

17 March 2007

Financial Secretary  
Financial Services and the Treasury Bureau  
The Government of the Hong Kong Special Administrative Region  
4/F, Main Wing, Central Government Offices  
Lower Albert Road, Central, Hong Kong

Dear Sir:

**Tax Reform – Public Consultation on Base Broadening Measures**

The enclosed submission is made in response to the Government's solicitation of views from the public in the Consultation Document issued in July 2006 and the Interim Report thereon issued in December 2006.

I am submitting this paper in my personal capacity. I am a permanent resident of Hong Kong, living and working here on a full-time basis. My involvement in Hong Kong's tax community began almost 20 years ago, when I moved to Hong Kong in 1987 to work in the tax practice of a prominent Hong Kong solicitors firm. I am the author or co-author of three books on Hong Kong taxation<sup>1</sup> and numerous published articles on Hong Kong and international tax issues. From 1991 to 1994 I was a full-time lecturer in Revenue Law and other subjects at the University of Hong Kong, Faculty of Law, and I currently serve as the external examiner for their Revenue Law course. In 1995 and 1996 I was a member of the Joint Liaison Committee on Taxation, in my capacity as the chairman of the Tax Committee of the American Chamber of Commerce in Hong Kong. I am a Fellow of the Chartered Institute of Taxation (UK) and served in 2005-06 as Special Counsel to the Associate Chief Counsel (International) of the Internal Revenue Service in Washington, DC.

My submission advocates a number of base-broadening measures with a common theme: they would accomplish a significant broadening of Hong Kong's revenue base while being politically acceptable to the public. They are broad-based consumption tax measures that would accomplish much of what the Government had hoped to accomplish with a Goods and Services Tax. They should not give rise, however, to the objections that were raised to the GST proposal, for reasons explained in my paper.

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<sup>1</sup> VanderWolk, *The Source of Income: Tax Law and Practice in Hong Kong* (Sweet & Maxwell Asia: 3<sup>rd</sup> ed. 2002); VanderWolk, Halkyard, and Chow, *Hong Kong Tax Law: Cases and Materials* (Butterworths Asia: 4<sup>th</sup> ed. 2004); VanderWolk and Halkyard, *Taxation of Property Transactions in Hong Kong* (Butterworths Asia: 1995).

I appreciate having the opportunity to submit my ideas on broadening the tax base to the Government. Please do not hesitate to contact me with any questions or comments on any aspect of my submission.

Yours sincerely,

Jefferson VanderWolk

**Broadening Hong Kong's Tax Base:  
Politically Acceptable Broad-based Consumption Charges**

A submission in response to the Hong Kong Government's Consultation Document on  
Tax Reform dated July 2006 and the Interim Report thereon dated December 2006

by  
Jefferson VanderWolk  
March 2007

*I. Introduction*

In July 2006, the Government published its Consultation Document on Tax Reform, in which it advocated the adoption of a Goods and Services Tax (GST). The Government argued that a GST would broaden the tax base, stabilize public finances, comply with the "capacity to pay" principle and help maintain Hong Kong's competitiveness and its low-tax business environment. In the ensuing several months, the community expressed strong opposition to the GST proposal on a number of grounds, including concerns that a GST would complicate tax compliance, making Hong Kong a more expensive and less business-friendly place, and would increase the cost of consumer goods and services, reducing Hong Kong's attractiveness to international visitors.

In December 2006, the Government published its Interim Report on tax reform, in which it acknowledged that the community's general opposition to the GST proposal, despite the majority's acceptance of the need to broaden Hong Kong's tax base, meant that the enactment of a GST could not be pursued in the immediate future. The Government solicited further public comment on base-broadening possibilities other than GST prior to the end of the consultation period on 31 March 2007. A list of 10 possible measures (other than GST) was published on the Government's tax reform website. One of the listed possibilities was so-called "green" taxes such as a tax on plastic shopping bags or a tax on electricity consumption.

More recently, the Financial Secretary mentioned the ongoing tax reform consultation exercise in his Budget speech on 28 February 2007. He reiterated the Government's intention to introduce base-broadening measures after giving due consideration to all submissions received.

In late December 2006, the South China Morning Post conducted a survey of the tax reform views of 690 decision-makers in the Hong Kong community. Nearly two-thirds of those surveyed felt that the tax base needs to be broadened. The two most popular options out of a range of tax options suggested by the surveyors were taxes on luxury goods (favored by 82%) and "green" taxes such as a plastic bag tariff or an additional surcharge on waste disposal (favored by 73%).

The Financial Secretary also mentioned the possibility of “green” taxes in his Budget Speech on 28 February 2007. Specifically, he noted that a possible tax on plastic bags was being considered.

## *II. Executive Summary*

### 1. Base broadening without the drawbacks of a GST

It is submitted that the Government should broaden the revenue base through the imposition of well-designed “green” taxes as described below. The proposed green tax package would have most of the benefits, but few of the drawbacks, of the GST proposal. The environmental benefits, though significant and important, are secondary for the purposes of this base-broadening consultation exercise.

The proposed tax measures would yield multiple benefits. First and foremost, they would have a significant base-broadening effect, producing a stable flow of revenue fairly and efficiently, without requiring significant start-up or ongoing administrative costs. Second, they would enable a so-called “green shift” of the tax burden toward negative externalities, alleviating the burden on beneficial productive activity, such as labor, thereby producing a more business-friendly economic environment. Third, the new taxes would encourage the adoption of cleaner and more efficient methods of producing and using energy and water, and would help to tackle Hong Kong’s air pollution problem. Thus, the tax measures would improve our public financing as well as Hong Kong’s attractiveness as a business location.

The proposed taxes (described briefly in section 3 of this Executive Summary and in more detail in later sections of this submission) would relate to the use of fossil fuels in the energy and transport sectors; to the use of water; and to the use of plastic bags. Hong Kong’s revenue base would be greatly broadened by new or increased government charges that would be borne either directly or indirectly (through increased prices) by the end consumers of these utilities and products. Virtually every household and business in Hong Kong uses electricity, gas, and water. Most of Hong Kong’s population uses motor vehicles in some way, by using public buses or private vehicles for personal transport or using commercial vehicles for business purposes. And the number of new plastic bags that are used and then discarded every day in Hong Kong is truly astonishing.

### 2. Political acceptability

Although these green taxes would raise revenue from a base as broad as the base of a GST, they should be acceptable to the community, provided that the public is fully informed of the benefits as well as the costs. It is widely recognized that Hong Kong’s standing as a leading international business center is being harmed by its air pollution problem, and that more needs to be done to discourage carbon emissions and encourage clean energy and energy conservation. The proposed taxes would conform to the “polluter pays” principle, falling more heavily on those who consume more. The taxes

would also be relatively simple to administer. The vast majority of the broad base of consumers who would share the cost would not be required to file any forms or pay any additional bills. Moreover, the taxes would be invisible to international visitors, who would continue to enjoy a Hong Kong with no sales tax on retail goods. And giving appropriate relief to low-income households would help ensure that the taxes were perceived as fair. Finally, the Government could use the revenue from the new taxes for a “green shift” of the overall tax burden, reducing taxes on beneficial economic factors, ie non-polluting goods and services and related labor.

### 3. Recommended tax measures

The recommended green taxes are as follows:

A. **Harmful Emissions Tax (HET).** HET would be imposed on the basis of monitored emissions from the use in Hong Kong of specified fossil fuels (including coal, oil, naphtha, and natural gas, but excluding LPG and hydrocarbon oils currently subject to duty in Hong Kong) for:

- production and/or distribution of electricity, gas, or LPG; or
- manufacturing, construction, and/or any other industrial or commercial activity.

Given that relatively little industrial activity occurs in Hong Kong, HET would be collected primarily from Hong Kong’s main suppliers of electricity and gas, namely China Light and Power (CLP), Hong Kong Electric (HKE), and Hong Kong and China Gas (Towngas). Under relevant pricing regulations, the cost of HET would be passed on to their customers – that is, essentially every household in Hong Kong as well as non-residential users. (Relief would be provided to low-income households in the form of increased CSSA relief or other cash transfers.) Thus, the HET would broaden the revenue base as much as a GST would, without imposing on the public any of the implementation costs or complications of a GST.

B. **Motor fuels duties enhancement.** Hong Kong already collects duties on motor fuels such as petrol and diesel fuels. However, the level and scope of these duties can and should be increased. In particular, the franchised bus companies should be subject to full rates of duty on the fuel that the buses consume. In addition, liquefied petroleum gas (LPG), which is used by a broad base of over 700,000 customers, should be subject to duty as well, although at a lower rate. As in the case of the HET, the cost of these duties would ultimately be borne by the public at large through increased prices for transport and motor fuels, thus broadening Hong Kong’s revenue base. At the same time, energy efficiency would be encouraged, as more efficient commercial users of motor fuels would have a competitive advantage over less efficient competitors.

C. **Water and sewage charges enhancement.** The Government provides subsidized water and sewage services to over 99% of Hong Kong’s population. The current charges should be increased significantly, thereby raising more revenue from the

broadest possible base of taxpayers (with appropriate relief for low-income households and for desirable uses of water, such as for water-cooled air conditioning systems, which are more energy-efficient than traditional air-cooled systems). As with the other green taxes, increased water and sewage charges would encourage conservation and discourage waste.

- D. **Plastic bag tax.** The Government has indicated that it is already studying a tax on the use of plastic shopping bags. Millions of these bags are used every day in Hong Kong by the public at large. Consequently, a tax on them would have a base broadening effect. The harmful effect of plastic bags on the environment is well documented, so the tax would have the beneficial effect of discouraging their use.
- E. **Traffic congestion-zone charge.** This charge would be imposed on motor vehicles crossing the boundary line of a defined “congestion zone”. Cities such as London and Singapore have successfully implemented this type of charge. Appropriate exemptions should be given to particular classes of vehicles.
- F. **Cross-Harbour Tunnel charge enhancement.** The charge for using the central Cross-Harbour Tunnel should be increased to at least the same level as the charge for the other harbour tunnels.

### *III. Discussion*

#### 1. Background to the GST proposal

In 2002, the Financial Secretary received the Final Report of the Advisory Committee on New Broad-Based Taxes. The Advisory Committee had met regularly since June 2000 to consider the best options for broadening the tax base. Eight widely accepted principles of good taxes were used in evaluating different possibilities: neutrality, fairness, effectiveness, efficiency, certainty and simplicity, flexibility, international competitive effect, and stable revenue yield. The Advisory Committee concluded that, of all the options that it had surveyed, a general consumption tax was the only one that satisfied the main goals of being broad-based and effective in producing a significant amount of revenue even when imposed at a low rate. In addition, a general consumption tax scores well on most of the other criteria for evaluating the design of a tax.

Thereafter, the Government concluded that a GST should be introduced following a period of public consultation, which began in July 2006. As noted above, the public was generally hostile to the GST proposal, and the Government shelved it in December 2006. The public’s concerns, as identified in the Interim Report, were that a GST would be regressive, complicated, and costly to administer and comply with, and would hamper the development of tourism by detracting from Hong Kong’s status as a “shopping paradise”.

#### 2. Green tax options: Advisory Committee’s decision not to decide

Notably, the Advisory Committee excluded from its deliberations all “green tax” proposals related to the consumption of goods that have a harmful environmental effect, choosing instead to refer the issue to the Government for further study. In paragraph 40 of its Final Report, the Advisory Committee said:

A specific “green tax” may yield meaningful revenue and have a broad tax base. That said, the Advisory Committee is concerned that it does not possess the expertise to advise whether it will hamper or help the environmental protection objective, or whether a non-tax measure could achieve a superior result. The Advisory Committee considers it appropriate to leave to the Government and its relevant advisory bodies to deliberate on what “green taxes” would be most useful in furthering the environmental protection cause and how each initiative should be prioritized and targeted. The Advisory Committee has therefore not discussed “green taxes” as a tax-base-broadening proposal.

The Advisory Committee seems to have given precedence to the environmental protection aspect of green taxes, rather than focusing on the revenue-raising and base-broadening potential of particular proposals.

**It is submitted that the Government should now give serious consideration to a green tax package that has most of the benefits, but few of the drawbacks, of the GST proposal.** The environmental benefits, though significant and important, are secondary for the purposes of this base-broadening consultation exercise.

### 3. Preserving the benefits of a GST without losing existing strengths of HK’s system

A broad-based consumption tax such as GST has a number of favorable elements, including effectiveness (significant, stable revenue yield), fairness (vertical equity), and neutrality (horizontal equity). Hong Kong’s current tax system, with its narrow tax base and income-based taxes, is not at all certain to achieve the systemic goals of effectiveness, fairness and neutrality in any given year. There is widespread agreement, therefore, that Hong Kong’s tax base should be broadened, provided that the new taxes are fair and neutral.

At the same time, the people of Hong Kong have made it clear that they are not willing to live with the negative aspects of a full-fledged GST. Hong Kong’s prosperity is due, at least in part, to the ease of doing business here and the relative lack of government intrusion in the private sector. Taxes have always been low and tax compliance has always been very simple: an annual tax return must be filed, after which an assessment is received and the tax due is paid. In addition, Hong Kong has been free of most import duties and has never had a general sales tax. Compared to most other jurisdictions, Hong Kong is wonderfully free of red tape and tax-related paperwork and cost. This advantage must not be lost.

Now that the GST proposal has been shelved, the Government should seek to adopt alternative base-broadening taxes that will provide the same systemic benefits as a GST would have provided. In order for such alternative taxes to be acceptable to the community, they must not involve the problematic aspects of the GST proposal, namely: substantial new tax filing requirements and compliance costs, and the imposition of a general sales tax on retail goods and services.

#### 4. Public support for green taxes

The political acceptability of green taxes in Hong Kong is indicated by a public opinion survey published by the South China Morning Post (SCMP) on January 3, 2007 entitled "Tax Reform, Fiscal Health and the Proposed Goods and Services Tax." The survey comprised 690 people described as "opinion leaders and business decision-makers" aged 25 or above with monthly household income of at least HK\$40,000. Only 32% were readers of the SCMP. A two-thirds majority felt that Hong Kong's tax base is too narrow and that tax reform is needed, but a majority said that a GST was not a good idea. Of 15 tax options presented, only two were supported by at least a two thirds majority: a "tax on luxury goods" (82%), and a "green tax such as plastic bag tariff and additional surcharge on waste disposal" (73%). More than 60% of those surveyed felt that new taxes would be acceptable even if the reduction in their salaries tax and profits tax liability was only 5% or less.

After the shelving of the GST proposal, a public commentator observed:

One of the options that seems to have gained increasing support from lawmakers and civic leaders is the introduction of an environment-related 'green' tax. This appears to be the most sensible choice because Hongkongers can be counted on to chip in for the improvement of the environment, which has been a major concern not only to environmentalists but also to the general public. (Hong Liang, "Green tax the most sensible for Hongkongers", *China Daily*, December 19, 2006)

The work of groups such as the Business Coalition on the Environment (Project Clean Air) and the Business Environment Council's Business-Led Initiative on Air Pollution in Hong Kong and the Pearl River Delta reflects the desire of the business community to tackle the worsening air pollution in Hong Kong. In a December 2005 report, "Living Under Blue Skies Paper No. 4: Clean Energy for the PRD", the following conclusions are stated by the BEC:

[T]he current deterioration in environmental quality is a result of burning fossil fuels. ... The main regional sources of air pollution are power and transport. For any improvement measures to be effective, general policy mechanisms must be in place ... Both fuel technologies and pollution controls require financing. Novel ways to do so should be explored, for instance the air emissions trading programme that is being considered by both governments [ie of Hong Kong and Guangdong] ....



As discussed further below, the implementation of a tax on emissions in Hong Kong would not be inconsistent with the emissions capping and trading program that the Government has been developing in cooperation with the Mainland authorities. The Hong Kong community would be likely to accept such a tax if it did not have the objectionable features of a GST.

#### 5. Trend in China and elsewhere

Internationally, there is growing support for taxes that are linked to pollution. According to a recent survey of 6,576 people in Britain, France, Germany, Italy, Spain and the United States, more than 80% of those surveyed in each country supported taxing industrial companies on the basis of how much pollution they produce: “Analysts said the poll results indicated that the public wanted responsibility for global warming to bear a financial consequence, even though such costs would probably be passed on to consumers.” (“Poll finds strong support in Europe and U.S. for polluter taxes”, International Herald Tribune, February 23, 2007) Similar percentages said that their governments were not doing enough to address global warming. However, “between 54 and 61 percent in the six countries said that industry, governments and people in general were all responsible” for global warming. In other words, most people recognize that everyone has a duty to help meet the financial costs of reducing pollution.

Closer to home, the National People’s Congress of the PRC is now considering environmental tax measures. The Wall Street Journal recently reported that the NPC would look at “proposals to raise consumption taxes on fossil fuels ... Energy-intensive and polluting companies are also likely to be asked to pay more for their power supplies.” (“China aims to cut energy use”, The Wall Street Journal, March 5, 2007) This was confirmed by Mr Jin Renqing, the PRC finance minister, on March 9<sup>th</sup>. According to an Associated Press report, Mr Jin said the government is “working on plans to impose taxes on fuel consumption and pollution in order to encourage environmental protection... ‘We are now in active discussions on how to introduce new tax rules in order to encourage environmental protection, for example a carbon dioxide tax,’ he said.” (“China tax plan would hurt foreign firms”, Associated Press (published on chron.com, the website of the Houston Chronicle), March 9, 2007)

As Hong Kong is a part of the PRC, base-broadening measures in Hong Kong that are in line with tax policy initiatives of the national government in Beijing are likely to be viewed as natural and appropriate.

#### 6. Effectiveness of environmental taxes: OECD Policy Brief

A recent policy paper published by the Organisation for Economic Co-operation and Development (OECD) states that “using taxes to achieve environmental objectives is clearly efficient for the economy as a whole”. (“The Political Economy of Environmentally Related Taxes”, OECD Observer, February 2007) The paper notes that in the OECD countries, environmentally related taxes currently raise revenues of 2-2.5% of gross domestic product. The paper also observes that such taxes can be designed to

have low administrative costs: “For example, taxes on petroleum products are usually levied on a limited number of petroleum refineries and depots, and are hence relatively simple to administer and enforce.”

With respect to base broadening, the OECD paper says, “Applying the new taxes to broad-based tax bases, and introducing them as part of broader fiscal reform, can also make it easier to win political acceptance, and thus make the tax easier to implement.” The paper stresses the importance of public awareness of the environmental problem being tackled and the contribution of the tax to the reduction of the problem, along with involvement of all stakeholders in policy formulation.

Regarding the regressiveness of broad-based consumption taxes, including those linked to polluting factors, the OECD paper recommends using “direct compensation measures to address concerns for low-income households, e.g. through the social security or tax systems. ... For individuals whose income is so low that they pay little or no tax, it can be preferable to provide cash transfers.” The paper highlights the importance of addressing regressivity concerns early in the policy-making process, so as to ensure that the public perceives the taxes to be fair.

## 7. Proposed base-broadening green taxes for Hong Kong

Against this background, the following tax measures are proposed:

- Harmful Emissions Tax (HET)
- Increased and expanded duties on motor fuels
- Increased water and sewage charges
- Plastic bag tax
- Traffic congestion charge
- Cross-Harbour tunnel toll increase

Each is discussed below.

### 7.1 Harmful Emissions Tax (HET)

Part of the GST proposal would have been the imposition of GST on the consumption of electricity and gas by both businesses and households. One alternative base-broadening consumption tax measure – a harmful emissions tax, or HET – is premised on the same concept of raising revenue from the broadest possible base: domestic and business users of electricity and gas. HET would not require any new tax filing requirements by the general public; nor would it be, or have the effect of, a general sales tax. As “icing on the cake”, HET would help reduce Hong Kong’s air pollution.

HET would be imposed in respect of harmful emissions from the use in Hong Kong of specified fossil fuels (including coal, oil, naphtha, and natural gas, but excluding LPG and all hydrocarbon oils currently subject to duty in Hong Kong) for:

- production and/or distribution of electricity, gas, or LPG;

- manufacturing, construction, and/or any other industrial or commercial activity.

HET liability ideally would be determined on the basis of actual emissions data reported for purposes of compliance with air pollution regulations or other obligations. For purposes of the tax, “harmful emissions” would need to be clearly defined. Most likely the definition would include, at a minimum, emissions of sulphur dioxide (SO<sub>2</sub>), nitrogen oxide (NO<sub>x</sub>), and respirable suspended particulates (RSP). Depending on whether relevant information could be easily obtained, the definition might also include carbon dioxide (CO<sub>2</sub>) emissions. The tax might be applied to each type of emission at a separate rate, or alternatively, it might be applied to total emissions at a single or blended rate.

Most of the revenue raised by the HET would be payable by Hong Kong’s two electricity suppliers, China Light and Power (CLP) and Hong Kong Electric (HKE). Under the Scheme of Control agreements between the Government and the electricity suppliers, their HET cost would be passed on to their customers – that is, essentially every household in Hong Kong as well as non-residential users. In addition, Towngas, which supplies over 1.6 million customers, and any other companies subject to HET (including LPG suppliers other than Towngas) could also be expected to raise prices in order to recover the cost of the tax.

Thus, the HET would broaden the revenue base as much as a GST would have, without imposing on the public any of the implementation costs or complications of a GST. The immediate effect on the community would simply be that most households and businesses in Hong Kong would see an increase in their electricity and gas bills.

Estimates of the total annual revenue that might result from the HET can be obtained by applying alternative percentage increases to the total sales of electricity and gas in Hong Kong of the companies that would be liable for HET. Based on the most recent financial results of CLP, HKE, and Towngas, the total sales number would be at least HK\$50 billion. Thus, each percentage point of increase in the cost of electricity and gas due to HET would mean annual HET revenue of at least HK\$500 million. For example, a 20% increase in electric and gas bills would indicate HET revenue of at least HK\$10 billion. The HET rates on harmful emissions could be set so as to reach the desired amount of revenue, based on projected emissions.

Public acceptance of significant increases in the cost of electricity and gas would depend in large part on the Government’s ability to communicate that Hong Kong’s continuing prosperity requires both that the revenue base be broadened (with appropriate relief for low-income households) and that more must be done to tackle the air pollution problem. HET would probably be viewed as an appropriate means to help achieve these goals. It would be levied on the “user pays” principle and would encourage beneficial economic factors such as energy efficiency and consequent cost reductions, as well as cleaner air. Moreover, it would not have the objectionable features of a GST, ie new filing and recordkeeping requirements for all and the creation of a general retail sales tax.

Relief from increased electricity and gas bills could be provided to low-income households in the form of increased CSSA relief or other cash transfers. More generally, the Government could provide relief by way of a “green shift” of the tax burden, reducing other taxes to offset the cost of HET, thereby minimizing the risk of an inflationary effect.

## 7.2 Increased and expanded duties on motor fuels

Currently, Hong Kong generally imposes duty on hydrocarbon oils at the following rates per liter:

- |                           |          |
|---------------------------|----------|
| • Aircraft spirit         | HK\$6.51 |
| • Light diesel oil        | HK\$2.89 |
| • Leaded petrol           | HK\$6.82 |
| • Unleaded petrol         | HK\$6.06 |
| • Ultra low sulfur diesel | HK\$1.11 |

Duty on diesel oil used by franchised bus companies is refunded to those companies, effectively giving them an exemption from the duty. The total refund for 2005 has been estimated as exceeding HK\$1 billion. The net revenue to the Government from duties on hydrocarbon oils in 2005 was approximately HK\$3.3 billion.

It is submitted that:

- the current rates of duty on aircraft and motor spirit should be increased by at least 10%,
- the rates of duty on light diesel oil and ultra low sulfur diesel oil should be doubled,
- no refund of duty should be made to the franchised bus companies; and
- duty should be imposed on LPG, but at a rate lower than the rate for ultra low sulfur diesel.

These increases and expansions of duties on motor fuels should raise several billion dollars of additional revenue annually. Most of the cost would be indirectly borne by users of transport – ie the public at large – through increased prices. Thus, there would be a significant base-broadening effect for the Hong Kong tax system as a whole.

As discussed above regarding price increases due to HET, it would be important for the Government to communicate to the public that transport price increases due to increased and expanded duties on motor fuels are necessary for the continued prosperity of Hong Kong. Again, relief could be provided to low-income households through CSSA and other means. Given the link to reducing harmful roadside air pollution and improving the tax base, the adherence to the “user pays” principle, and the minimal administrative requirements, the increased and expanded duties should be acceptable to the public.

## 7.3 Increased water and sewerage charges

The Government provides water and sewage services to the community through the Water Supplies Department (WSD) and the Drainage Services Department (DSD). These

services are provided at a loss, in that the revenue from water charges and sewage charges is far less than the operating costs of the WSD and DSD respectively. It is submitted that the charges should be substantially increased, so that the cost of these services is borne by their users in proportion to their level of use. This would help broaden the base of Hong Kong's public finances.

In 2005-06, the WSD collected approximately HK\$2.6 billion of water charge revenue from 2.64 million accounts (2.37 million of which were households). Approximately 45% of households paid no more than HK\$25 per month in water charges, and only 21% paid HK\$75 or more per month. The operating costs of the WSD for 2005-06 were approximately HK\$6.25 billion (of which HK\$2.5 billion was the cost of purchasing water from Guangdong).

The DSD collected sewage charges from 2.44 million accounts in 2005-06, raising approximately HK\$700 million. Its operating costs for the year were approximately HK\$1.76 billion, resulting in an operating deficit of more than HK\$1 billion. The DSD website states: "There is a need to raise steadily the charge in the coming years." There has been no increase in either sewage charges or water charges since 1995.

Doubling the current charges for water and sewage would raise approximately HK\$3.3 billion annually from an extremely broad base of payers. The WSD and DSD would still be operating at a loss (assuming they cannot cut costs significantly), but the financing of their operations would be much more in line with the "user pays" principle, and therefore much more fair. Moreover, the revenue increase would not require any new administrative machinery or cost. As a side benefit, the increased charges would encourage conservation of water and reduction of sewage.

The international trend is for governments to set water and sewage charges at a level that will cover costs. The OECD has noted that, in member countries, "pricing structures for municipal and industrial water services increasingly reflect the full costs of providing the services. ... OECD countries are working towards more complete recovery of infrastructure and operating costs from users." ("Pricing water", OECD Observer, March 2003)

Relief for any low-income households in Hong Kong affected by the increased water and sewage charges could be provided through the CSSA system. Also, beneficial uses of water could be encouraged through refunds of water charges imposed on the relevant use. For example, a refund mechanism could be instituted for water used in water-cooled air conditioning systems, which are far less energy-intensive than air-cooled systems. The refund could be for a portion (or even all) of the water charge payable in respect of the water used for the beneficial purpose.

#### 7.4 Plastic bag tax

The Government has reportedly been studying possible methods of implementing a tax on plastic bags used in grocery stores and other retail outlets. Given that an estimated 5

billion new plastic bags are used (very briefly) and then discarded each year in Hong Kong, it is essential that measures be introduced to discourage their use. Imposing a tax on plastic bags would have that beneficial effect. More importantly, for purposes of this submission, a tax on plastic bags could have a significant base-broadening effect for Hong Kong's public finances, at least in the short term.

A tax of HK\$1 per bag would raise approximately HK\$5 billion per year, unless the use of plastic bags dropped significantly due to the tax. Even if the use of such bags dropped by 50%, the revenue would be significant, ie HK\$2.5 billion per year.

The base-broadening effect would be most direct if the tax were imposed on end-users, ie the customers of the retail stores and take-away food outlets. As is the case in Ireland, the tax could be itemized as a separate charge to the customer, collected by the retailer, and paid over to the Government by the retailer at a convenient time (say, at the time of filing the annual Profits Tax Return). Retailers would have to be required to keep records of their bulk purchases of plastic bags as well as the taxes collected from customers. They would have the financial benefit of being able to use the money collected until the required time for payment to the Government.

#### 7.5 Traffic congestion-zone charge

The Government is reportedly considering the implementation of a congestion-zone charge along the lines of those which are applied in London or Singapore. This type of user fee has proven to be effective both as a revenue source and as a means of improving the flow of high-priority traffic, such as public buses, in the central urban area. It is submitted that, unless a more comprehensive electronic road pricing mechanism can be implemented in the near future, a congestion-zone charge would be advisable as an additional source of revenue for the Government.

Given the level of household income of the owners of most private cars in Hong Kong, a charge as high as HK\$100 per day would not be excessive. Appropriate reductions or exemptions from the charge should be given for vehicles such as public buses, taxis, emergency services, and emissions-free or emissions-reduced private vehicles. Assuming that several hundred thousand chargeable crossings would occur each day, the amount of revenue generated could easily be in the range of HK\$5-10 billion per year.

#### 7.5 Cross-Harbour Tunnel toll increase

The central Cross-Harbour Tunnel is by far the most widely used tunnel in Hong Kong. In 2005 it was estimated that over 120,000 vehicles used the tunnel each day. The tolls charged for the central tunnel are significantly lower than the tolls for the Eastern and Western tunnels, which undoubtedly is the main factor in the central tunnel's popularity.

This situation presents an obvious revenue-raising opportunity for the Government. Simply raising the central tunnel tolls to the same levels as those for the other tunnels should generate close to HK\$1 billion per year.

#### *IV. Conclusion*

The Government's "Brief of Other Options for Broadening the Tax Base" stresses three widely accepted principles for evaluating the strength of a proposed tax: (1) fairness, which depends on adherence to the "user pays" and "capacity to pay" principles; (2) stable and significant revenue yield, regardless of economic conditions or demographic structure; and (3) maintenance of international competitiveness, which in the case of Hong Kong means simplicity, lack of paperwork and compliance costs, and a low overall tax burden. In addition, the need to broaden Hong Kong's tax base means that base-broadening potential is a key criterion for any new tax proposal.

For reasons discussed above, all of these criteria are met by the tax measures proposed in this submission. They would be fair, assuming that appropriate relief was provided to low-income households. They would yield a significant amount of revenue regardless of economic conditions or demographic changes, as they would be based mainly on consumption of essential utilities. They would raise the revenue from an extremely broad base, ie every household and business in Hong Kong. And they would maintain, and even enhance, Hong Kong's international competitiveness, because: they would not require any significant new administrative or compliance requirements; they would permit reduction of other taxes which currently affect businesses and employees; and they would contribute to the reduction of air pollution, which is currently threatening Hong Kong's reputation as a desirable base for international business activities.

The proposed taxes should be politically acceptable, provided the Government does a good job explaining their benefits and includes all stakeholders in the process of designing the final form of the taxes. The most effective message to the community might be "This package of green taxes will apply to a base as broad as that of a GST but will not involve the features of a GST that were considered objectionable; and as a side benefit the taxes will help improve the environment and preserve our attractiveness as an international business center."