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Hong Kong General Chamber of Commerce

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The Hon Henry Tang Ying-yen
Financial Secretary
Hong Kong Special Administrative Region
12/F, West Wing, Central Government Offices
Lower Albert Road, Central
Hong Kong

Dear Henry,

Public Consultation on the Broadening the Tax Base through the Introduction of a Goods and Services Tax

The Hong Kong General Chamber of Commerce is pleased to submit our views on the proposed measures for broadening the tax base. As you know, we have expressed our concern for many years on this subject, and despite the challenges of discussing taxation with the community at large, we believe this consultation is the right thing to do.

In the attached appendix, we lay our specific answers to the questions raised in the consultation document. For now, let me draw your attention a the key points:

1) **The Chamber agrees that the tax base is too narrow**, and that steps need to be taken to ensure more stability in our revenues over the course of the economic cycle. We have long believed that a Goods and Services Tax (GST) might, if properly designed and presented to the community, address the critical structural weakness in our finances. While the proposals in the consultation document appeared reasonable, they were not presented to the public in a manner that would generate recognition of the challenges we face and the various options available. However, we still believe the right GST would be the right choice.

2) Equally important, the obverse side of the discussion has not been given its due: **operating expenditure remains much too high**, and needs to be reduced step by step over a relatively brief period, perhaps 3-5 years.

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Despite an 18.5% reduction in civil service headcount since 1999/2000 spending increased more than 11%, according to the estimates for end-March this year. The 2007/08 Budget forecasts a greater than 25% increase in operational expenditure from the best estimates for 2006/07 to the projections for the end of the Medium Range Forecast. This level of spending cannot be supported by so narrow a tax base, and must be reduced.

Public perceptions

Perhaps the most disappointing aspect of the consultation is the very broad and persistent misunderstanding of the basic principles involved. To our distress, the government's proposals were presented by the popular media as revenue-positive, which they clearly were not. People were encouraged to believe that the purpose of the exercise was to raise additional revenue while reducing the taxes of the better-off members of society, and to do so at the expense of the poor, which it clearly would not. The very generous provisions made for insulating the least fortunate one-third of society from the effects of the GST were lost in the discussion, leading to unsubstantiated claims that the measures would be regressive.

In the end, the very loud voices of ignorance and short-term political gain won the day, and the government felt it necessary to 'no longer advocate' the GST as an option. We find this unfortunate, but understandable. The timing might have been better, too. In particular, the highly charged political atmosphere in the run-up to the Chief Executive's election was, in hindsight, not the most opportune time for raising fiscal issues.

Despite this, the problem remains, and must be addressed: our spending is too large and our tax base is too narrow. And so, in looking to the less attractive means of achieving the necessary objectives, we offer three principles:

1) We believe taxation is one of the most important ways in which the community feels a direct stake in public affairs. Our current tax structure takes revenue from a limited number of sources and directs spending across society, as necessary. As you know, an overly narrow tax base is a shaky foundation upon which to build a more participatory civil society. As demands for greater representation in public affairs increase, the responsibility for financing public affairs must be more broadly borne.

2) An insufficiently broad tax base provides very limited – and more cumbersome – means to alleviate the effects of periodic economic downturns. Reducing the Salaries Tax rates, for example, cannot affect more than the 18% of the population that pays such a levy. Reducing profits taxes during hard times, when companies do not generate as much profit, is equally inefficient. A full 70% of profits tax revenue is derived from just 2% of the companies filing. In short, reducing tax rates does not help those who do not pay taxes.

3) Moreover, there are important long-term considerations. As we more deeply integrate with the Mainland of China, there will necessarily be a rise in the risk to our current tax base. Because of Hong Kong's small geographic, demographic and economic size, companies will likely expand their operations across the boundary. That will, to a degree, remove their taxable income from our jurisdiction, thereby increasing the risk that our own revenues will be insufficient to cover necessary spending.

Finally, there are the fiscal reserves. Because of volatility in our revenues, we need to hold in reserve sufficient funds to cover an extended period of economic hardship. We note that your latest Budget envisages a nearly 60% increase in the reserves, to $584.4 billion, over the next five years. A consolidated surplus averaging $43.7 billion, year in and year out, removes this money from private hands, where it is most likely to generate investment, consumption and jobs. But, given the threats to our revenues – and the hitherto fore inability to reduce spending – we have little choice but to make the best of such insufficiencies. Broadening the tax base will lessen the need to hold such large amounts in reserve, and may allow a significant portion of that money to be returned to taxpayers.

Our conclusion is that, when the political circumstances permit, the consultation on broadening the tax base through a revenue-neutral Goods and Services Tax is the best option for Hong Kong. However, the right timing may be several years away, and we need solutions sooner, rather than later. Hence, a combination of significant spending reductions coupled with a steady reduction in personal allowances and perhaps some modest additional measures such as departure taxes would provide the most reasonable and useful near-term solution.

We sincerely hope that the views presented here will be accepted in the spirit intended.

Best personal regards,

(Signed)

David Eldon
Chairman

Att

Appendix

Response to the Consultation Document Questions

Chapter 1

Do you think that our existing tax base is too narrow?
On the whole, we believe the tax base is too narrow. However, there are different ways of measuring breadth, and we believe it would be useful to distinguish between them. First, a tax base may be narrow in the sense that revenues are derived from too few *sources*, such as salaries or profits. For Hong Kong, this does not seem to be the case. The second measure looks at the *number* of taxpayers as compared to the population as a whole, and here there can be no question: only 18% of the population pays tax on a portion of their income, a ratio which is the lowest in the developed world.

Do you believe that Hong Kong needs a tax base where revenue is generated from diversified sources that are less susceptible to external shocks and cyclical economic conditions?
The events of the first half of this decade clearly indicate that the existing tax base is insufficiently robust to withstand major external shocks. However, it should be noted that the 1998-2005 deflation was an extremely rare occurrence, and is unlikely to be repeated at regular intervals.

With that in mind, we believe expanding the number of people paying taxes – and not necessarily the means by which taxes are paid – would be useful. The very deep decline in both salaries and profits taxes suggest that these are not suitable, in and of themselves. Hence, a broader and less vulnerable tax base is needed.

Do you think the Government should take action to reform the tax base to ensure our future growth and prosperity?
Framed as it is, this question can only be answered in the positive. However, what is missing from this question, the consultation paper and all discussion of reforming the tax base is any consideration whatsoever of the level of operating expenditure. We firmly believe that operating expenditure needs to be reduced to somewhere near the 11% of GDP level that prevailed before the depression. This should be achieved through headcount reduction, delayering, rationalizing civil service compensation and greater use of public-private partnerships.

Chapter 2

Do you agree that there are only two viable options?
Within the context of the question –broadening the tax base through either a GST or lower personal allowances – we would agree with this assertion. However, once again we note that no consideration is given to reducing expenditure.

Other options were discussed in the 2002 report by the Advisory Committee on New Broad-Based Taxes. Briefly, our views are as follows:

Taxation Options	**Effectiveness at broadening tax base**	**Ability to raise useful revenue**	**Impact on competitiveness**	**Conclusion**
G S T	**Strong**	**Strong**	**Insignificant**	**Ideal, if done right**
Billboards, phones	Moderate	Modest	Modest	Acceptable
Capital gains taxes	Moderate	Moderate (homes)	Highly damaging	**Unacceptable**
Departure tax	Strong	Poor	Modest	Acceptable
Dividends taxes	Moderate	Poor	Highly damaging	**Unacceptable**
General Rates	Strong	Strong	High	**Unsuitable**
Interest taxes	Moderate	Poor	Highly damaging	**Unacceptable**
Luxury goods tax	Poor	Poor	Modest	**Unsuitable**
Personal allowances	Strong	Moderate	Modest	Acceptable
Worldwide income	Poor	Poor	Highly damaging	**Unacceptable**
Green taxes	*Green taxes should be considered on environmental rather than fiscal grounds.*			
- Electricity	Poor	Poor	Significant	**Unsuitable**
- Plastic bags	Poor	Poor	Insignificant	**Unsuitable**

Hong Kong's extremely light regulatory regime forbids consideration of world-wide income, capital gains, interest or dividends taxes, which would rapidly undermine our competitiveness and likely raise little or no revenue from segments of the economy that are not already taxes. The single exception, which we do not believe to be a wise choice, would be a capital gains tax on family homes.

Higher General Rates taxes would significantly broaden the tax base and likely raise useful revenue for off-setting other taxes. However, as we are already on of the most expensive cities on earth, increasing the cost of living and doing business here would be extremely unwise. Similarly, taxing luxury goods sales would quickly reduce our attraction to tourists, and as a result raise little revenue. Hence, we believe these taxes to be unsuitable for Hong Kong.

Green taxes, which we support, are uniquely unsuitable for the purposes of this tax base broadening exercise. Such levies are not intended to raise revenue; rather, their objective is to change behaviour, much like so-called sin taxes. If green taxes (or, sin taxes) are successful, revenue will drop as behaviour changes. While there would be a brief broadening of the tax base, once behaviour changes, the tax base would again narrow. We therefore are opposed to using green taxes as a means of broadening the tax base.

Do you agree that a reduction in personal allowances is not a preferred option?
On this point we disagree. Hong Kong has the highest personal allowances, in comparison to incomes, of any developed economy in the world. We believe that the personal allowance rate should be reduced steadily, without regard to revenues, over a period of several years. A 50% reduction over five years, for example, would bring our personal allowance into line with that of the OECD economies.

Our conclusion is that, when the political circumstances permit, the consultation on broadening the tax base through a revenue-neutral Goods and Services Tax is the best option for Hong Kong. However, the right timing may be several years away, and we need solutions sooner, rather than later. Hence, a combination of significant spending reductions coupled with a steady reduction in personal allowances and perhaps some modest additional measures such as departure taxes would provide the most reasonable and useful near-term solution.