



2006/07/24 07:21 PM

 Urgent Return Receipt

To: <taxreform@fstb.gov.hk>
 cc:
 Subject: Response to consultation exercise

Please find my response to the GST consultation exercise below.

Yours sincerely
 Prof H.K.Tsang

A detailed reply to GST consultation document by one of Hong Kong's salary tax payers.
 Submitted by Professor H.K.Tsang, The Chinese University of Hong Kong

Introduction: outcome based analysis

The outcomes of introducing GST will include:

1. Higher salary earners may benefit because lower income earners would bear a greater proportion of the total tax collected by the government.

2. Businesses would suffer a high cost of implementing GST.

There is a

real cost to businesses in the form of physical hardware/software changes (e.g. cash registers need to be changed in retail), and increased administration costs for reporting GST and auditing GST returns. The estimate of AU\$1300 from Australia is an underestimate of the impact of GST as it may not include all the hidden GST administration costs within businesses.

3. Accountants (and lawyers) would benefit from increased demand for their services. Hence they (e.g. the Taxation Institute) lobby for GST.

4. The tourism industry and retail businesses in Hong Kong would lose competitiveness to businesses based in e.g. Macau and Shenzhen. Hence they are mainly against GST.

5. If net revenue to the government is increased, then government expenditure will inevitably increase in the ideal balanced budget.

6. Many government departments would "benefit" from the need for increased headcount to administer the GST. A substantial part of the increased revenue will be spent directly by government departments (e.g. Customs and Excise department, Inland revenue department and social welfare

dept etc would all need more staff). The government's does not appear objective in the debate for GST as many government spokesmen have taken a very pro-GST stance.

7. The government will likely alienate a large part of the population

8. Increasing the cost of government makes Hong Kong less competitive

internationally and should be avoided. Important questions

(1) Can GST be introduced together with a reduction in direct government expenditure?

(2) Is increased government expenditure necessary?

Specific response to questions in consultation document

Chapter 1

Do you think that our existing tax base is too narrow?

Hong Kong's direct taxbase is indeed narrow but many of the government's non-tax income is a form of indirect taxation (e.g. land rent, rates and income from sale of land is a form of indirect tax since all businesses pay

ultimately either in the form of higher rent or higher property costs). The case for raising taxes to cover increased government expenditure has not been established.

Do you believe that Hong Kong needs a tax generated from diversified sources that are less shocks and cyclical economic conditions? Do you think the Government should take action to ensure our future growth and prosperity? Hong Kong should increase its direct taxbase and the government should always try to ensure Hong Kong's general future prosperity. However GST revenue will fluctuate with the economy more than salary tax and thus a swing of revenue from salary tax to GST will lead to increased cyclical variations in tax revenue.

Chapter 2

Do you agree that a reduction in personal allowances is not a preferred option?

The two options for increasing the tax base have not been compared directly or fairly in the consultation document.

Let us make a direct comparison :

1. The administrative cost for reducing personal allowance will be less than that for implementing GST. (Reducing tax allowances will not have the additional costs of GST enforcement by customs etc; nor the hidden costs to private sector (accountants by companies to prepare GST tax returns and claims).

The costs of measures for income relief to low income families will also be needed for GST (which may have a wider impact).

Conclusion: Reducing personal tax allowance is a more viable alternative, particularly as Hong Kong has one of the largest personal tax allowances in the world

Reducing personal tax allowances (with appropriate low tax bands) will allow the tax base to be broadened without the substantial impact of GST on the economy, and indirect costs in private sector and increased government expenditure.

From the numbers given in Chapter 8 , out of \$30 billion collected only about \$20.4 billion net is available for tax relief after the various costs are taken into account. Reducing the personal tax allowances is thus clearly be more efficient than GST as the cost of collecting salary tax will not be 1/3 of the tax collected.

Chapter 3

Do you agree that GST is an appropriate option to broaden Hong Kong's narrow tax base?

Despite being one from the "narrow base" of salary tax payers in Hong Kong and presumably one who may possibly benefit from paying less salary tax, I do not agree that GST is the best option to broaden Hong Kong's tax base because:

(1) There is a large high hidden cost to the private sector in implementing GST

(2) Low to middle income earners will pay more tax : but salaries tax is a better way of collecting this if we want to tax this sector of the population since there is already an established mechanism for reporting and paying salary tax.

(3) Bigger governments makes Hong Kong less competitive: The increased government expenditure for more staff to administer the GST (including law

enforcement agencies to deal with tax fraud, justice department to prosecute tax fraud, auditing and social welfare agencies to provide the proposed low income subsidies, and increased expenditure by correction services department etc) will all increase direct government costs. The document does not provide a detailed estimate of such costs. As the civil service in Hong Kong has one of the highest salary scales in the world, the cost for such government departments may be much more than that experienced overseas. The collection of GST will be prone to fraudulent reporting and some new GST enforcement agency will be needed to deter fraud.

(4) GST is not as stable an income source as salary tax: The income from GST will fluctuate depending on the economy: in recessions, consumption will be less and GST income will be reduced more than corresponding fluctuations in salary tax. Salary tax is a more stable form of income to the government than GST.

Chapter 4

Do you agree that GST is preferable to RST as a form of general consumption tax?

From the point of view of greater simplicity and lower cost of implementation/enforcement, RST is better than GST. In GST services are subject to tax. However there are many services in Hong Kong (e.g. plumbers, electricians, private tutoring services) where book-keeping is not easily audited and this will inevitably increase the number of fraudulent tax reporting and increase the cost for enforcement against tax fraud.

Chapter 5

What are your views on the proposed GST framework and design features as outlined in this Chapter?

Although much work has been put into the proposed framework there are a number of major potential flaws and omissions:

1. The high registration threshold of \$5 million will prove unworkable because:
 - a. individual consumers would not know if a medium sized business (say a small restaurant) is registered for GST and authorized to charge GST for its services. This will lead to potential cases of fraud.
 - b. There is unfair penalization of large businesses compared to the smaller businesses which do not need to charge GST on their value added.
 2. The proposed framework does not discuss how the GST framework will apply to educational establishments. Universities carry out research and have income from research grants - are university fees liable for GST and do universities need to hire staff to administer GST reimbursement (e.g. for buying equipment used in contract research which is subject to GST)?
 3. The proposal for taxing e-commerce is and e-services is complicated by the fact that e-commerce may typically involve non-Hong Kong based businesses. In many states in USA for example sales tax is not levied on goods ordered by mail order from out-of-state companies (but is levied on goods supplied from companies with a physical presence in the state). It may make sense from the point of view of reducing the cost for customs inspections to include similar exemption from GST for mail order goods imported to Hong Kong?
- To minimize the costs for enforcing GST at borders, a case can be made for

increasing the exemption amount, say to \$50,000, for travelers who are outside Hong Kong for more than 24 hours. A \$4000 limit may easily be exceeded by individual travelers and thus would need substantial increase in customs to enforce. A \$50,000 exemption will be more more difficult to exceed and the impact on travelers will be minimized. The cost of enforcing GST (employing additional customs inspectors or the lost productivity due to longer travel delays for incoming travellers) versus the potential income that can be generated should be studied before setting the exemption level.

Chapter 6

Do you support providing tax relief and compensation measures for households if GST is introduced?

To make GST effective as a revenue generator, the tax relief and compensation measures should be minimized and kept as simple as possible. It is pointless to introduce GST and then spend a significant proportion of the extra revenue on implementing and administering the various tax relief measures. I therefore do not support the specific measures on tax relief that require substantial additional administration such as the proposed \$2000 GST allowance. Rather it may be better to introduce zero rate GST on essential items like food, books and public transport.

Chapter 7

Should we use the opportunity of tax reform to enhance business competitiveness in Hong Kong, by reducing existing taxes and charges on businesses if GST is introduced?

Businesses will bear a large hidden cost in introducing and operating GST compatible practices. These costs are real and will affect the bottom line of businesses e.g. businesses will need to hire accountants to prepare GST returns, buy new hardware and software, use new invoices and other documentation with GST registration numbers etc. The introduction of GST will make businesses less competitive. That is why one hears loud vocal opposition from business leaders in the community.

On the other-hand, it does not make sense to use the income from GST to reduce the tax burden of businesses since this would beg the question of why introduce GST in the first instance.

I therefore do not support the proposed measures to reduce existing taxes on businesses. Indeed businesses may find it preferable to pay slightly more profits tax instead of having to bear the high cost of implementing GST.

Chapter 8

What are your suggestions on how to return the remaining balance of available funds to the community?

Revenue generated from GST should not be wholly returned to the community in the form of tax cuts - if this were done then what is the point of introducing GST (other than the increase in size of various government departments)?

Rather the extra income from GST should be invested in education, industry, health, cultural and social services. However the case for any increased expenditures should always be carefully considered and justified.

Chapter 9

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

The numbers quoted in the consultation document do not appear reasonable, and should be carefully examined from first principles. The impact on industry and costs for administering the tax may be much higher than that estimated in the GST compliance cost estimates published in Australia of AU\$1300. Will AU\$1300 be sufficient for businesses in Hong Kong to (1) hire accountant to prepare GST returns (2) extra labor time to handle the GST book-keeping (3) change software/hardware to make sales receipts GST compliant (4) store extra tax documents or even undergo GST tax audit (say once every 7 years). (5) In retail industry there is a danger of reduced consumption particularly when neighbouring jurisdictions such as Macau or Shenzhen do not charge GST.

Also the administrative costs from overseas of 1 to 2 % of the GST may be an underestimate for Hong Kong because of the higher salaries in the Hong Kong civil service.

Conclusions

1. Hong Kong may need a broader tax base but indirect taxation (in the form of high land prices that is borne ultimately by individuals and businesses in Hong Kong, and government land rent and rates) should also be considered as a part of tax income in Hong Kong. Taking indirect taxation into account, the case for increasing the taxbase is not clear cut.
2. GST is not the only viable means to broaden the taxbase in Hong Kong. A reduction of personal allowances and appropriate changes in the salary tax bands will achieve the same broadening of taxbase but at lower overall administration cost than the comparable introduction of GST.
3. The proposed framework for GST can be improved with the aim of reducing the cost of administering the GST and thus increase its net return as a tax revenue source. For example instead of offering tax relief to low income families, a more effective measure may be to zero-rate the GST for essential items like uncooked food, bus and train fares etc. Also to minimize cost of customs enforcement, the personal exemption from GST for goods accompanying travelers can be increased from the proposed \$4000 (which may easily be exceeded e.g. by purchase of a new mobile phone or camera overseas) to \$50,000 (which is more difficult to exceed particularly given the luggage weight allowance in airlines).
4. The introduction of GST should provide some additional net revenue to the government: otherwise the additional costs borne by industry cannot be justified. The additional revenue should be invested in Hong Kong's education, industry, health services and social welfare and not merely to increase the size of various government departments to administer the new relief schemes and enforcement issues associated with GST.

Final conclusion: GST is an expensive (and likely unpopular) means of taxation in Hong Kong and should not be implemented. Rather the stated goal of increasing the tax base may be more cost-effectively attained via the reduction of personal tax allowances.