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Subject: Paper Submisson for Broadening of HK Tax Base

Dear Hong Kong Financial Services and Treasury Bureau,

Please accept the attached paper, "TAX PAPER", as a public submission for principles of and various options for broadening the HK tax base.

I am a third year law student at Queen's University Faculty of Law in Canada. Between September - December 2006, I attended City University of Hong Kong School of Law as an academic exchange student. This was my first visit to Hong Kong, and I found HK to be a magnificient SAR with a superbly efficient and open-minded government.

During my stay in HK, I became interested in the widely-publicized issue of how to broaden HK's tax base and endeavoured to join HK's Civic Exchange. To learn more about this issue, I met and spoke with HK Secretary for Financial Services and the Treasury, Frederick Ma Si-hang at a CityU conference.

Upon my return to my home university in Canada, I felt compelled to prepare a submission to offer my views on the debate. Attached here is my "TAX PAPER", in Microsoft Word format.

I was extremely impressed with Hong Kong and am planning to come back for a second time this summer!

With kind regards,
Gary Chui

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TAX PAPER.doc

THE ADVENT OF THE GOODS AND SERVICES TAX IN HONG KONG:

INSIGHT FROM THE CANADIAN EXPERIENCE

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QUEEN'S UNIVERSITY FACULTY OF LAW

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THE ADVENT OF THE GOODS AND SERVICES TAX IN HONG KONG: INSIGHT FROM THE CANADIAN EXPERIENCE

5142466 LAW508 MONDAY 2 APRIL 2007

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INTRODUCTION

Tax reform is coming to Hong Kong.

On 19 July 2006, the Government of Hong Kong launched a nine-month public consultation on whether to implement a 5% goods and services tax (GST), a form of sales tax on local consumption. Tax is collected at each stage of the production and distribution chain by registered vendors, who need to account for the tax on the value that they have added to goods and services, and the cost is finally borne by end consumers. According to the government, the Hong Kong (HK) tax base is too narrow, and so tax reform is needed to establish a steady revenue source to secure future prosperity. Now that Hong Kong has recovered economically from the Asian Financial Crisis of 1997 to 2003, the HK government intends to broaden the tax base to build public finances in order to better withstand future economic challenges.[1]

The stable and high revenue prospects of the GST are enticing. In generating tax revenue, Hong Kong is heavily reliant on its Salaries Tax, Profits Tax, and property-related taxes – all of which are

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[1] The Government of the Hong Kong Special Administrative Region of the People's Republic of China, *Broadening the Tax Base Ensuring Our Future Prosperity: What's the Best Option for Hong Kong?* Chapter 4. Available at http://www.taxreform.gov.hk/eng/document.htm. Accessed on 18 March 2007. [GST Consultation Paper] [Chapter 4].

volatile and unpredictable sources which fluctuate with economic conditions.[2] But as learned from other countries, the GST can contribute between 12% to 30% of tax revenue, representing as much as 10% of gross national product and create a valuable, reliable tax source especially in countries that have a limited income tax base.[3] The HK government forecasts that a 5% GST, with minimal exemptions and zero-rated items, would yield approximately HK$30 billion in revenue per year.[4]

However, the current version of the GST proposal may not survive a constitutionality test for three related reasons. First, a GST with no exemptions on daily necessities such a food, health care, and education means that GST payments by low-income households will constitute a notably higher proportion of their income than payments by higher-income households.[5]

Second, introduction of a new tax on consumption can cause upward pressure on inflation, a rise in the consumer price index (CPI), and deleterious consumption pattern changes, especially affecting low-income households.[6]

Third, although the HK government has proposed annual transfer payments to low-income households not in receipt of Comprehensive Social Security Assistance (CSSA) welfare payments[7], this relief package may be insufficient to mitigate the GST effects given Hong Kong's consumption-driven lifestyle, and force many non-CSSA low-income families into collecting CSSA. The resultant psychological harm, inadequate proposed subsistence payments, and threats to economic security imposed upon lower-income households may amount to an ensnaring of their "new property".

This paper argues that these three possible consequences of the HK government's GST implementation would so adversely, seriously, and disproportionately affect the poor to a greater extent versus the rich, such that there are sufficient legal grounds to establish the GST as unconstitutional:

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[2] GST Consultation Paper, *supra* note 1, Chapter 1, [Chapter 1].
[3] Alan A. Tait, *Value-Added Tax: Administrative and Policy Issues*. (Washington DC: International Monetary Fund, 1991), [Tait].
[4] GST Consultation Paper, *supra* note 1, Chapter 5, [Chapter 5].
[5] Tait, *supra* note 3.
[6] Organization for Economic Co-operation and Development, *Taxing Consumption*. (Paris: OECD, 1988), [OECD].
[7] GST Consultation Paper, *supra* note 1, Executive Summary, [Executive Summary].

first, the GST violates the *Hong Kong Bill of Rights Ordinance*[8] Article 22 by unfairly discriminating upon lower-income households according to the justification test set out in *R. v. Man Wai Keung (No. 2)*[9]; and second, this infringement cannot be justified according to the proportionality test set out in *Leung Kwok Hung & Others v. HKSAR.*[10]

But total rejection of the GST plans would be fiscally imprudent. Hong Kong's narrow tax base, reliance on few and unstable revenue sources, and ageing population pose a formidable structural problem that will put increasing pressure on public finances in the long term. After examining alternative solutions, this paper shows that HK's best option is to broaden the tax base, and the best method of doing so would be to introduce a GST.

However, given that the current GST design may be declared discriminatory against the poor and hence unconstitutional, this paper recommends that Hong Kong mirror Canada's GST legislation[11], which survived a similar constitutional challenge. By adopting Canada's GST system of exemptions and zero-ratings, Hong Kong may successfully and significantly reduce the GST's regressive effects, broaden its tax base, and ensure sustainable public finances in the long run, while respecting its constitution.

THE PRESSING NEED FOR TAX REFORM IN HONG KONG

Of a working population of 3.4 million in Hong Kong, only one-third pay Salaries Tax. Of these 1.2 million salaries tax payers, the top 100,000 contribute 60% of that tax, while 500,000 pay 95% of the total.[12] Furthermore, out of the 750,000 registered businesses in Hong Kong, only the top 800 pay 60% of the total Profits Tax.[13] These figures have led the HK government to advocate that its dependence primarily on these two types of taxes, paid by only small number of taxpayers, is inequitable, conflicts with global norms, and results in a very narrow tax base. Additionally, given that

[8] (Cap.383) s.8. Available at http://www.legislation.gov.hk/eng/home.htm. Accessed on 18 March 2007.
[9] [1992] HKCLR 207, [Man].
[10] (2005) 8 HKCFAR 229, [Leung].
[11] *Excise Tax Act*, R.S.C. 1985, c. E-15.
[12] GST Consultation Paper, Chapter 1, *supra* note 2.
[13] *Ibid.*

the current tax revenue is volatile and unpredictable, the HK government foresees that it may not be able to withstand international competitive pressures or handles another sudden economic downturn. A further major source of budgetary resources is nontax revenue from land sales and investment income, which are also highly volatile over business cycles.[14]

Although the issue of tax reform has been ongoing in Hong Kong for 20 years, with current Financial Secretary Henry Tang (FS) being the fifth FS to speak on the matter, the HK government believes that this is the right time to introduce discussion to broaden the tax base, given the current low unemployment rate (4.4%)[15], mild inflation (2%)[16], and booming economy[17]. In this ongoing public consultation period, the government is soliciting views on how to share the tax burden and responsibility in a more equitable and fair manner.[18] In its aim to stabilize public finances, produce predictable and significant revenue, and establish a broad-based tax where avoidance is difficult, the HK government intends to introduce a goods and services tax.

According to the International Monetary Fund (IMF), GST introduction in Hong Kong is prudent, timely, and appropriate for two reasons: first, having a GST would generate substantial revenue and lessen the need to raise salaries and profits taxes for building budgetary resources; and second, the GST would address equity concerns by providing an alternative instrument to bring salaries tax evaders into the tax net.[19] Heeding the IMF recommendations, the HK government began hosting town hall meetings in July 2006 to explain its proposed GST operations to its citizens. Tax reform is on its way.

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[14] *Ibid.*
[15] People's Daily Online, *HKSAR government unveils budget measures to share fruits of prosperity.* 28 February 2007. Available at http://english.people.com.cn/200702/28/eng20070228_353109.html. Accessed on 19 March 2007.
[16] Beijing 2008, *HK's GDP to increase by 4.5 to 5.5 pct in 2007.* 1 March 2007. Available at http://en.beijing2008.cn/04/24/article214022404.shtml. Accessed on 19 March 2007.
[17] *Ibid.*
[18] *Press Conference on Public Consultation on Proposed Reforms to Broaden Hong Kong's Tax Base.* 18 July 2006. Available at http://www.taxreform.gov.hk/eng/news.htm. Accessed on 29 March 2007, [Press Conference].
[19] International Monetary Fund, Fiscal Affairs Department, *Hong Kong SAR Policy and Administrative Issues in Introducing a Goods and Services Tax: Further Considerations.* May 2004. Available at http://www.taxreform.gov.hk/eng/pdf/fundreport2004_e.pdf. Accessed on 30 March 2007, [IMF].

THE GOODS AND SERVICES TAX

The GST, or value-added tax, is a broad-based tax on consumption levied at multiple stages of production, with taxes on inputs credited against taxes on output. So, while sellers are required to charge the tax on all their sales, they can also claim a credit for taxes that they have been charged on their inputs. As opposed to a retail sales tax which is imposed at the final point of sale, the GST system collects tax throughout the process of production and secures such revenue. IMF calculations show that in most countries, the share of GST revenues in GDP exceeds that of the predecessor sales tax, on average by about 1.1% of GDP. [20] First introduced less than 50 years ago, the GST is now a key source of government revenue in more than 135 nations, encompassing over 70% of the world's population.[21]

THE HONG KONG GST PLAN

The Government of Hong Kong believes that a low-rate 5% GST would be appropriate and consistent with the Basic Law[22] – its constitutional document – which stipulates that:

> **Article 108**. The Hong Kong Special Administrative Region shall, taking the low tax policy previously pursued in Hong Kong as reference, enact laws on its own concerning types of taxes, tax rates, tax reductions, allowances and exemptions, and other matters of taxation.

In broadening the tax base, the government intends to levy GST on virtually all expenditure items, with very limited exemptions – namely, some financial services, residential property sales and rentals, exports, and tourist purchases. However, ordinary household expenditures would be subjected to the GST.[23]

In anticipation of this GST impact on household spending, the government is proposing relief measures for the financially vulnerable groups crippled even further by the GST – i.e. CSSA families and non-CSSA low-income families. For CSSA families, the government intends to provide an upfront

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[20] Liam Ebrill, Michael Keen, Jean-Paul Bodin, and Victoria Summers. *The Modern VAT.* (Washington, D.C.: International Monetary Fund, 2001), [Ebrill].

[21] International Tax Dialogue: VAT Conference, *ITD Press Release: Value Added Tax System in a Global Environment.* 15 March 2005. Available at http://www.itdweb.org/VATConference/Pages/PressRelease.aspx. Accessed on 19 March 2007.

[22] *The Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China.* Adopted on 4 April 1990 by the Seventh National People's Congress of the People's Republic of China at its Third Session. Available at http://www.info.gov.hk/basic_law/fulltext/index.htm. Accessed on 21 March 2007, [Basic Law].

[23] GST Consultation Paper, Chapter 5, *supra* note 4.

one-off supplement to offset the GST impact. For non-CSSA low-income households, the government intends to hand out an annual cash allowance, an annual $500 water and sewage credit, plus an annual credit of Rates. However, further GST impact analysis below demonstrates that these relief packages may not suffice in alleviating the heavy financial burden on the poor.

THE REGRESSIVE GST: A HEAVY BURDEN SPECIFICALLY TARGETING THE POOR

As a tax on consumption, the GST would be regressive: since consumption falls as a percentage of income as income rises, then the GST would take relatively more of the income of low-income than of higher-income households.[24] That is, since lower-income households spend a greater proportion of their expenditure on basic necessities than higher-income households, then lower-income households will be faced with greater financial burden. Although the government purports to send relief packages to CSSA and non-CSSA low-income households, an American study has shown that, even with adjustment of indexed transfer payments, the GST burden can be significant upon low-income families and relatively trivial versus higher-income families.[25]

Using food as an example in its Consultation Document[26], the government denies GST regressivity by asserting that in money terms, higher-income groups usually spend more on food than lower-income families – that is, the higher the spending, the higher the amount of tax paid. For example, the government contends that the highest 20% household income group spends $7490 per month on food and would remit GST $374.50 (=5%), whereas the lowest 40% group spends $2530-3880 and would remit a mere GST $126.50-194 (=5%). Thus, the government argues, if they were to exempt food from the GST, then the greatest financial benefit would go to higher-income households.[27] However, the government is misguided for regressivity is measured by the proportion of income taken

[24] Charles E. McLure, Jr., *The Value-Added Tax: Key to Deficit Reduction?* (Washington, D.C.: American Enterprise Institute for Public Policy Research, 1987), [McLure].
[25] *Ibid.*
[26] GST Consultation Paper, Chapter 5, *supra* note 4.
[27] *Ibid.*

in tax, not by the actual tax amount paid. Although higher-income families will pay a higher sum of GST, consumption as a proportion of income always falls as income rises because those with higher incomes tend to save, whereas those with lower incomes tend not to save and even spend in excess of their earnings: the highest 20% income group spends a mere 19.8% of total household expenditure on food, whereas the lowest 40% group spends 31.7-31.4% monthly.[28] Thus, since lower-income families pay a significantly greater proportion of tax upon their income, the GST is regressive and its effects specifically and adversely target this group.

HONG KONG'S SITUATION DIFFERS SUBSTANTIALLY FROM OTHER COUNTRIES

Although numerous other countries have successfully implemented a GST and mitigated its regressive effects on the poor, this does not indicate that GST introduction in Hong Kong will be similarly successful for the Hong Kong situation differs substantially from the others. For example, to reduce the unequal burden upon the poor when the GST was introduced, Australia reduced personal income taxes, state stamp duties, federal wholesales tax, and some fuel taxes.[29] Whereas the European Union's *Sixth Value-Added Tax Directive* requires medical care, postal services, lending, insurance, and betting to be exempt from GST[30]; whereas the Government of India has exempted 49 goods from GST, including aids and implements used by handicapped persons, books, milk, fresh vegetables and fruits, meat, and contraceptives[31]; and, whereas the Canadian Government has exempted certain essential goods, including groceries and medical services, the Hong Kong government has no plans to exempt any of these items.

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[28] Senator S. Syvret, *Goods and Services Tax: Exempt or Zero Rated Items.* (States of Jersey: Jersey, 16 August 2005).
[29] Wikipedia: The Free Enclyclopedia, *Goods and Services Tax (Australia).* Available at http://en.wikipedia.org/wiki/Goods_and_Services_Tax_%28Australia%29. Accessed on 26 March 2007.
[30] Wikipedia: The Free Enclyclopedia, *Value Added Tax.* Available at http://en.wikipedia.org/wiki/Value_added_tax. Accessed on 26 March 2007.
[31] Government of Andhra Pradesh, Hyderabad, India, *The Andhra Pradesh Gazette Part IV-B Extraordinary. Andhra Pradesh Act, Ordinances, and Regulations, Etc.* 28 March 2005. Available at http://www.pdicai.org/vatap/APVATACT_2005.pdf. Accessed on 30 March 2007.

As regards to basic necessities of low-income families, such as food, health services and education, the government has adopted the IMF position paper justification in refusing to exempt such essential goods:

> "The GST is first and foremost an instrument of revenue generation in the most neutral manner possible; it is ill-suited to be used to achieve other economic and social objectives...Hence, it would not be advisable to burden the GST with features largely designed to address equity concerns, such as food exemptions."[32]

Thus, by refusing to exempt inelastic items from the regressive GST, the government is imposing an instrument of equity injustice upon low-income families.

GST CONSEQUENCES: RISING PRICES, RISING INFLATION SHALL CRIPPLE THE POOR

As a consequence of introducing the GST, prices of all non-exempted goods and services will immediately escalate – a fact recognized by the Hong Kong Government. Indeed, in Denmark, there was a clear case of upward pressure on inflation and a 5% rise in the Consumer Price Index following GST introduction, triggering even greater wage increases. In Italy, the rate of inflation accelerated following GST introduction, due to uncertainty and widening profit margins.[33] In Australia, inflation increased dramatically following the GST launch, which pushed the CPI level permanently higher.[34] Thus, by introducing the GST, the government will cause prices of basic necessities to escalate instantaneously and potentiate inflation. Even with the government's proposed relief packages, the regressive GST and increased prices in inelastic goods and services may distort economic choices, force low-income families to consume cheaper, unhealthier foods, refrain from obtaining medical services, or extinguish dreams of higher education.

NON-CSSA LOW-INCOME FAMILIES MAY BECOME COMPELLED INTO TAKING CSSA

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[32] IMF, *supra* note 19.
[33] OECD, *supra* note 6.
[34] Reserve Bank of Australia, *Inflation Targeting: A Decade of Australian Experience*. 10 April 2003. Available at http://www.rba.gov.au/Speeches/2003/sp_dg_100403.html. Accessed on 21 March 2007.

Household offset packages were designed by the HK government on the basis of the need and consumption patterns of different income groups. But, since the government calculated its proposed GST relief measures based on 2004 household expenditure patterns, then such compensation will be deficient for they do not reflect post-2004 consumption trend shifts, increased prices following GST implementation, nor reduced purchasing power of households post-GST introduction. Furthermore, although the household expenditure estimations take food and housing into account, they omit to consider other necessary expenses, such as medical care and high school tuition, which will both be subject to the GST. Thus, due to these many calculation omissions and the usage of outdated consumption pattern data, the proposed household relief packages for lower-income families will be insufficient to offset post-GST costs.

The juxtaposition of Hong Kong's consumption-driven lifestyle, regressive GST effects, and inadequate government relief packages may also force such financial strife upon non-CSSA low-income families so as to compel them into seeking CSSA status. Non-CSSA low-income families may work very hard to free themselves from collecting welfare. But GST introduction may induce this group into financial difficulty and drive them into seeking welfare – a status that may produce significant psychological stress and stigma, causing such families to "lose face"[35].

THE GST AND "NEW PROPERTY"

With these deficient subsistence payments unable to mitigate the GST impact, the government's GST introduction, its ensuing psychological harm, and economic insecurity may be seen as an attack on their citizens' "new property" and ability to pursue economic development, contrary to HK Basic Law and its enshrined International Covenant on Economic, Social and Cultural Rights (ICESCR)[36].

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[35] "lose face" concept in Chinese social relations means "to be humiliated or discredited" and "to not maintain one's reputation and the respect of others". Wikipedia: The Free Encyclopedia, *Face (social custom)*. Available at http://en.wikipedia.org/wiki/Face_(social_custom). Accessed on 20 March 2007.

[36] Adopted by General Assembly resolution 2200A (XXI) of 16 December 1966. Entered into force 3 January 1976. Available at http://www.unhchr.ch/html/menu3/b/a_cescr.htm. Accessed on 21 March 2007. Enshrined in Hong Kong Basic Law Article 33, *supra* note 22.

"New property" – named by American legal scholar Charles Reich in 1965 – describes the new kinds of "things" on which people rely for their sustenance.[37] Reich advocated that for most people, employment, work related benefit, and dependency claims against governments have replaced land and capital as the principal forms of wealth, where the common thread between these new forms of wealth was income security. [38] Since status or "face" – deriving primarily from livelihood – are so closely linked to personality, destruction of one may destroy the other.[39] Reich argued that this "new property" should be accorded the same standard of legal protection as has been accorded in the past to more traditional entitlements of private property, for "it makes a vital difference whether or not the individual owns and has sovereignty over the economic means of survival."[40]

Mary Ann Glendon argues that since the primary source of economic success for the individual is no longer the family, but rather the individual's employment or her dependency relationship with the government, then adequate government subsistence ought to be secured as a new form of proprietary right.[41] The deprivation of the economic decision-making power due to their forced economic turmoil may amount to a loss of lower-income families' human maturation, which involves a movement from passivity to activity, from dependence to independence, from subordinate positions to equality.[42] The inclusion of participation in productive activity as a property right is simply a good thing since it enables more people to achieve these types of maturity in their lives, and by encouraging commitment to people's work, people will do better work than those who feel ignored and manipulated.[43]

Thus, in imposing the GST without providing sufficient relief for low-income families, the HK government will be inducing substantial psychological harm and economic insecurity among the poor,

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[37] R. Vogt, *Whose Property? The Deepening Conflict between Private Property and Democracy in Canada.* (Toronto: University of Toronto Press, 1999), [Vogt].
[38] C. Reich, *The New Property* (1964) 73 Yale LJ 733.
[39] M.A.Glendon, *The New Family and the New Property* (1979) 53 Tulane LR 697.
[40] C. Reich, *Beyond the New Property: An Ecological View of Due Process* (1990) 56 Brooklyn LR 731.
[41] K.J. Gray and P.D. Symes, *Real Property and Real People: Principles of Land Law.* (London: Butterworths, 1981), [Gray].
[42] Vogt, *supra* note 37.
[43] *Ibid.*

amounting to an attack upon their "new property", contrary to HK Basic Law and ICESCR, which protect private property of citizens and their right to economic development.

Next, this paper argues that the above repercussions of GST introduction would so adversely and unequally harm the poor such that there are sufficient legal grounds to establish that the GST would unjustifiably discriminate against low-income households on the basis of "property" as set out in *Bill of Rights Ordinance* (*BORO*) Article 22, and hence should not be implemented in its currently proposed form.

THE GST VIOLATES BORO ARTICLE 22 WITH RESPECT TO LOW-INCOME HOUSEHOLDS

BORO Article 22 establishes that everyone is entitled to the same protection of law and prohibits discrimination. Discrimination implies treatment which is unfair because it is different on grounds such as property. In *R. v. Man Wai Keung*, Bokhary JA set out the test for discrimination:

> "To justify such a departure [from identical treatment] it must be shown: one, that sensible and fair-minded people would recognize a genuine need for some difference of treatment; two, that the difference embodied in the particular departure selected to meet that need is itself rational; and, three, that such departure is proportionate to such need."[44]

Genuine need: Although the GST would be a 5% tax borne by all consumers, it will more adversely, severely, and disproportionately affect low-income families versus higher-income families for the reasons studied above. Thus, by introducing the GST, the HK government will create differential treatment among two groups, distinguished on the basis of property. A sensible and fair-minded person would see no genuine need to impose such differential treatment on the poor, for there are viable revenue-generating alternatives, such as creating an energy tax or elevating tariffs on alcohol and tobacco.[45] Also, the disproportionate adverse effects on the poor could be significantly reduced if the government were to exempt inelastic necessities such as food, medical services and education, or

[44] Man, *supra* note 9.
[45] McLure, *supra* note 24.

guarantee more generous mitigation packages that are not subject to revocation. Thus, the discrimination justification test would fail here.

Difference is rational: The difference in this case is based on property – rich versus poor. The differential effects on the rich and poor are not rational since, as argued above, there are multitudinous alternatives that could equalize effects among these groups. Thus, the discrimination justification test would also fail here.

Proportionate to such need: The differential effects on the low-income families versus higher-income families are alarming. The GST regressivity, escalation in prices of basic necessities, and potential economic choice distortions may force low-income families to spend in excess of their earnings and inflict significant psychological trauma. Given that alternative revenue-generating taxes and other mitigating measures are realistic and possible, the differential effects are unjustifiable and disproportionate. Thus, the discrimination justification test would also fail here.

Since the discrimination justification test would fail at each criterion, lower-income families' right against discrimination based on property, as protected by *BORO* Article 22, would be infringed by implementation of the current GST plan. Next, this paper argues that this infringement cannot be justified.

BORO ARTICLE 22 INFRINGEMENT CANNOT BE JUSTIFIED

In *Leung Kwok Hung & Others v. HKSAR*, the Court of Final Appeal outlined the components of the proportionality test. After the applicant (low-income groups) takes the burden of proof and establishes the *BORO* breach, the burden shifts to the respondent (HK government) to demonstrate that the breach is justified. Any restriction on a constitutional right can only be justified if:

> "(a) it is rationally connected to a legitimate purpose and (b) the means used to restrict that right must be no more than is necessary to accomplish the legitimate purpose in question."[46]

[46] Leung, *supra* note 10.

Rationally connected: The purpose of generating revenue and broadening the tax base to stabilize Hong Kong's fiscal position and prepare for sudden economic downturns is a legitimate aim of a responsible government. However, the infringement of low-income families' right against discrimination based on property is not rationally connected to these purposes since the government can generate tax revenues in other ways, guarantee better mitigation packages to low-income groups for the duration of the GST, and fight GST regressivity by exempting basic necessities. Since the government can ensure prudent fiscal management without infringing the poor's right against discrimination, the proportionality test would fail here.

Proportional: In opposing GST implementation, the Hong Kong Retail Management Association warned that GST imposition would cause an immediate negative impact on the economy, reduce consumption, and raise inflation[47], all which gravely affect the financially vulnerable. The means used to restrict *BORO* Article 22 are patently disproportionate to the accomplishment of the government's purpose for the deleterious impact upon low-income families would far outweigh any pressing need to raise such revenue. As noted in FS Henry Tang's 28 February 2007 budget speech, HK is enjoying a better-than-expected budget surplus of HK$55.1 billion as a result of higher investment income, stamp duty and land revenue collections, and expenditure savings[48]. So, since revenue generation is not a pressing matter whereas the harmful economic effects on the poor would be immediate and substantial, GST implementation would disproportionately and unjustifiably damage this group. Thus, the proportionality test would also fail here.

Because the infringement cannot be justified, the HK courts would likely declare the current proposed version of the GST as unconstitutional and of no effect.

LONG TERM JUSTIFICATION FOR A HONG KONG GST

[47] Hong Kong Retail Management Association, *HKRMA Opposes Implementation of GST*. 19 July 2006. Available at http://www.hkrma.org/en/pa/press/press20060719.html. Accessed on 21 March 2007.

[48] Government of Hong Kong, *Budget aims to hone HK's edge*. 8 March 2007. Available at http://news.gov.hk/en/category/ontherecord/070308/html/070308en11001.htm. Accessed on 21 March 2007.

Although Hong Kong presently enjoys a strong financial position, Hong Kong has an externally-oriented economy that is highly susceptible to outside shocks such as high oil prices, rising interest rates, and global economic imbalances. Major domestic sources of revenue, such as Profits Tax, Stamp Duties on stocks and immovable property, and land premiums are also vulnerable to cyclical fluctuations. Furthermore, the increasing demand for elderly care services, the need to address pollution concerns and public health impediments after SARS and before Avian Flu, and the push to improve the equality of and access to education will place higher demands on HK public expenditure, and in turn the tax base. But an ageing HK population means that associated health and social welfare costs will rise as tax revenue from Salaries Tax will fall while the Salaries Tax base shrinks. Thus, Hong Kong's narrow tax base, coupled with heavy reliance on unstable revenue sources and an ageing population, is a formidable structural problem that will put increasing strain on the public wallet in the medium to long term.[49] The need for the government to broaden the HK tax base is irrefutable.

A successful solution to broadening the tax base would also address the staggering equitable problem that only one in three HK workers pays Salaries Tax. While a citizen has the right to enjoy government services and facilities, she also has the obligation to bear a fair share of the costs of such things. The HK government needs to invite more citizens to contribute to public resources and enhance civic responsibility.[50]

Although three major alternatives to broadening the tax base have been suggested over the years, they are undesirable for various reasons. In the first alternative, increasing current tax rates would not broaden the tax base, but instead would increase the tax burden on existing taxpayers, go against the international trend of lowering income taxes, and risk losing mobile labour and capital to more competitive jurisdictions. Also, increasing property-related taxes would merely further increase HK's already significant reliance on such taxes. Second, expanding existing taxes to include taxing capital

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[49] GST Consultation Document, Chapter 1, *supra* note 2.
[50] *Ibid.*

gains, dividends, and non-business interest income would jeopardize HK's status as an international financial and commercial centre. And third, broadening the salaries taxpayer base by significantly reducing the personal income exemption, currently set at HK$100,000, is unwise because HK uses its personal allowances as a mechanism for providing financial relief to individuals and households with dependents, it would make HK less attractive to international talent, raising more revenue from direct income tax would still leave HK prone to income volatilities, and this tax base will shrink as the ageing population shrinks the workforce.[51]

The GST is the most viable option for broadening the HK tax base for 3 reasons. First, it can produce stable and predictable revenue that is based on consumption expenditure, which does not fluctuate to the same extent as income or asset values do. Second, since the GST is very broad based, it may be levied at a low rate to produce significant revenue, be difficult to avoid, and enhance civic responsibility. Third, it is capable of growing in line with consumption, even with an ageing population, and would maintain HK's competitiveness as a low-tax environment for attracting foreign investment and talent.[52] Indeed, various international organizations have advocated for GST introduction in Hong Kong, including the IMF[53], Standard and Poor's[54], and KPMG[55].

However, as discussed above, since the current GST design may be found unconstitutional for unjustifiably discriminating against the poor, this article suggests that the HK government mirror the Canadian GST design which alleviates this through a system of exemptions and zero-ratings.

THE GST IN CANADA

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[51] GST Consultation Document, *supra* note 1, Chapter 2.
[52] GST Consultation Document, *supra* note 1, Chapter 3.
[53] International Monetary Fund, *IMF Executive Board Concludes 2005 Article IV Consultation with the People's Republic of China – Hong Kong Special Administration Region.* 13 February 2006. Available at http://www.imf.org/external/np/sec/pn/2006/pn0616.htm. Accessed on 22 March 2007.
[54] Hong Kong Economic and Trade Office, *Standard and Poor's upgrades Hong Kong's ratings.* 29 August 2005. Available at http://www.hketosf.gov.hk/sf/ehongkong38/HKrating.htm. Accessed on 22 March 2007.
[55] KPMG, *Tax Base Study: KPMG Consultancy Study for the Advisory Committee on New Broad-based Taxes.* July 2001. Available at http://www.fstb.gov.hk/tb/acnbt/english/finalrpt/annex_hktaxbasestudy.pdf. Accessed on 22 March 2007.

In Canada, the GST was introduced on 1 January 1991 – a time when Canada was going through a deep recession – to replace the flawed and inefficient Federal Sales Tax. A "value-added" consumption tax which applies to final consumption at a fixed rate of 6%, the Canadian GST supplied CA$33 billion in revenues in 2005-2006[56], or 18% of total federal tax revenue for that period[57]. Its enabling legislation, the *Excise Tax Act*[58], provides for two types of supplies: taxable and exempt. Taxable supplies are further categorized into those that are taxable at 6% and those that are zero-rated. A zero-rated supply is taxable at zero per cent, whereas exempt supplies are not subject to GST – the distinction between zero-rated and exempt supplies is that input tax credits are available for items used in the making of zero-rated supplies, but not for items used in the making of exempt ones.[59]

Zero-rated classification is based on the Canadian Parliament's determination that the imposition of GST would not be appropriate on certain items that are fundamental to Canadians or that involve a degree of international movement. Examples of such "fundamental" items include basic groceries, prescription drugs, and medical devices.[60] The Government of Canada has advocated that basic groceries are not taxed under the GST because taxes on food are perceived as being more heavily borne by the poor, since the poor spend a larger fraction of their income on food – a clearly anti-regressive policy targeted at relieving economic strife imposed by the GST upon the poor. However, in their Consultation Document, the Government of Hong Kong rejects the granting of food exemptions on the basis that the greatest financial benefit would go to higher-income households since they spend more on food, even though lower-income groups spend a higher *proportion* of their expenditure on food than higher-income households. Also, the HK government argues that food exemptions would

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[56] Public Works and Government Services Canada, *Public Accounts of Canada 2006: Volume I Summary Report and Financial Statements*. 19 September 2006. Available at http://www.pwgsc.gc.ca/recgen/pdf/v1pa06-e.pdf. Accessed on 23 March 2007.
[57] Public Works and Government Services Canada. *Public Accounts of Canada 2006: Volume II Details of Expenses and Revenues*. 19 September 2006. Available at http://www.pwgsc.gc.ca/recgen/pdf/v2pa06-e.pdf. Accessed on 24 March 2007.
[58] R.S. 1985, c. E-15.
[59] Robert Brakel & Associates Ltd., *Value-Added Taxation in Canada: GST, HST, and QST. 2nd Edition*. (CCH Limited: Toronto, 2003.
[60] Natasha Menon, *A Practical Guide to the Goods and Services Tax: 3rd Edition*. (CCH Limited: Toronto, 2004).

narrow the tax base, impair economic neutrality, and increase compliance and administrative costs for itself and for businesses. To maintain Hong Kong's competitiveness as a leading financial centre and international trading hub, Hong Kong plans to zero-rate only exports and financial services.[61]

Exempt supplies are those that, although made in Canada, are not subject to GST because of either the nature of the supply or the nature of the supplier. For the recipient, GST exemption means there is no need to pay GST; for the supplier, it means there is no need to collect GST and that no input tax credits are available for products or services used in making the exempt supply. Examples of such supplies include services pertaining to health care, education, child care and even legal aid. Canadians believe that such services should not be taxed on the equitable ground that everyone has a right to them. However, in their Consultation Document, the Government of Hong Kong rejects the granting of exemptions to such services regardless of whether they are provided by the government, charitable or private business organizations. The HK government argues that such exemptions would benefit high-income more than low-income families because private hospitals, clinics, and schools are patronized more by high-income families. Thus, the only proposed exemption in the HK GST goes to sales and rentals of residential property.

Representing almost 20% of total tax revenue, the Canadian GST is an impressive source of revenue for the government despite the CA$5.8 billion in foregone taxes from exemptions and zero-ratings of basic groceries (CA$3.9 billion), prescription drugs (CA$555 million), medical devices (CA$155 million), health care services (CA$515 million), education services (CA$525 million), child care and personal services (CA$130 million),and legal aid services (CA$25 million). In Hong Kong's consumption driven economy, these goods and services are the basic necessities heavily relied upon by lower-income families, represent a notably larger proportion of their expenditures than for higher-income households, and constitute the principal culprits in the GST's regressivity. Hence, exempting and zero-rating such supplies, as Canada has done, would significantly reduce regressivity, mitigate the

[61] GST Consultation Document, Chapter 5, *supra* note 4.

deleterious psychological strain and choice distortion upon the poor, and minimize the law's discriminatory impact upon low-income groups. In 1992, the Supreme Court of Canada held[62] that the GST does not unjustifiably violate the Canadian Charter of Rights and Freedoms[63], and a lower court recently held that, as opposed to the appellants' submission, the GST does not impose forced labour nor involuntary servitude and slavery. Thus, if Hong Kong also introduced a GST with extra exemptions and zero-ratings for the above-named basic necessities, then the Hong Kong courts may find the Canadian jurisprudence persuasive, and declare this tax constitutionally valid if such a challenge was put forth.

However, as the HK government points out in its Consultation Document, selection of goods and services for exemption and zero-rating eligibility will certainly increase compliance and administrative costs for both business and the government. In the next section, we learn about possible exemption choices by examining some Canadian exemptions.

SELECTING HK GST EXEMPTIONS BY LOOKING AT THE CANADIAN MODEL

In selecting which supplies are to be GST exempt and zero-rated, Hong Kong could study those supplies listed in Schedule V and VI of Canada's *Excise Tax Act*, respectively. We highlight some exemptions here. In Canada, institutional health care services that are provided in a health care facility are exempt from GST. Educational services provided by schools, universities and public colleges are often exempt, including tuition fees charged by private schools, courses for which credit may be obtained toward a diploma or degree, and professional or trade course and examination fees are exempt. Child and personal care services, such as services provided to individuals who are unable to provide for their basic requirements or to individuals with a disability, are exempt. Legal aid service exemptions are provided to qualifying persons who have inadequate funds to pay for basic legal services. Zero-rating of prescription drugs depends on their classification for purposes of other legislation and whether

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[62] *Reference re Excise Tax Act (Canada)*, [1992] 2 S.C.R. 445.

[63] *Canadian Charter of Rights and Freedoms*, Part I of the Constitution Act, 1982, being Schedule B to the Canada Act 1982 (U.K.), 1982, c. 11.

they are dispensed under prescription, and certain medical devices that are sold to the final consumer – such as hearing, speech or vision impairment devices, heart-monitoring devices to be used by patients with heart disease, and service dogs – are zero-rated.[64] Indeed, an IMF survey found that countries around that world agree that education and health services ought to be exempted to ameliorate the distributional consequences of the tax, both through the effect on prices that consumers face.[65]

However, international experience also shows that granting exemption for specific categories or selective food items cause disputes, controversies, and criticisms because there is no universally accepted definition of what constitutes "basic food" that may be zero-rated and how it can be differentiated from non-basic items.[66] In Canada, the problem in defining "basic groceries" has resulted in an item's tax status to be determined by apparently minor details. For example, whereas sweetened baked goods (e.g. donuts) are taxed at GST 6%, unsweetened baked goods are zero-rated. But, if at least six sweetened baked goods (½ dozen donuts) are purchased together, they are zero-rated. Also, plain and rice cakes are zero-rated, as are ones that are flavoured, but not sweetened. But, sweetened rice cakes are taxable at GST 6%.[67]

Although HK will need overcome these definitional problems when designing its exemption system, and although HK will consequentially incur higher administrative and compliance costs versus a GST with minimal exemptions, basic necessities exemptions ought to be studied and implemented because this would be perceived both as concern for the people's welfare and as taking active steps towards mitigating the GST's regressive effects. Indeed, a Canadian study has shown that the GST becomes progressive when basic items, such as food, are excluded from the tax base.[68]

And this is the right time to do it. Against the backdrop of an improving economy and healthy position of government finances, Hong Kong now needs to implement a GST with basic necessities

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[64] *Ibid.*
[65] Ebrill, *supra* note 20.
[66] *Ibid.*
[67] Menon, *supra* note 62.
[68] John Whalley and Deborah Fretz, *The Economics of the Goods and Services Tax.* (Canadian Tax Foundation: Toronto, 1990).

exemptions and invest the costs to design this system. In his budget speech delivered on 28 February 2007, FS Henry Tang surprised the international community with the news of Hong Kong's outperforming of economic expectations: an astonishing budget surplus nearly HK$50 billion higher than originally forecast, 32% and 43% higher revenues from Profits Tax and Stamp Duty, respectively, versus three years ago, 28% higher land premiums/sales versus last year, and a predicted 4.5% economic growth rate for 2007/8.[69] Given Hong Kong's superb economic report card, this is the correct time to study an exemption-based GST and address HK's longer term competitiveness and tax system sustainability if HK is to continue its long cherished role as the leading financial and business centre in Asia.

CONCLUSION

Since recovering strongly from both the Asian Financial Crisis of 1997-2003 and the SARS crisis of 2003, Hong Kong's fortunes have turned around remarkably. Robust global expansion, deeper financial integration with Mainland China, and a surge in tourist arrivals have resulted in Hong Kong's rapid growth and sensational fiscal performance. However, there are looming fiscal challenges that must be confronted.

Hong Kong's ageing population means that by 2030, households' health-care costs could rise by 7 percentage points of GDP, thus requiring significantly higher public spending. The ageing population will also shrink the size of the workforce, thus reducing the income tax base. The IMF estimates that by 2030, the proportion of non-working population to the working population will double to 32% and exceed those of other Asian countries.[70] In addition, Hong Kong's revenue base is narrow and depends heavily on volatile tax sources and land sales. The narrow tax base also means that

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[69] KPMG, *KPMG's Hong Kong Budget Commentary*. 28 February 2007. Available at http://www.kpmg.com.hk/en/about/KPMG_news/070228_budgetSummary07.html?TopMenuOn=4&LeftMenuOn=5. Accessed on 28 March 2007.

[70] International Monetary Fund, *Hong Kong's Fiscal Policy – Look Beyond the Good Times*. 22 February 2006. Available at http://www.imf.org/external/np/vc/2006/022206.htm. Accessed on 28 March 2007.

although the vast majority of HK workers do not pay Salaries Tax, everyone enjoys its benefits. These threatening problems pose an alarming danger to fiscal revenues and reserves.

The Government of Hong Kong needs to broaden its tax base, and the best way to do so is to implement a GST. Although the HK government has proposed a GST with minimal exemptions and zero-ratings, such a GST would cause an upward pressure on inflation, an escalation in the Consumer Price Index, would distort consumer choices, be strongly regressive, and force non-CSSA low-income families into collecting welfare. The resulting serious psychological trauma, economic insecurity due to insufficient household relief packages, and substantial deprivation of economic decision-making power for lower-income families versus higher-income groups amount to an ensnaring of "new property" and unconstitutional discrimination upon the poor.

However, since Hong Kong needs a long term solution to fix its fiscal structural problems, plans of a GST should not be abandoned. In designing a GST that mitigates regressive effects, Hong Kong ought to mirror Canada's GST system of exemptions and zero-ratings on basic necessities. Since Hong Kong is very concerned about rising administrative and compliance costs for the government and businesses, we propose that HK adopt extra exemptions only on items heavily relied upon by the poor to reduce discriminatory impact – basic groceries, prescription drugs, medical devices, health care, education, child care and personal services, and legal aid – to avoid a declaration of unconstitutionality if HK courts were faced with such a challenge. After all, the Canadian GST was found to be consistent with the Canadian Charter of Rights and Freedoms. Although HK will face administrative costs due to definitional problems in determining exemptions, HK ought to invest this money both because they will benefit greatly from a newly designed GST and because they currently enjoy a spectacular budgetary surplus.