

Consultation on Broadening Hong Kong's Tax Base

The FHKI appreciates the Government launching the present consultation, which provides a timely opportunity for in-depth and reasoned discussion in the community about the best approach to securing the financial sustainability of the Government.

The community at large, including the business sector, accepts that Hong Kong's tax base is too narrow and needs to be broadened to improve the stability of government revenues. The adverse effects of the narrow tax base on our public finances have been thoroughly explained in the consultation document and are well understood both inside and outside the Government; we find no need to elaborate further in this connection.

Defects of Goods and Services Tax

In our view, the community does not support using GST to broaden the tax base because it has many inherent defects that would severely undermine the competitiveness of our economy in the long run. Some of the obvious shortcomings of GST are highlighted below:

1. It would weaken the simplicity of our tax regime, which is one of our strongest advantages as a premier international business centre;
2. It would deter domestic spending and affect our tourism by tarnishing our repute as a tax-free shopping paradise;
3. It would increase the cost of doing business by adding substantial administrative and operating costs to companies;
4. As illustrated in many countries with such a tax, GST rates tend to go up over time; and
5. It would create inflationary pressure on the economy.

Considering these significant negative effects, we are in support of the Government's decision to shelve the GST proposal.

Maintaining Strict Control on Public Expenditure

Before suggesting alternative options which the Government may consider in broadening the tax base, we would like to make a few observations on public expenditure as the two are inter-related.

1. Civil Service

We are appreciative of the efforts that the Government have made in reining back public spending. We are particularly pleased to note that the Government has kept its annual operating expenditure lower than \$200 billion for three consecutive years, with total public expenditure as a percentage of GDP staying below the 20% mark.

Despite these commendable achievements and the favourable financial results in 2006/2007, we do see the need for the Government to continue with strict control on public expenditure with a view to minimising operating costs as well as eliminating waste and inefficiencies. In this regard, we are distressed to hear that the Government will unfreeze open recruitment of civil servants, adding headcounts to the civil service establishment. We are concerned that this would derail the Government's cost control exercise and open the floodgates to a new round of expenditure growth.

As a steadfast supporter of the 'Big Market, Small Government' philosophy, the FHKI strongly encourages the Government to maintain a lean and efficient civil service. We firmly believe that any expansion of the civil service must be well justified and their pay levels should be benchmarked against those of the private sector to ensure proper use of public money.

2. Welfare Spending

Currently, education, social welfare and healthcare are the three largest expenditure areas of the Government, accounting for 21.6%, 13.8% and 13.1% of total public expenditure, respectively. As shown in the table below, public expenditure on social welfare has increased by 2.7 times over the period between 1993/1994 and 2006/2007, surpassing remarkably the corresponding increases in education, healthcare and total public expenditure.

Public Expenditure by Major Policy Areas

	Financial Year 1993/94		Financial Year 2006/07 (Estimate)		Expenditure increase over the period
	Nominal Spending (in \$ bn)	As a % of total public expenditure	Nominal Spending (in \$ bn)	As a % of total public expenditure	
Education	25.4	16.4%	53.1	21.6%	109.1%
Social Welfare	9.2	5.9%	34.0	13.8%	269.6%
Healthcare	18.5	11.9%	32.1	13.1%	73.5%
Total Public Expenditure	155.2	--	245.6	--	58.2%

Source: Census and Statistics Department, Hong Kong Annual Digest of Statistics 2004 and Budget Speech 2007-2008.

The upsurge in welfare expenditure is a matter of grave concern to the FHKI. We are worried that if the current rising trend is allowed to go unchecked it would eat into government resources which would otherwise be put into other worthy uses, such as education, environmental protection and infrastructure development.

As Hong Kong is a caring society, we agree that the Government has the responsibility to care and provide a safety net for the needy, not least the elderly and disabled. However, it is equally important that the Government should advocate the spirit of self-reliance by encouraging those with working ability to take up employment as a way to improve one's living. It also needs to put in place an effective mechanism to guard against abuse of the Comprehensive Social Assistance Scheme (CSSA).

At present, there is no entitlement time limit for unemployed CSSA recipients. This is contrary to the practice of many countries, where the amount of social security payment is gradually reduced over time. As a supplement to the existing Support for Self-reliance Scheme, we suggest that a maximum entitlement time limit of say not more than five years be introduced for unemployed CSSA recipients. This requirement will keep welfare within reasonable limits, while propelling recipients to seek employment and become self-supporting over time.

In addition, in order to minimise misuse of welfare payments, the Government should consider providing vouchers to non-adult CSSA recipients in lieu of cash.

To sum up, there is still room for the Government to reduce waste and spending. We strongly encourage the Government to conduct a thorough review of the fiscal structure to identify areas where higher efficiency can be achieved and to draw up plans for implementation of cost-saving measures. The review should also aim to project the Government's financial position in the next ten to twenty years, taking account of these measures.

We think that if the Government can convince the community with hard figures of the difficulty to maintain financial sustainability after exhausting all possible cost-saving methods, Hong Kong would be more receptive to the necessity of introducing new taxes to broaden the tax base.

Options to Broaden the Tax Base

In broadening the tax base, it is imperative that the Government adhere to the following principles:

1. The simplicity and predictability of the tax system should continue to prevail;
2. Hong Kong should remain a place of low taxes; and
3. Any new tax to be introduced should be:
 - broad-based;
 - easy to administer and comply with;

- with high collection efficiency; and
- without undue interference in the operation of businesses.

In accordance with these principles, we believe the following options are worth consideration.

1. Land Departure Tax

Presently, air departure tax and sea departure tax are levied on travellers departing from Hong Kong at the airport and Macao/China ferry terminals, respectively. We consider it fair to introduce a land departure tax as a step to broaden the tax base.

Our recommended standard rate for each trip made on weekdays (i.e. Monday to Friday, except public holidays) is \$20. A higher rate of \$100 per trip is suggested for weekends and public holidays, as most travellers visit the Mainland mainly for recreation purposes.

We estimate that, based on the above schedule, the tax would initially generate an annual income of around \$4 billion for the Government. However, given the continued growth in cross-boundary traffic between Hong Kong and the Mainland, we expect the revenue level to rise steadily.

2. Rates on Tenements

As a broad-based levy, rates on tenements are a stable source of income for the Government. The existing rates percentage charge is 5%. An increase of a single percentage point will yield additional revenue of \$2.8 billion annually, assuming that the rateable values of properties remain at the present level.

In its final report released in 2002, the Advisory Committee on New Broad-based Taxes stated that rates are less susceptible to economic cyclical fluctuations than profits and salaries taxes, and therefore, an increase in rates could be used as a measure to boost government income. We concur with these views. This option is worth revisiting if a genuine need rises to increase revenue.

3. Salaries Tax

Lowering personal allowances and deductions under salaries tax back to the levels of 1993/94 financial year is another option that may be considered by the Government for broadening the tax base. While we understand that this would yield only marginal incomes for the Government, it can nonetheless significantly enlarge the tax net and serve a useful purpose of enabling the populace to take on their civic responsibility to contribute to the funding of public services which they can enjoy.

March 2007