



2006/09/28 01:47 PM

☐ Urgent☐ Return Receipt

To: taxreform@fstb.gov.hk

cc:

Subject: Comments on GST Tax Reform

Henry Tang
Financial Secretary
The government of the Hong Kong Special Administrative Region

Dear Sir:

I welcome the opportunity to express my views on the government tax reform proposal of introducing a GST. The attached document contains an analysis of the proposal and comments on the questions raised in the Tax Reform Consultation Document.

Should you have any further questions regarding this matter, feel free to contact me via e-mail.

Sincerely,

So Hon Hing



HK GST comments v2.pdf

Analysis of Government GST Proposal and Comments on Consultation Document

So Hon Hing

1. Overview

After reviewing the Consultation Document on tax reform, the most serious problem I found is that most of the arguments presented are general and qualitative, without the support of detailed quantitative analysis.

Based on the data I can gather and my own analysis, many of the key government assertions cannot be justified. My analysis is necessarily incomplete and somewhat crude due to limited resources. However, I believe it yields a useful quantitative perspective on the main issues, and forms a more concrete basis for making choices and decisions. I encourage the government to provide more comprehensive data and analysis to substantiate its decisions. At this time, I do not support the government GST proposal.

In the following, I first discuss four general topics, followed by comments and answers to questions raised in the Consultation Document.

A capsule summary of the main conclusions is provided here:

Section 2 examines the government's objective to achieve a stable revenue stream through GST, especially during economic downturns. I find that the GST scheme, as proposed, reduces the variability of revenue by an almost undetectable amount.

Section 3 examines the claim for the need to prepare for the future (of a aging population). There is no actual projection of government income and expenditure reflecting the effects of the demographic changes. However, I find that the government has ignored the compensating effects of the reduction in the young (0-15 years old) population. This reflects a general attitude to expand government expenditure rather than appropriately redeploy resources.

Section 4 examines the redistribution of tax burden due to the GST proposal. It is found that households with the lowest 20% income continue to pay no tax; the next 45% pay more tax, while the top 35% of households pay less tax.

Section 5 examines the notion of "expanding the tax base". In regard to this, the government has narrowly focused on the people or businesses actually paying salaries or profits taxes under the current system, but ignored the tax base that is paying indirect taxes such as rates, bets, etc. Even considering only the direct tax base, it is artificially narrowed due to the overly generous exemption amount and exceptionally low starting rates.

In Section 6, comments and answers to the questions raised in the Consultation Document are provided. Even I in general do not support implementation of the proposal, in the event it were accepted by the public, I offer two propose changes: (1) provide a "luxury goods/services" rate to reduce the regressive effects of GST, and (2) instead of the complex relief measures proposed in Chapter 6 of the Consultation Document, provide a single across-the-board rebate of GST paid on a "poverty" consumption level.

2. Government Revenue Stability

The most important objective of the government appears to be stabilizing revenue especially during economic downturns (similar to what we have experienced from end of 1997 through mid-2003). The government argues that the best way to accomplish this is the introduction of a broad-based consumption tax, referred to as GST. Let's look at whether this claim can be justified.

We assume GST will track closely the Private Consumption Expenditure¹. Table 1 shows the statistics of selected items for comparison of their volatility.

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	Coef Of Var ²
GDP	1,116	1,229	1,365	1,293	1,267	1,314	1,299	1,277	1,234	1,292	5%
PCE	692	756	834	796	765	774	783	748	719	767	5%
OR	151	171	198	167	175	171	151	153	175	188	9%
PT	47	50	55	45	38	43	44	39	49	59	14%
ST	26	29	30	25	25	26	29	30	28	33	10%
GR	6	6	6	4	7	14	13	9	11	13	41%

All figures are in billion HK\$³. Coef of Var = coefficient of variance; GDP = Gross Domestic Product; PCE = Private Consumption Expenditure; OR = Operating Revenue; PT = Profits Tax; ST = Salaries Tax; GR = General Rates.

It can be observed that Private Consumption Expenditure, as a proxy of GST, is indeed more stable than various tax revenue streams (e.g., Profits Tax, Salaries Tax, total Operating Revenue, and General Rates). However since GST is expected to generate approximately \$30B out of a total Operating Revenue of almost \$200B, the difference of 9-14% variation compared to 5% variation is actually quite insignificant overall. This amounts of a reduction of approximately \$1.8B of variability (6% of \$30B) – less than 1% of total Operating Revenue.

Figure 1⁴ shows historical HK Government Operating Revenue compared to the hypothetical revenue stream if \$30B of 2005 Earnings and Profits Tax is substituted by GST (to maintain

¹ Since some government consumption is also subject to GST, we should include Government Consumption Expenditure. However it is actually more volatile, but is much smaller compared to private consumption, we do not include it in our analysis for simplicity reasons.

² Coefficient of Variance is defined as (Standard Deviation) / (Average).

³ Sources of statistics: GDP and PCE – “2005 Gross Domestic Product”, Census and Statistics Department, HKSAR; OR, GR – “Hong Kong Annual Digest of Statistics”, various editions, Census and Statistics Department, HKSAR; PT, ST – “Accounts of the Government for the year ended 31 March, 2005”, and previous annual editions, The Treasury, HKSARG.

⁴ The construction of Figure 1 is briefly summarized here. The Private and Government Consumption Expenditure in 2004 total to \$895B. To yield a GST tax of \$30B, the effective rate is 3.35%. This rate is applied to all previous years to estimate the GST receipts in previous years. The Earnings and Profits Tax

neutral revenue). For previous years, a proportional amount of substitution is assumed. The variability of the two curves is essentially identical. The revenue stream is more volatile during economic downturns, but substituting with a \$30B-worth of GST does not alter the picture in any appreciable amount.

Other tax items, such as General Rates chosen simply as an illustrative example, are more volatile than Profits and Salaries Taxes. But they are much smaller, and even if they are replaced by GST, the overall stability of revenue cannot be improved significantly.

What analysis has the government performed to arrive at the conclusion that the proposed GST scheme will stabilize government revenue whether during economic downturn or not?

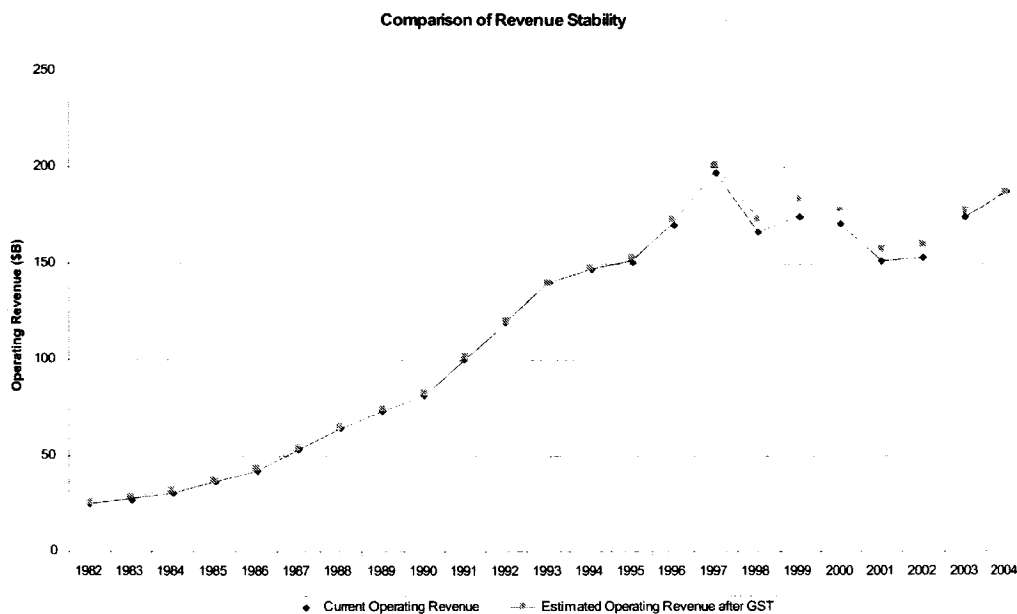


Figure 1

The government claims that current revenue is vulnerable to cyclical fluctuations. One of the reasons, it correctly points out, is that we rely too heavily on non-tax revenue. However, the proposal GST does not replace or substitute these non-tax items. Another mayor source of instability, the government fails to point out, is due to the fact that our tax rates are unusually progressive (0% → 2% → 7% → 13% → 19%, progress through narrow bands of \$30,000). A slight downshift in general salaries (in an economic downturn) would shift a large number of people from high to low brackets – thus disproportionately reduce the total receipt.

in 2004-05 is \$96.7B. Replacing \$30B of this amount leaves \$66.7B – an effective 31%. This fraction of reduction is applied to the Earnings and Profits Tax receipts of all previous years.

3. Aging Demographics

The next most important argument given by the government to initiate GST is the anticipated aging demographics. Similarly to most advanced industrialized countries, Hong Kong's population is undergoing an aging trend – i.e., there will be fewer and fewer younger people, while at the same time the number of older people increases.

The impacts on government finance due to growth in older population are:

(a) Older people have less income (salaries) and since current tax is based on income, it is expected that the tax base will shrink.

(b) Older people require more public support (health, social welfare, etc.). It is expected that (per capita) government expenditure will increase.

The general argument appears to make sense. However, there is little analysis provided to quantify the problem. The only data provided is Chart 7 in the Consultation Document showing the raise in percentage of 65+ population.

Let's look at the data more carefully. Figure 2⁵ below shows the change in "Dependency ratios" in Hong Kong for both old-age and young-age cohorts.

Table 1.6 Dependency ratios in Hong Kong

	Year	Child	Elderly	Overall
Actual	2001	227	155	382
	2003	216	161	378
	2005	197	164	361
	2013	163	173	341
Projected	2023	168	282	449
	2033	171	428	598

Notes: Figures may not add up to the respective total owing to rounding.

Figure 1.2 Demographic window¹

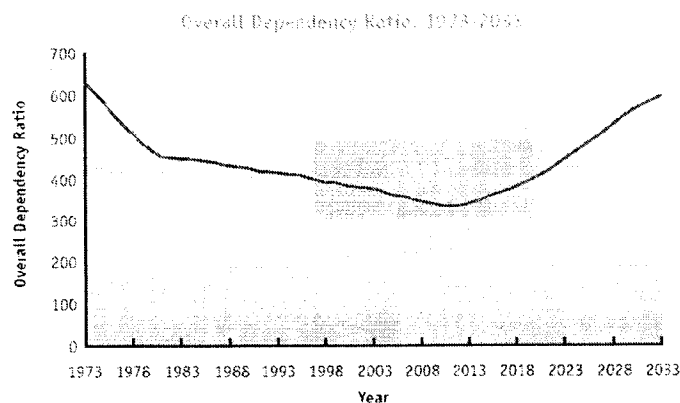
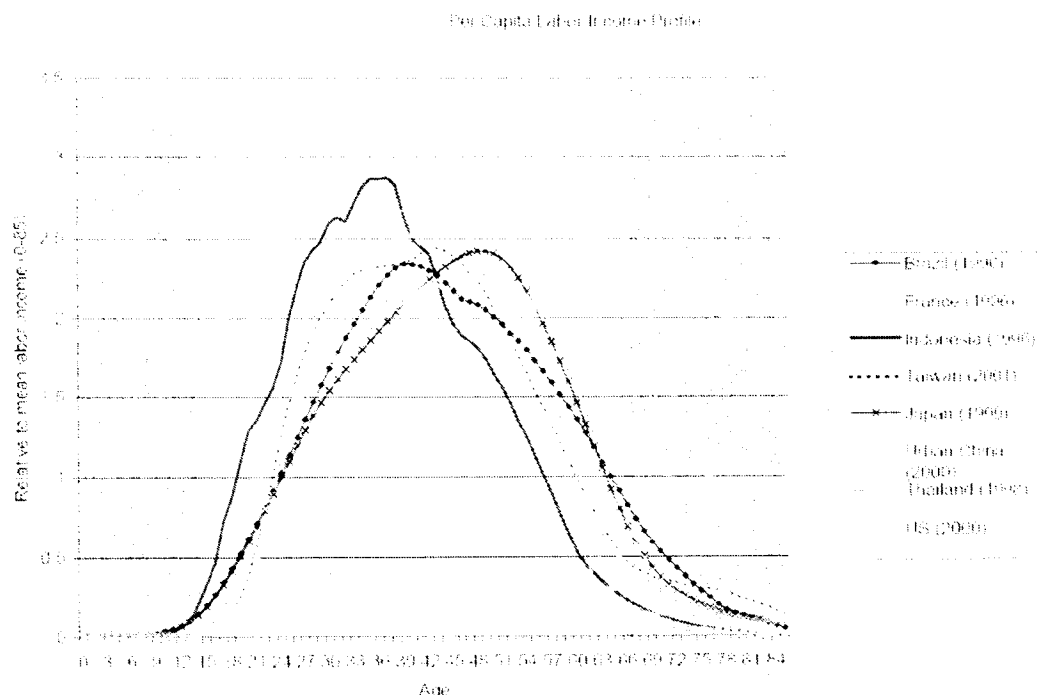


Figure 2

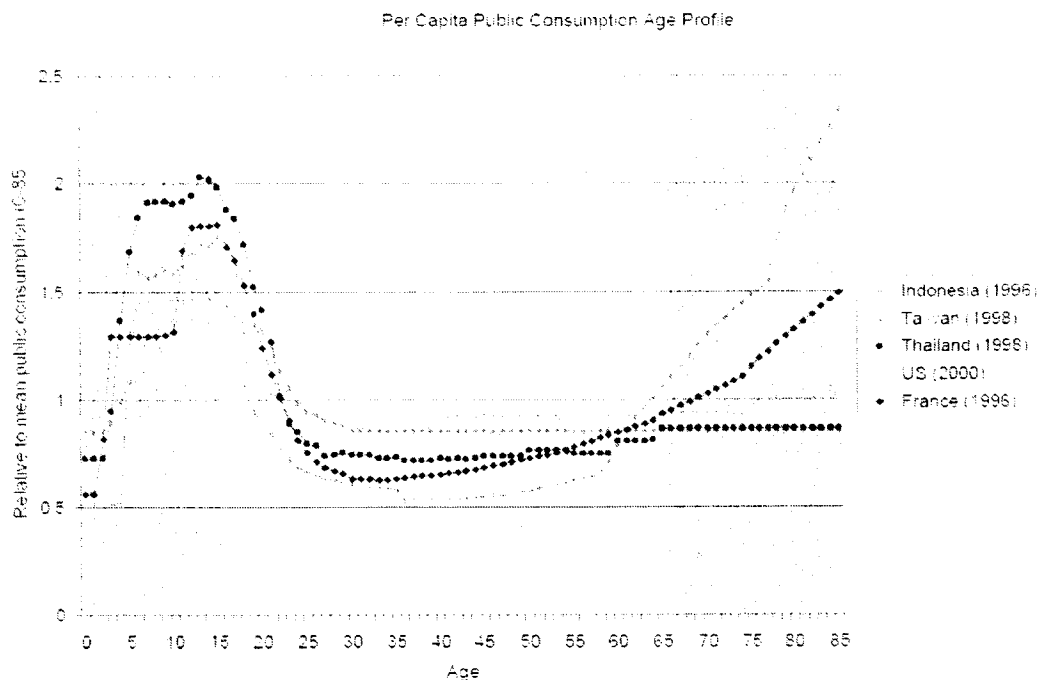
⁵ Source: "Enhancing Population Potential for a Sustainable Future", Council for Sustainable Development Invitation and Response Document for the Second Engagement Process (June 2006). The "Child" and "Elderly" dependency numbers are expressed as numbers of under-15 and 65-and-above, respectively, per 1,000 persons aged between 15 and 64.

Note that while the “Elderly” dependent population increases, it is accompanied by a decrease in the “Child” dependent population. Indeed, we are currently enjoying a “population aging dividend” (declining dependency and support overall) until 2011 or so. The society has supported a large number of children before (also no or little income to tax and a relatively higher public support). Now the society is transitioning to the other side with more older people.

The following two figures⁶ show respectively the income and public support profiles of the two dependent groups. They are roughly comparable. One can argue, one for one, an older person has more income to tax compared to a child. And, an older person takes relatively less public support than a child. The effective overall fiscal challenges are not radically different from before (although the focus will shift). Unlike some other countries (such as Japan), Hong Kong’s population is expected to continue to grow well into 2033, instead of shrinking, providing a base for the society to grow economically as a whole.



⁶ Source: “Charting the Economic Life Cycle”, Ronald Lee, *et. al.* University of California, Berkeley, November 2005. International data are used here because income and public expenditure profiles by age groups specific to Hong Kong are not available.



What analysis has the government performed to quantify the needs for additional tax due to population aging and justify initiation of GST?

Even if there is a genuine need to generate additional tax revenue, we have to consider whether GST is fair to the elderly population.

The following relationship holds:

$$\text{Income} = \text{Consumption} + \text{Savings}$$

In the past, we tax income only. In a GST regime, we tax current consumption. Savings are not taxed until consumed. When we transition from a pure income tax to GST, we in effect impose a tax on **all accumulated savings** in the society. A young person has not accumulated any savings, so that net effort is minimal. A retired person does not earn further income, but he is taxed for his consumption derived from the savings throughout his career. All his earnings (in the form of past income) have been taxed at a relatively high rate in the past, and he enjoys no benefits from a reduced income tax rate in the future. This seems to be grossly unfair. It is true that the older population requires relatively more public support, but it must also be considered that these people have supported the young population in the past.

4. Redistribution of Tax Burden

In paragraphs 66 and 67 of the Consultation Document, the government changes the subject on the discussion on the issue of the progressivity of the tax system, and turns it into an argument for "fairness" and "capacity to pay". The fact of the matter is that the current system is much more progressive than a proportionate tax like GST. Furthermore, since the people with a higher income have a much higher propensity to save, GST is downright regressive. Table 2 shows likely saving rates of various household income groups.

Table 2: Household Income and Expenditure				
	Lowest Quartile	Second Quartile	Third Quartile	Highest Quartile
Household Monthly Income Range ⁷	0 – 8,400	8,401 – 15,500	15,501 – 30,000	> 30,000
Average Monthly Expenditure ⁸	6,783	12,264	17,876	38,624
Saving Rate ⁹	0%	0%	21%	35%(?)
Total number of households = 2,231,500				

We have estimated the change in tax burden due to the GST proposal, taking into account most of the provisions:

(a) GST rate of 5%, and the projected short-term impact on household expenditure (Appendix C of Consultation Document)

(b) Proposed household relief measures (Table 9 of Consultation Document)

(b) Proposed salaries tax rates (Table 17 of Consultation Document)

In addition, the following assumptions are used:

(a) A household with \$200,000 married-person exemption

(b) Estimated household expenditure based on the saving rates in Table 2.

⁷ Source: "Hong Kong Digest of Annual Statistics", 2005, Census and Statistics Department, HKSAR.

⁸ Source: "2004/05 Household Expenditure Survey and the Rebasing of the Consumer Price Indices", Census and Statistics Department, HKSAR.

⁹ Very rough estimates.

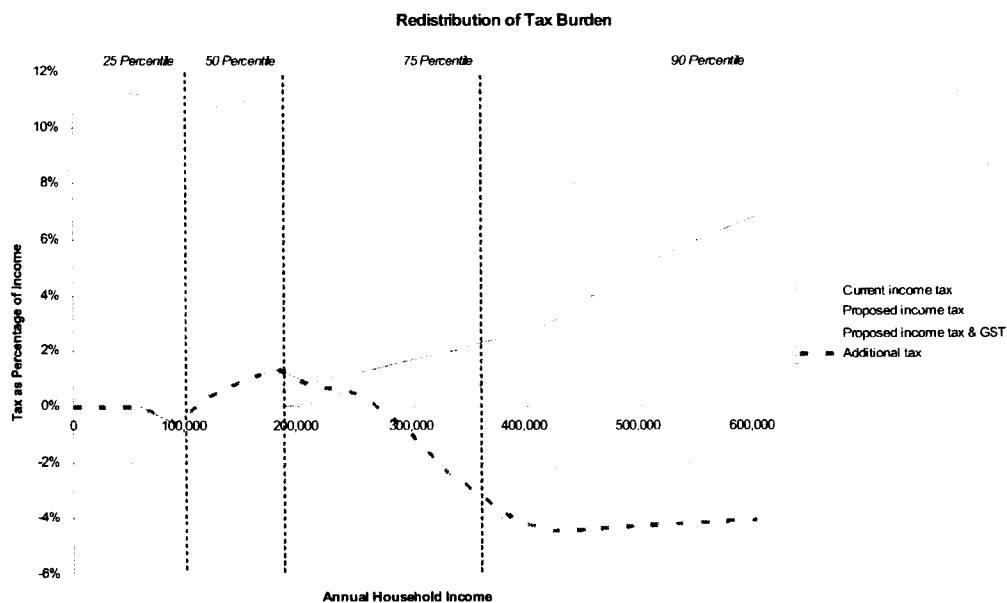


Figure 3

The graph shows tax paid as a percentage of annual household income. The vertical dash lines divide household income groups by quartiles.

As well known, under current tax law, well over 50% of the households pay no salaries tax (green curves).

The proposed reduced salaries tax rates result in substantially lower tax (light blue curve).

The dark blue curve combines the salaries tax and the proposed GST. This curve has a strangle shape due to various reasons (some are artifacts of the simplifying assumptions). The proposal makes special provisions to assure that CSSA and low-income households (Group 1 and Group 2) are fully compensated for their GST payment. Group 2 is defined to be households with income in the lowest 20% (approximately \$80,000 annual income). Hence, there is generally no tax paid in the lowest 20% income households. The negative tax around income level of \$90,000 is due to the fact that the proposed across-the-board credits more than compensate for the GST paid.

The red-dash curve shows the difference in tax between the current system and the proposed regime. Positive values mean additional taxes, and negative values (for higher income households) indicate net reduction in tax liabilities¹⁰.

Several observations are worth making:

¹⁰ Based on the household income and expenditure statistics for 2004, the total amount of household expenditure is \$502B. If a 5% GST is levied, this yields about \$17B in tax collected – far short of \$30B. It is not clear how the government estimates a total of \$30B from a 5% tax rate. It could be based on a slightly larger economy than that in 2004. In addition to households, the government and some non-profit organizations also have final consumption expenditures subject to GST.

(a) Additional taxes will be paid by households with annual income between \$110,000 and \$270,000. There are about 815,000 households in this income range. Households with income over \$270,000 have a reduction in tax, of as much as 4% of their income. There are about 795,000 households. For example, a household income of \$600,000 pays 11% of its income in salaries under current law, and only 7% under the GST proposal (5.5% in salaries tax and 1.5% in GST).

(b) For those households paying additional taxes, the amount is quite small -- about 1% of household income (after special credits and reduction in salaries tax rates in certain cases).

The new profile of household tax is clearly and significantly less progressive than before. It is difficult to agree which one is "fairer". For better or worse, the society has come to accept some redistribution of income under the current system. If the government were to propose changing the current system, it must explicitly lay out the resulting changes on the distribution of tax burden (instead of glossing over them), and provide compelling reasons for the proposed redistribution.

It would be useful for the government to publish projected distribution of tax burden, before and after implementation of the GST proposal, by income groups.

5. Broadening Tax Base

The central theme running throughout the GST proposal is to broaden the tax base.

"Tax base" refers to the total resource of the community that is legally available for taxation. It does not only mean the number of people actually paying direct tax (such as Hong Kong's Profits and Salaries Taxes).

For example, as long as wage income is taxed, then the tax base includes everyone who earns wages. The fact that only few are actually paying any tax is because the tax structure allows very large exemption and deduction amounts. If we can argue that certain income ought to be exempted from tax, I don't see how it can be argued that the consumption from the same people ought to be taxed -- by simply relabeling the tax.

On the other hand, we should not say that the current tax base is "narrow" by looking at the number of people paying salaries tax. We should also look at indirect taxes such as Rates and Bets and sweeps. As the Consultation Document correctly points out, most people (including low-income, renters, old and retired people) pay these taxes also. Under this light, the current tax base is probably as broad as the GST base.

6. Specific Answers to Questions in Consultation Paper

Chapter 1 IS TAX REFORM REQUIRED IN HONG KONG

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

Generally I do not agree. Please see discussion in Section 5 above.

2. Do you believe that Hong Kong needs a tax base where revenue is generated from diversified sources that are less susceptible to external shocks and cyclical economic conditions?

Yes. However, the proposed scheme in this Document does not achieve the objectives. GST does not diversify -- consumption is ultimately derived from income sources. The only part that can be considered diversification is during

transition, a tax on “existing” wealth and assets is imposed. This is neither fair nor permanent. Also, as discussed in Section 2 above, the proposal does not make government revenue less susceptible to external shocks.

3. *Do you think the Government should take action to reform the tax base to ensure our future growth and prosperity?*

Yes, definitely. However, we need to look at the tax base more broadly. See discussion in Section 5 above.

Chapter 2 BROADENING THE TAX BASE : WHAT ARE OUR OPTIONS?

4. *Do you agree that there are only two viable options?*

Agree.

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

No. See my objections to the argument provided:

Paragraph 53. Increasing Salaries Tax and Profits Tax rates, Stamp Duty on property-related transactions and Rates would increase the tax burden on existing taxpayers but would not broaden the tax base. Therefore, any proposals to increase rates for existing taxes are not feasible alternatives for addressing the fundamental problems of our narrow tax base.

This is plainly wrong. Tax base can be “broadened” within existing Salaries Tax by lowering exemption and deduction amounts.

Paragraph 54. Increasing Salaries Tax and Profits Tax rates would go against the international trend of lowering income taxes and risk losing mobile labour and capital to more competitive jurisdictions. As noted in Chapter 1, the rapidly ageing population means that fewer and fewer salaries taxpayers will shoulder more and more of the tax burden in the coming years; hence narrowing the tax base.

Increasing Salaries Tax and Profits Tax rates at the low-end would not go against the trend of lowering income taxes. In fact, we can reasonably raise the rates of the lower brackets, and this would produce a slightly more stable revenue stream. On the high-end, we can abolish the Standard Rate and keep the top rate at 19% and will remain competitive.

As the population ages, it is not clear the actual labor falls significantly in the near-to mid-term. In fact, there will be relatively more experienced and productive labor who earns higher wages. As long as the overall population increase, old-age dependency increases while child-dependency decrease, there can be a net increase in labor. (See discussion in Section 3)

Paragraph 60. Using a drastic reduction in personal allowances as a means to broaden the tax base is not the preferred approach for the following reasons:

(a) Hong Kong uses its personal allowances as a mechanism for providing financial relief to individuals and households with dependants and in the event of

their removal would need to adopt an alternative approach, such as direct government payments, similar to that used in many OECD jurisdictions. This would involve increased government welfare outlays and administrative expenses;

The real issue is whether it is appropriate to set the exemption amount so high that only about 1 third of workers need to pay direct income tax. The proposed GST essentially achieves this, albeit by a different name.

(b) this would draw wage earners currently paying no Salaries Tax into the tax net. However, much of the additional revenue would come from existing taxpayers who do not pay tax at the standard rate. It would make Hong Kong less attractive to international talent, and hamper our competitiveness;

Hong Kong's current salaries tax rate is very competitive. Imposing a GST will also be less attractive to some international talent. You can't please everybody.

(c) as the workforce shrinks with the ageing population, the salaries tax base would shrink and become less productive;

See above.

(d) raising more revenue from direct income tax would still leave Hong Kong prone to income volatilities;

How much more volatile? Volatility is an inherent part of the progressive nature of current system. Are we ready to convince the Hong Kong people to have a less progressive tax structure?

(e) disproportionate additional administrative resources would be required as a huge number of new taxpayers would need to lodge returns, generally for relatively low tax amounts.

How is the cost of expanding on existing collection (simply increasing the volume with well established procedures) compared to that of creating a new tax system? The new taxpayers will probably have much simpler returns.

Chapter 3 THE CASE FOR GST

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

No. More specific points below.

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

The overall effect on stability depends on how much it replaces current government revenue. At \$30B a year, it has no effect (see Section 2 above).

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

Need to rebate low income groups as proposed. Salaries Tax can be made on the same tax base.

(c) it is fair, as similar and competing forms of economic activity are taxed in the same way. Individual consumption determines the amount of tax to be paid. The more money one spends, the more tax one has to pay;

What is "fair"? Tax progressivity is a matter of public consensus.

(d) avoidance is difficult, due to its multi-stage taxing and crediting mechanism, and all those who purchase from registered businesses have to pay the tax irrespective of their background, income level or other circumstances. Even if their source of income is not liable to tax, they will still be taxed when they spend;

How is the cost of compliance maintenance compared to GST collection?

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

Propensity or ability to consume is lower in elderly groups, while public expenditures on these groups grow disproportionately.

(f) it would maintain Hong Kong's competitiveness and its low-tax environment for attracting foreign investment and talent.

Foreign talent also considers additional GST.

Chapter 4 WHAT IS GST AND HOW DOES IT WORK?

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

Yes.

Chapter 5 A PROPOSED GST FRAMEWORK FOR HONG KONG

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

This is generally acceptable if we were to implement one. The only feature I would like the government to reconsider is whether there should be a single tax rate. Many countries imposing VAT implement 2 rates – a standard rate and a reduced rate. I think we ought to have a standard rate and a luxury (or premium) rate. People consuming luxury goods and services should have a higher ability to pay. Many of the items under excise taxes, and perhaps others, should be put under this category.

Chapter 6 HOUSEHOLDS: IMPACTS AND OFFSETS

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

Yes.

10. *What are your views on the measures proposed in this Chapter?*

I think they are too complex and overly generous, and defeat the purposes of a general consumption tax.

I would propose providing an across-the-board rebate to all households an amount annually corresponding to the “minimal living consumption in HK”. For a 5% GST rate, this amount may be on the order of \$2,000. The amount may be slightly fine tuned to vary with the number of members in the household.

This will replace all the measures proposed. This single item will be much simpler and is less vulnerable to frauds. A household has to file a tax return to claim the GST rebate along it has no assessable income taxes. This will increase the volume of the existing tax collection system, but the new returns will be very simple and only require mechanical processing.

11. *How do you think that Group 2 should be defined?*

Adopting the above proposal can eliminate the need to define Group 2.

Chapter 7 BUSINESS AND OTHER ORGANISATIONS: IMPACTS AND OFFSETS

12. *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?*

Yes, definitely.

13. *What are your views on the measures proposed in this Chapter?*

These measures are reasonable.

Chapter 8 OPTIONS FOR RETURNING THE FUNDS FROM GST TO THE PUBLIC

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

The primary reason stated by the government to introduce GST is to stabilize revenue especially during economic downturns. The analysis in Section 2 shows that due to the relatively small amount of tax collected, it is not expected to reduce the overall volatility significantly. However, were the proposal be adopted, it seems to me more appropriate to consider substituting the most volatile revenue streams with the remaining balance. It cannot be done mechanically, though. Each item on

the government revenue budget should be looked at carefully and its economic impact analyzed carefully.

Chapter 9 ECONOMIC AND INDUSTRY SECTOR IMPLICATIONS

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

The major concern I have is an impact on the whole economy as a whole. Once GST is introduced, it provides a easy means for the government to increase tax revenue easily without carefully scrutiny from the public. It will be easy to increase the GST rate by a few percentage points. Most countries who have introduced GST have quickly increase the tax rates subsequently.