Tax Reform
Financial Services and the Treasury Bureau
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To whom it may be concern,

Re: Tax Reform

In response of the consultation paper on tax reform, the following comments are reserved and presented for your kind consideration.

Introduction

Structural deficit problem of the HKSAR Government (the government) is an un-evitable fact from a prudent view of financial management. Broadening tax base, as agreed by majority of public, of the government is at the fore, otherwise, as mentioned in the consultation document, the government will be required to increase tax and cutback government consumption, thought, during the next economic downturn. However, the government faces various obstacles from the public, competitors, and existing system during the tax reform.

As suggested by the government and accounting profession, Goods and Services Tax (GST) is an effective measure to tackle the deficit problem through broadening the income source of the government. Accordingly the government could rely less on profit tax, which suffer the most in economic downturn, and enjoy a higher level and more stable income in the next economic downturn. However, this measure is totally unacceptable to the general public and businessmen, as the GST will transfer the burden of inefficient use of resource to them and increase their living costs and operating costs.

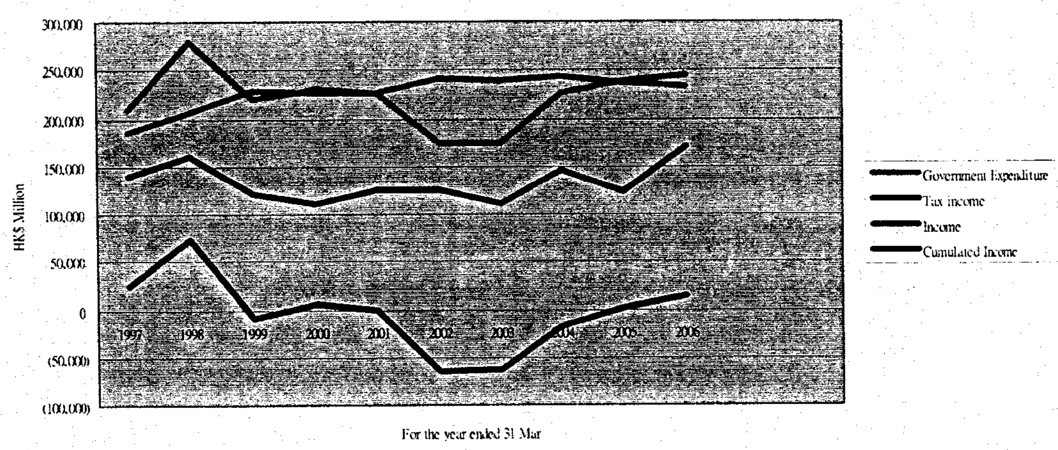
In this article, the need and proposal of tax reform are analysed and an alterative approach of tax reform is raised out for further consideration.

Remaining part of this response is organized as follows. Section 1 is an analysis of financial structure of the government. Section 2 is an analysis of tax reform approach adopted by the government. Section 3 is an analysis of possible tax reform alternatives. Section 4 is a conclusion.

Section 1: Analysis of financial structure of the government
Graph 1 shows that the annual government expenditure ranged between, approximately, HK$200 billion and HK$250 billion while the routine tax income ranged between, approximately, HK$100 billion and HK$150 billion.

The financial gaps were bridged up mainly by incomes of unstable, non-routine and unsustainable in nature, like investment income and income from sale s of assets. It is unhealthy that significant part of the routine government expenditure is financed by non-routine income. The government's financial position is now largely depends on the prosperity of economy and uncontrollable events. In other words, the current financial position is fragile to the economic impulse and easily to be in deficit.

Graph 1



The continuous deficit will use up the reserve created in previous years that, in turn, will lessen the flexibility to the government in adopting fiscal policy and weaken the protection to the Hong Kong financial system.

Section 2: Analysis of tax reform approach adopted by the government
The consultation paper suggests the government to broaden the tax base, i.e. the income source, by imposing GST.

From economic view, imposition of GST, or other new tax, is a contracting fiscal policy. The new tax will cool down the rising consumption and demand in Hong Kong because of the decrease of disposable income (income minus tax) of the public and the increase of operating costs of businesses. Intuitively the consumption, **formula (2)** and import, **formula (3)** shall drop by 5%, if GST rate is set at 5% level. Accordingly, assume that the GST will not affect investment, government consumption and export, the aggregate demand is likely to be drop by less than 5%, **formula (1).**

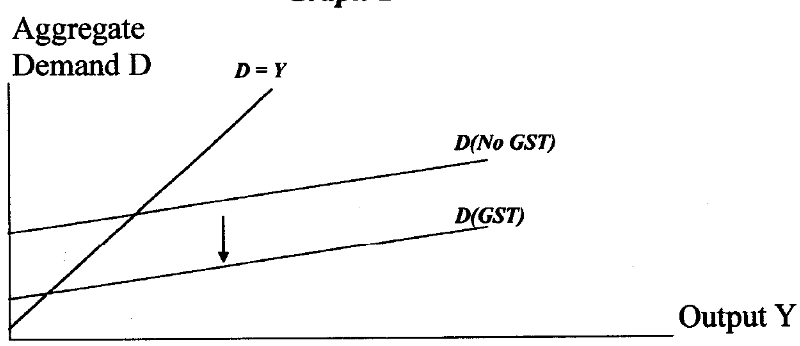
(1) Demand =Consumption +Investment +Government Consumption + Export - Import

(2) Consumption =F(Income - Tax)
(3) Import = G(Income - Tax, Exchange Rate)
(4) Nominal money demand-supply = I(Interest rate, Exchange Rate, Output), which is constant as HK$ is hanged with US$.
(5) Real money demand-supply = Nominal money demand-supply / Price Level

Combining (1), (2) and (3):
(5) Demand =H(Income – Tax, Exchange Rate)

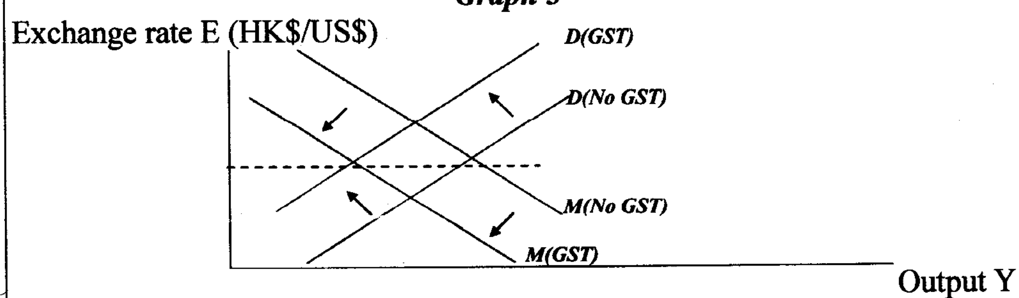
Graph 2 shows that the output will drop at the same extent of the aggregate demand in order to achieve equilibrium.

Graph 2



Graph 3 shows that the drop in output, the demand curve (D) shift to the left, as a result of imposing GST, imposes a downward pressure to HK Dollar. In order to maintain the exchange rate at a fixed level, the monetary system has to make demand-supply curve of real money (M) shifted to left. This may cause unnecessary impact to the monetary system, from **Formula 4** and **Formula 5** the domestic interest rate may have to change in order to balance out the effect from the drop of output and increase of price level.

Graph 3



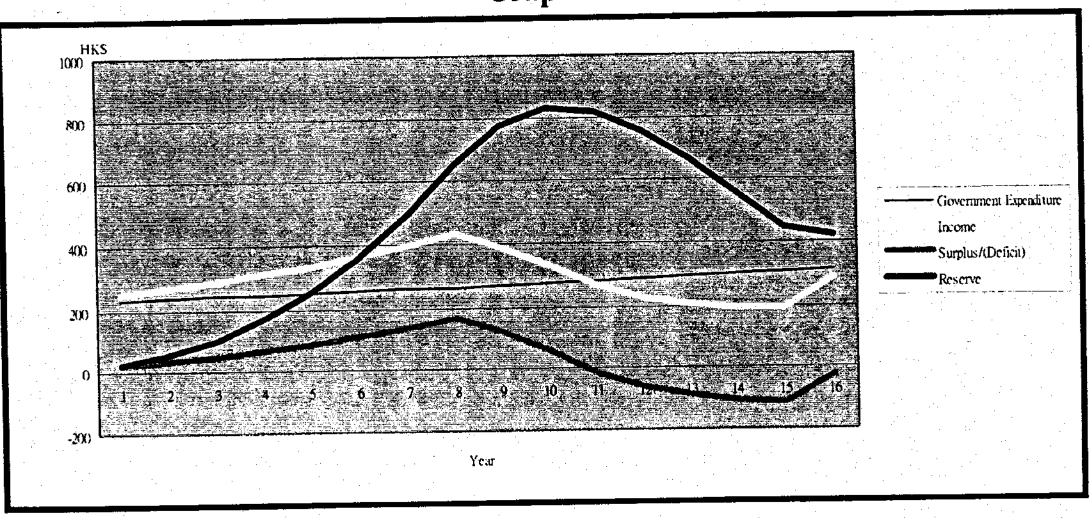
Facing the higher operating costs and falling sales, profit of businesses, especially the small and medium-sized enterprise and retailers, will significantly plummet. <u>The government may not be well off as the income from GST may not compensate the double losses of profit tax, caused by the proposed profit tax reduction after imposing</u>

the GST and the fall of business profits. In the consultation paper, the government has not considered the impact of the GST to the loss of profit tax caused by the fall of business profits.

Furthermore, the tax administration of GST is complicate comparing to the existing tax system, especially when tax rebate and allowance are involved, and the administration costs on GST is too high to be acceptable. It is estimated that the administration costs will be as high as HK$500 million, approximately 2% of GST expected to collect, given that the tax level is 5%. The administration costs borne by individuals and businesses and their consequence are totally omitted in the overall consideration of GST.

The consultation paper mentions that the tumble of the GST would trigger the reduction of tax allowance, which is viewed by the government as another feasible alternative, in order to achieve a broader tax base. The tone of the consultation paper sound like that the government would like to use a single-year approach to deal with its structural deficit and the burden of the future deficit will, almost, fall on the shoulders of Hong Kong residents. Under the approach, the government expenditure for certain fiscal year will be covered by its domestic incomes, mainly sourced from taxes collected from Hong Kong residents, for the same year. From my own opinion, this approach is too strict and the government seems to care too much on deficit for a single year. Instead, I would like to suggest to use a **cumulative approach**, which sound more preferable, to handle the challenge. Under the suggested cumulative approach, stable and appropriate tax rates and system is implemented to create reserve in bloom of economy. The tax rates and system are planned that the reserve created in bloom is more than sufficient to cover deficits occurred in adverse economic environment and stimulate the domestic economy with fiscal policy, as shown in **Graph 4**.

Graph 4



Furthermore, rather than putting the whole burden on the Hong Kong residents, the government should find way to share it out to make the reform more acceptable.

Section 3: An analysis of possible tax reform alternatives

At the time this response is finished, the GST suggestion was called off. Alongside with reducing the salary tax allowance suggested by the consultation paper, various sectors from the society voiced out the following alternatives of tax reform:

- increment of salary tax, profit tax, stamp duty or rate;
- imposition of Capital Gain Tax; and
- tax on the offshore income.

Generally speaking, the reduction of salary tax allowance is feasible in the sense that this can alleviate the structural financial problem. But as the income brought by the reduction is small, compared with GST, the government needs to use the suggested cumulated approach, i.e. implement the reduction even in the bloom time. However, this alternative may cause a strong public aversion, like GST's, as it directly imposes the burden to the shoulders of general public, including poverty, and businesses are not require to share the burden.

The implementation of tax on offshore income and tax rate increment will weaken the Hong Kong's overall competitiveness as a regional financial and human resource hub. In opposite, the government should reduce the tax rates in order to attract investment and expatriate experts.

Capital gain tax may be a feasible alternative, as it tends not to tax on poverty. What's more, intuitively, taxpayers are more willing to pay the tax if capital gain is made. In my own opinion, specific capital gain tax is preferable to general capital gain tax in order to minimize negative effect on the financial market and avoid double-tax on same income. Among those categories, I reckon that saving interest tax may be a choice. Basing on statistics for October 2006 from Hong Kong Monetary Authority, the estimated annual saving interest tax revenue is HK$ 22.8 billion [0.5% (tax rate assumed) x HK$4,563 Billion (customer deposits with authorized institution)]Pros for this alternative are as follows:

- it is simple and cost-effective in the sense that the administration and collection are responsible by financial institutions;
- it achieves a fair resource allocation, which is the spirit of tax, while rich people will pay more and poor people pay less;
- it is simple to implement exemption policy by setting a taxable starting amount of saving, for example average saving amounting more than HK$10,000 will be subject to the saving interest tax of 0.5% on the exceeding saving (with a cap of the saving interest income earned);
- it is simple and easy to forecast the tax income;
- it is stable as it relative to the amount of savings; and
- the tax base is wide as individual and business will fall into the tax net.

Section 4: Conclusion.

Because of the government's huge expenditure and commitment, the financial deficit appears to be structural. The structural deficit for each year is covered by non-routine income from the sales of government-owned assets. This situation is unhealthy as this income source is not stable and sustainable. In case the business profit and individual salary shrink of economic recession, the government will be in a deficit position and the reserve created will be used up gradually. The deficit position and reserve insufficiency may restrict the government's use of fiscal policy in stimulating the economy in the recession and, consequently, hold back the economic recovery.

In order to resolve the structural issue, the government requires improving its cost-effectiveness and exploring new income sources. In this regard, broadening tax base is a necessary step to exploring new income and stabilizing its income. Among those suggestions, saving interest tax is a feasible alternative worthwhile for further consideration and study.

Hope that the above opinions would be useful to the government in formulating the tax reform and the tax reform will be implemented successfully. If you have any enquiry on the abovementioned views, please feel free to contact me at

Last but not least, please note that the abovementioned views are presented for the **restricted use** of tax reform and **the author reserves the right for reproduction and publication** of the abovementioned content

Regards,

(Signed)

(Name provided)

(Editor's note: The sender requested anonymity.)