a formal application from the trader. Likewise, the CED's initial proposals for export controls were more appropriate for operating a duty drawback scheme than a GST. The following sections attempt to promote a better understanding of the customs aspects of GST operations. Standards and recommended practices relating to many of the procedures mentioned in this report will be found in the Kyoto Convention.

B. Imports

With respect to import controls in the presence of a GST, carriers should produce cargo manifests to the CED listing all consignments carried. Copies of, or information from, house bills are needed for consolidated cargo. Provision of the information before arrival is preferred, but in any case it should be submitted promptly on arrival. Carriers have this information on departure, and often send it to their office or agent in the import country before the goods arrive. Prompt submission of the information to the CED should not be a problem.

On arrival, the goods should go into temporary storage pending customs clearance on payment of GST or being entered into a suspensive customs regime, such as long term storage in a bonded warehouse, or use as ship or aircraft stores. Secure storage is normally provided by the custodian of the goods after they have been unloaded. This may be the carrier or a terminal or jetty operator, and good commercial practice requires physical security of the goods. These storage areas exist already, and as far as practicable the general approach should be to minimize disturbance to present practices by requiring the operator to give the CED some form of financial security (generically referred to as bond—see below for further discussion). If the present operator of a jetty does not accept responsibility for the goods, this situation should be changed, otherwise imported goods will not be allowed to land there.

Making existing areas into bonded areas is preferable to creating new bonded areas or zones that will change current cargo handling procedures by requiring cargo to be re-routed. The level of financial security should be set by a realistic assessment of the level of risk of revenue loss, not necessarily to cover a possible total loss of all goods that the store is capable of holding. Theft of all the goods is unlikely, and tax would not be charged in the event of total accidental destruction of the goods, e.g., by fire. The operator of temporary storage should not release the goods until it is known that the CED has authorized release. This may be by a document issued to the importer or by direct notification from the CED. To cover possible improper release of the goods to the home market, financial security may be required by the CED to cover payment of potential charges.

Before clearing the goods, the CED will require an import goods declaration. At present, importers are required to submit goods declarations for imports within 14 days of arrival of the goods. With the introduction of GST, this should change to the standard practice in other countries of submission before release of the goods from customs control. Importers are well aware of the nature, quantity, and value of goods that they have ordered. They should have no difficulty, nor incur any additional cost, in providing this information to the CED before customs clearance. Identification of importers should be based on the same BRN used by the IRD.

Information on the declaration may be subjected to credibility checking and risk assessment by the CED, supporting documents may be examined, and the goods may be physically examined. The amount of GST payable will be calculated or checked. The basis of valuation should be c.i.f. plus applicable excise duties (if any). The method of determining the cost of the goods is defined in the WTO rules set out in the Agreement on Implementation of Article VII of the GATT and in the Decision Regarding Cases Where Customs Have Reason to Doubt the Truth or Accuracy of the Declared Value.

Payment of GST will then be required before release of the goods unless a credit or deferred payment arrangement is in force. In many countries, processing of the goods declaration includes noting on the manifest that a declaration has been received for the consignment. Statistical data collected from import declarations will be passed to the CSD.

Current practice elsewhere is for most import consignments to be released without physical examination of the goods. In countries where customs charges are relatively low, not more than 10 percent of consignments are examined. Typically, the computer system that processes the import declarations includes a risk assessment program that selects the method of clearance. Most consignments are released through what is referred to as the green channel, which means that there is no examination of the goods or supporting documents. Consignments that are considered to involve a higher risk are given yellow channel treatment, which means that the supporting documents, but not the goods, are checked. Consignments designated as high risk are selected for red channel clearance that requires examination of supporting documents and the goods. The risk factors incorporated in the program are regularly updated, and the levels of selection for yellow and red channel clearance can be adjusted to match the level of resources available. Post clearance audit visits are made to importers.

Introduction of pre-clearance import declarations for GST purposes will provide three additional advantages for the CED:

- extension of risk assessment to consignment level entails much more effective use of risk management by the CED;

- improved information flow on imported goods enables earlier intervention by the CED, if and when necessary; and

- enhanced ability by the CED to fulfill international obligations relating to drugs, harmful chemicals, intellectual property rights, endangered species, and environmentally sensitive goods.

The above principles apply equally to control and clearance of imports by road, but because of the risk of adding to the already high level of congestion at border crossing points, it is highly desirable that credit arrangements be made in advance to avoid payment at the border. In the absence of such arrangements, the goods should go to secure temporary storage pending payment of GST and customs clearance. The temporary store could be at the border but shortage of land in the proximity might necessitate location at some inland point.

A threshold for charging GST on imports by mail should be fixed, and the post office should be required to produce to the CED all parcels with a declared value that brings them over the threshold charge. Any existing preventive control of the mail would not be affected by this.

Over 90 percent of Hong Kong SAR's exports are re-exports. Again, the same import controls should apply to imports destined for re-exportation, except that GST payment is suspended. The goods should be kept on commercial premises that are reasonably secure while in Hong Kong SAR, and the CED may require financial security to cover GST payment in the event of the goods not being re-exported. The importer should keep commercial evidence of re-exportation available for checking in default of which the GST should be paid.

C. Exports

Export controls by customs administrations in most countries are generally very light. Duty drawback schemes have widely been superseded by temporary importation and inward processing arrangements controlled by audit of commercial records. The possible risk of improper diversion of high duty export goods to the domestic market should be taken into account. Otherwise, interest in exports is mainly statistical rather than for revenue reasons.

Exporters who are not GST-registered traders cannot claim any refund in respect of their exports (although the suspension of GST on imports destined for re-exportation should apply equally to them). All exports by GST-registered traders would be subject to the normal credit-invoice mechanism of the GST. If, at the end of the accounting period, more tax has been paid by the trader on purchases than is payable on sales (particularly, for example, if all the sales in the period were zero-rated export sales), the trader will make a refund claim. Whether any particular consignment will result in a GST refund claim depends on the trader's balance of input and output taxes at the end of the accounting period. Hence, it is not relevant to ask any exporter at the point of exportation whether a GST refund claim will be made in respect of the exported goods.

Regular routine examination of export goods for GST purposes serves little purpose because no GST refund claims will be made prior to such examinations. GST-registered traders will be required to keep satisfactory commercial evidence of exportation. Over-valuation of exports does not increase the amount of input tax repayable (unless the exporter also produces exempt domestic supplies). However, it may indicate suppression of domestic sales records and non-accounting for the GST payable on them. Suppression of domestic sales is a matter for the IRD, and in suspected fraud cases they may ask the CED to give special attention to particular exports.

At present, exporters have to submit goods declarations for exports within 14 days of departure. The CED is thinking in terms of receipt of goods declarations for exports prior to loading of the goods. At the stage of loading of the goods the exporter has received an order for the goods, arranged payment and transport and probably prepared a sales invoice. The exporter is in possession of full information about the goods, and should be able to provide it without delay and without incurring additional expense. As with importers, exporters should be identified by the same BRN as used by the IRD.

A requirement for declarations to be lodged in advance of loading will give the CED an opportunity to compare the goods with the declaration before exportation. After receipt of the declaration, the CED will have to issue a clearance message to the carrier to authorize loading. Carriers may object to this requirement. For example, the positioning of containers in ocean-going vessels has to be carefully planned taking account of the port of discharge and possibly the weight and nature of the goods. This may require loading in a particular sequence. Carriers will probably claim that loss of their present freedom to plan and load will cause delay and disruption to their work.

One option would be to require submission of a goods declaration prior to loading but permit the carrier to load unhindered. This would allow the CED to have timely information without impeding trade. Non-submission of the declaration as required would provide useful information in itself and can be followed up post-exportation. Fines could certainly be levied on offenders. Hence, while the timely submission of export declarations has little relevance for claiming GST export refunds, it has a possible value in pre-export enquiries into suspect cases, although effective investigation of fraud cases would not necessarily be prevented by the non-lodgment of such declaration in advance of shipment. The CED may identify other advantages in having pre-shipment export declarations, and removal of the 14 days time allowance for submission of import declarations may be an opportune time to remove the 14 days allowance for export declarations. However, the removal of the latter delay is not a necessary condition for the GST's introduction.

D. Transhipments

The term "transhipment" is initially used here in accordance with the broad Hong Kong SAR definition of transhipment cargo as goods consigned through Hong Kong SAR from a place outside Hong Kong SAR to another place outside Hong Kong SAR. Such goods account for about 86 percent of trade in terms of tonnage through the port. A high proportion of this is carried out between ocean-going vessels and RTVs. There are about 60 operators of 1,800 Pearl River Delta RTVs acting as feeder vessels moving goods between Hong Kong SAR and mainland ports. It has been indicated to the mission that only about 10 percent of the goods carried by RTVs are Hong Kong SAR imports or exports. Road movements constitute a significant proportion of total transhipments in terms of number of consignments.

Hazardous cargoes would receive special attention but otherwise there are no license requirements for transhipment goods. Information about these goods, including tonnage but not values, is obtained by the CSD from cargo manifests. Trade declarations are not required. At present, other than excisable goods, no revenue risk attaches to possible retention of transhipment goods in Hong Kong SAR. This situation will change when all goods become liable to payment of GST if retained in Hong Kong SAR. It would, therefore, be appropriate to consider international practice in respect of transhipment goods. The first requirement is that GST should not be charged on transhipment goods on arrival and refunded on departure.

The necessary control requirements vary according to whether the goods arrive and depart from the same location, or whether they arrive at one location and depart from another. The standard terminology for the former is transhipment whereas for the latter it is transit. Currently the term "transit" is used in Hong Kong SAR for goods remaining on board a vessel for onward carriage to another port. Hong Kong SAR should consider adopting standard international usage of these terms to facilitate discussions and avoid misunderstandings at international meetings such as at the WTO and the WCO, and with other customs administrations.

A ***transhipment declaration*** should be submitted to the CED on arrival if the goods are to be shipped from the same location. The information requirements are much simpler than on a customs declaration required for importation. In accordance with international recommendations, any commercial or transport document containing the necessary particulars should be accepted as the descriptive part of a transhipment declaration (Standard 5 of Chapter 2 of Specific Annex E of the Kyoto Convention). Any suitable commercial or transport document that meets all customs requirements should, if practicable, be accepted as the transhipment declaration (Recommended Practice 6 of Chapter 2 of Specific Annex E of the Kyoto Convention). In the interests of trade facilitation, the CED should give careful consideration to these recommendations. Goods entered on a transhipment declaration should be kept under secure conditions, financial security may be required by the CED, and records should be kept to enable the CED to verify that the goods actually left Hong Kong SAR. A copy of the transhipment declaration should be attached to the export manifest.

A ***transit declaration*** should be submitted to the CED on arrival if the goods are to be shipped from a different location. This is a simplified customs declaration that should show where the goods will be shipped. The 1973 version of the Kyoto Convention included a specimen form that has been widely used as the basis of customs transit declarations. In accordance with current international recommendations, any commercial or transport document containing the necessary particulars should be accepted as the descriptive part of a transit declaration (Standard 6 of Chapter 1 of Specific Annex E of the Kyoto Convention). Any suitable commercial or transport document that meets all customs requirements should, if practicable, be accepted as the transit declaration (Recommended Practice 7 of Chapter 1 of Specific Annex E of the Kyoto Convention). In the interests of trade facilitation, the CED should give careful consideration to these recommendations.

Goods entered on a transit declaration should be carried under seal in a secure vehicle or container, accompanied by a copy of the transit declaration. Customs may require financial security to cover possible diversion to the home market, for which purpose general financial securities that cover all transactions by the same operator within a given period of time are used in preference to individual ones that cover only one consignment.

A copy of the transit declaration should be surrendered to the carrier if the goods leave by sea, river, rail, or air, and the carrier should attach it to the export manifest. A copy of the transit declaration should be surrendered to the CED at the border if the goods leave by road. In many countries, the customs administration receives and matches the documents for all transit operations to verify that transit goods have left. It is suggested that the CED verifies completion of transit operations from commercial records. Risk management would be used to decide the percentage check to be done.

Many transit consignments that arrive in Hong Kong SAR by road already have customs seals attached. This suggests that they are being cleared for export at an inland point in China and carried under seal and possibly bond to the Hong Kong SAR border under a transit procedure. There are numerous precedents for international transit agreements that provide for acceptance of foreign customs seals and transit declarations with financial security enforceable in more than one country. It may well be possible to agree on such an arrangement with China's customs. Such an agreement could significantly reduce any need to delay road vehicles at the border.

E. Nature of Modern Customs Control

After the introduction of GST, much of the CED's control work will be done by audit. CED audit will include verifying from commercial records of importers that the declared value and amount of GST paid on their imports were correct, from the records kept by carriers that transhipment and transit goods have left the country, and assist the IRD in its checking of the records of exporters who are GST-registered traders to ensure that their exports are genuine. Special training will be needed for the effective performance of these activities.

Placing emphasis on audit of commercial records is the modern approach to exercising customs control. It balances the important role of customs administrations in facilitating trade with monitoring to prevent irregularities. This approach contrasts with the traditional methods that placed much more reliance on physical control of movement of goods. Introduction of a low rate GST does not create a great incentive to smuggle goods into the domestic market. Nevertheless, preventive actions to combat abuses would still be necessary. The CED needs to be able to intervene when irregularities, such as possible improper offloading of break-bulk goods from small vessels and suspect midstream operations are taking place. Thus, some additional physical presence of the CED in the port may be necessary.

By way of illustration, the port area could be divided into a number of districts and a mobile team set up for each with responsibility for revenue policing of its district by monitoring, observing, and checking activities within it. It would be expected to know what happens on its patch, and would take appropriate actions in case of doubt or suspicion. The teams would have access to the records of traders in their areas. A small central office would be responsible for coordinating district activities, have access to the information available on the port control system of the Marine Department, and be responsible for liaison between the CED and the Marine Department. The teams would be required to supply regular management information to the central office. The value of the actual work done by them could be greatly enhanced by the deterrent effect produced by their presence.

The extent of the additional activity required depends on the current level of preventive work undertaken in the port, something that the mission has not been able to examine in the available time. CED management should determine what additional customs presence will be necessary in the port.

F. Financial Security

Security to cover both future customs charges and possible future customs charges (e.g., if certain conditions are not met) is often required by customs administrations. Circumstances in which it is required include storage of goods that have not paid customs charges (temporary storage and warehousing), conditional release of goods (e.g., temporary admission, transit), authorization to act as a customs broker or clearing agent, deferred payment of charges, and release of goods before the charges have been finally assessed.

Standard 5.1 in Chapter 5 of the General Annex of the Kyoto Convention states that national legislation shall enumerate the cases in which security is required and specify the forms in which security is to be provided. Other standards state that the amount of security shall be determined by the customs administration, and that any person required to provide security shall be allowed to choose any form of security provided that it is acceptable to the customs administration.

The amount of security to be provided shall be as low as possible and, in respect of the payment of duties and taxes, shall not exceed the amount potentially chargeable (Standard 5.6). The alternative forms of financial security that may be acceptable to a customs administration, with brief notes on each, are given in Appendix III.

G. Tourist Relief Schemes

Introduction of a GST at a rate of 3–5 percent would probably not create a great deterrent to tourists visiting Hong Kong SAR, but the CED would like to consider a possible scheme to relieve tourists from payment of GST on goods purchased in Hong Kong SAR and subsequently exported.

Countries often allow relief from payment of GST or VAT for visitors who export the goods when they leave the country, particularly when the rate of tax is in the range of 10–20 percent. A threshold is set below which trivial amounts of tax are not relieved or refunded, and small purchases cannot be aggregated to qualify. The lower the rate of tax, the higher the threshold should be if it refers to value of the goods. Alternatively, a minimum amount of refundable GST could be set.

Schemes vary in the way they operate. Reputable retailers may be registered by the customs administration to sell to visitors inland. Such retailers are allowed to sell to visitors on production of evidence that the person is not a resident. In some cases, the tax is not charged and the goods are sent by courier to the exit point for collection by the visitor on departure. In other cases, tax is initially paid by the visitor, and a refund is made at the border by the customs administration, or by an appointed agency, on production of the goods, provided that the sales invoice shows tax as a separate item.

Other schemes provide for the tax to be charged when the purchase is made, and the visitor is given a document on which a certificate of exportation is obtained from the customs administration on departure. This document is then sent back to the retailer or to an appointed agency for a refund to be made. An agency that makes refunds may deduct a service charge from the amount repayable. In some schemes, such as the one adopted in Canada, refunds are to be claimed by mail after the tourists have already left the country.

Duty free shops at exit points may sell goods for immediate exportation without charge of GST, but at land borders there may be a risk of quick return by the departing passenger with the goods, or the departing passenger may transfer possession of the goods to a passenger coming in the opposite direction. This danger can also exist at land borders with the exportation of goods sold by an approved retailer under the alternative schemes mentioned above. This may be difficult to control, and probably for this reason, some countries do not make refunds at land borders to tourists who export items that are small in size but high in value (e.g., jewelry, watches), or do not make refunds at land borders at all (as in Singapore).

APPENDIX I. KEY GST IMPLEMENTATION TASKS

A. Policy Decisions

Take major GST policy decisions on, for example,

- the scope of exemptions;
- the scope of zero-ratings;
- the small business exemption threshold; and
- the GST rate.

Make more detailed policy decisions on, for example,

- definition of time of supply;
- penalty structure; and
- disputes resolution process.

B. Legislation

- Draft GST law;
- passage of law by Legco;
- draft consequential amendments: (1) Customs Ordinance, (2) Inland Revenue Ordinance, and (3) other statutes; and
- pass consequential amendments.

C. Development Team

- Establish initial development team; and
- identify initial funding needs.

D. Financial Allocation

- Allocate sufficient funding for initial development;
- assess full development funding needs; and

- allocate additional operating funds in annual budget.

E. Organizational and Structural Issues

- Select administering agency;
- design organizational structure; and
- calculate staff numbers and types.

F. Staff Recruitment

- Decide staff mix (experience level, education levels);
- decide selection criteria and process; and
- select auditors, return processing staff, and collections staff.

G. Departmental Strategic Plan

- Develop GST performance standards;
- modify plan to incorporate GST issues; and
- redefine annual report to include the GST.

H. Interdepartmental Coordination

- Develop memorandum of understanding (MOU) between Customs and the IRD; and
- consider MOU with police in relation to fraud.

I. Operational Design

- Processing procedures;
- registration process;
- return processing, including non-filers;
- payment processing, including non-payers;
- taxpayer services procedures;
- phone management;

- counter services; and
- new taxpayer education.

J. Audit Policy and Procedures

- Determine case selection system;
- identify risk criteria;
- assess significance and likelihood of occurrence;
- establish selection criteria for each audit type;
- design audit process;
- verify refund claims;
- develop registration checks;
- perform issue-oriented audits;
- develop comprehensive field audit procedures; and
- undertake fraud investigations.

K. Forms Design

- Registration application;
- notification of registration;
- GST return; and
- special applications.

L. Staff Manuals

- Audit manual;
- processing manual; and
- debt collection manual.

M. Staff Training

- New recruits—induction training;
- all GST staff—general training for taxpayer education;
- auditors—audit processes and techniques;
- processing staff—return, payment, and debt processing;
- all non-GST staff—basic familiarization;
- new managers—managing groups and teams;
- new supervisors—managing people; and
- public education team—public speaking and influencing.

N. Consultation and Taxpayer Education

- Conduct broad consultation (prior to GST decision);
- establish task force and secretariat;
- develop GST consultation document;
- release consultation document;
- receive submissions;
- consider submissions by the task force; and
- report results to the government by the task force.

O. Public Information Campaign (Post-GST Decision)

- Make presentations to businesses and the community;
- issue general explanatory materials;
- consider industry-specific materials; and
- launch TV and other media adverts.

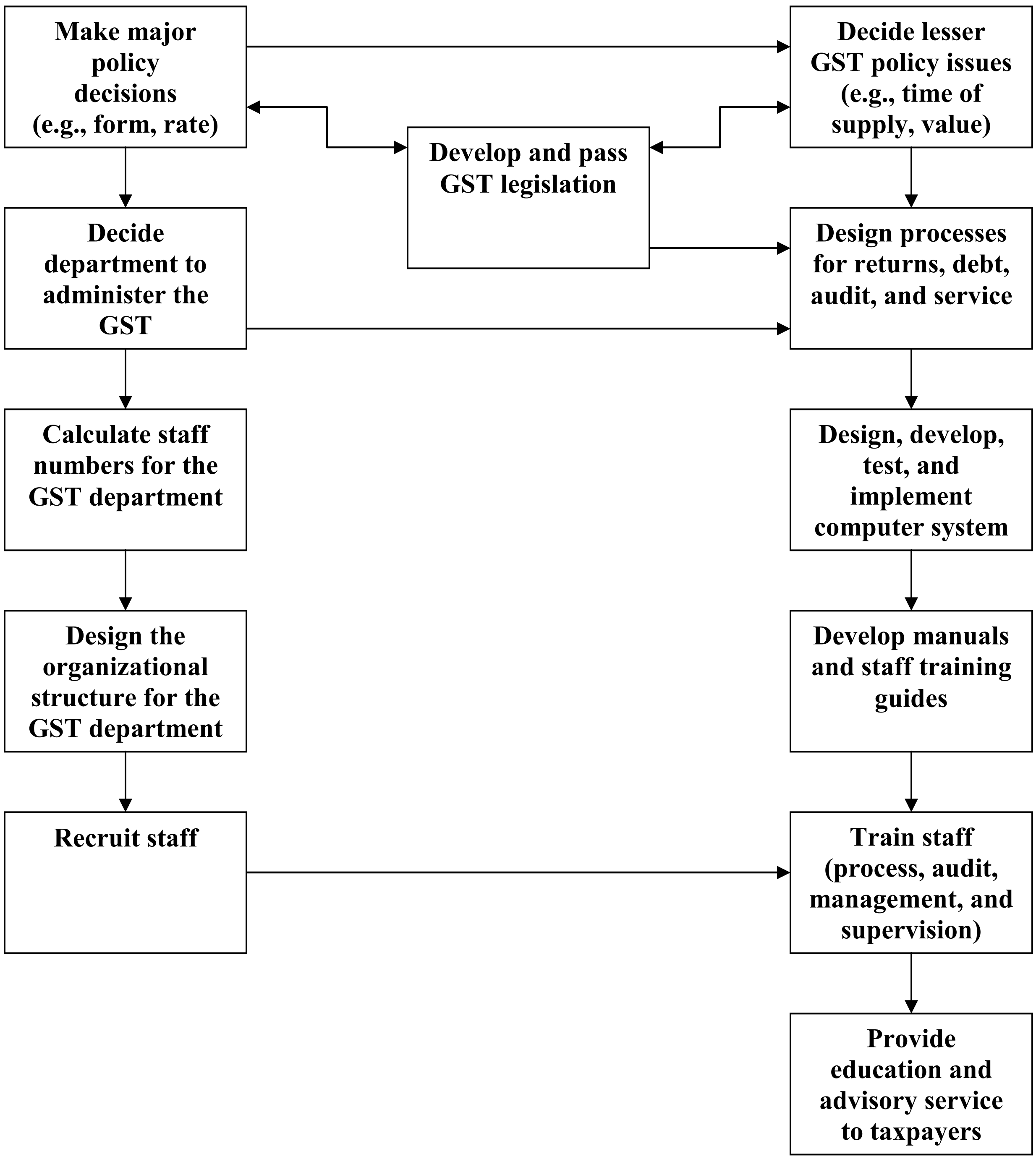
P. Taxpayer Education (Post Passage of GST Legislation)

- Advertise registration;
- issue registration packs (guide and form);
- provide advisory service to initial registrants; and
- issue full GST guide to registered taxpayers.

Q. Computer System

- Initial registration;
- general registration;
- processing returns and payments;
- debt and late return management;
- revenue accounting;
- audit support; and
- management information.

APPENDIX II. SEQUENCING OF GST DEVELOPMENT TASKS



Appendix III. Forms of Financial Security

Deposit

- Deposit of potential payment with the customs administration could adversely affect the cash flow of enterprises.
- Customs should pay interest on the sum that they hold.
- Suitable only to cover charges on goods released before duty rate or value finally decided. In this case the deposit is the amount that the importer expects to pay plus an additional amount.

Bond

- Guarantee from a natural or legal person of substance.
- May include a penalty for failure to pay the amount of the bond.
- The term "bond" is often used as a generic term for financial securities.

Direct debit mandate

- Often used when payment of customs charges is deferred to a later date.
- Charges over an accounting period (e.g., one month) are usually aggregated before deduction is made on a specified date after the end of the accounting period.
- Allows customs to take charges directly from trader's bank account.

Undertaking

- Generally acceptable only from large, well-established organizations.
- Suitable for government-owned enterprises such as railways.

Bank guarantee

- Bank guarantees to pay if trader fails to do so.
- Many commercial banks issue guarantees but do not take risk—they block up to 100 percent of the guaranteed amount in the trader’s bank account.

- The above practice by commercial banks negates the trader's cash flow benefit obtained with other methods.

Association guarantee

- Available from specialist associations.
- Useful when guarantee has to be valid in more than one country.
- TIR Convention chain of guarantee associations is best known example.
- Other guarantee chains have been modeled on the TIR chain.

Insurance

- Need for sufficient number of participants to spread the risk.
- A specialist form of insurance is widely used in parts of Asia for customs purposes, especially for transit goods.
- On introduction, insurance companies charge high premiums due to lack of claim data, but should then adjust in accordance with experience.