# Brief of
# Other Options for Broadening the Tax Base

## Introduction

Following the launch of the tax reform public consultation in mid July 2006, the Government released an interim report on 5 December which stated that the Government would not advocate the Goods and Services Tax (GST) for the remaining part of the consultation. However, the Government would continue the discussion with the public on other viable options for broadening the tax base.

This brief outlines the main options proposed by different sectors of the community and provides a preliminary assessment on these options with reference to the principles of a good tax system. It is hoped that the public could have a better understanding of these options and continue to provide comments on options for broadening the tax base before the consultation ends on 31 March 2007.

## How to choose a suitable tax reform option for Hong Kong?

Internationally, there is a set of widely accepted principles to evaluate the strengths and weaknesses of a tax system and these principles can be summarized into three major points -

(a) Fairness – a good tax system should comply with the 'capacity to pay' principle. The design and the support measures of the tax system should ensure that people with greater financial capacity will bear heavier tax liability without widening the wealth gap;

(b) Provision of a stable and significant revenue – a good tax system should be able to provide a stable and significant revenue for the Government to respond to challenges and needs of the community and create social harmony. A good tax system should work even when there is a change in economic conditions and demographic structure; and

(c) Maintaining international competitiveness – a good tax system should be clear and simple and be able to maintain Hong Kong's attractiveness to international capital and talent.

Besides, a suitable tax reform option for Hong Kong should be able to broaden our tax base effectively. Therefore, we include 'Capacity to broaden the tax base' as a principle for assessing the tax options.

**Preliminary assessment on other options for broadening the tax base**

We have conducted a preliminary assessment on major options for broadening the tax base proposed by the public based on the four major principles of a good tax system as follows -

**Option 1 ：Introducing a Progressive Profits Tax**

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| Capacity to broaden the tax base | • The burden of the additional tax would fall on businesses currently within the tax net only. It could not broaden the tax base. |
| Fairness | • Progressive tax would result in 'earn more and pay more' and is in line with the 'capacity to pay' principle. |
| Provision of a stable and significant revenue | • Corporate profits would drop during economic downturns and revenue generated from Profits Tax would fall as well. Therefore, progressive tax rate could not help provide stable revenue. In the past 8 years, the revenue generated from Profits Tax fluctuated by 85%.<br>• Supposing that the existing Profits Tax rate (i.e. 17.5%) applies to the first $1 million of annual profits while a progressive Profits Tax rate at 20% applies to the remainder, there would be an additional revenue of $9.2 billion based on the expected businesses profits level of 2006/07. About 30% of businesses currently paying Profits Tax would be affected. |
| Maintaining international competitiveness | • This option would go against the international trend of reducing direct tax rates and affect our ability to retain and attract businesses. When overseas investors consider investment in Hong Kong, how much tax they have to pay is one of their major considerations. Therefore, if we introduce a progressive Profits Tax, it would undermine their intention to invest in Hong Kong and hence affect our competitiveness directly.<br>• Should we impose a progressive Profits Tax, it would complicate our tax system and might encourage some larger businesses to split up into smaller establishments so as to avoid paying Profits Tax at a higher rate. |

**Option 2：Increasing the Progressive Element of Salaries Tax**

<table>
<tr><td>Capacity to broaden the tax base</td><td><ul><li>The burden of the additional tax would fall on existing taxpayers only. It could not broaden the tax base.</li></ul></td></tr>
<tr><td>Fairness</td><td><ul><li>Progressive tax would result in ‘earn more and pay more’ and is in line with the ‘capacity to pay’ principle.</li><li>But current non-taxpayers with high income, such as those who derive income from dividends and interest, still do not need to pay tax.</li></ul></td></tr>
<tr><td>Provision of a stable and significant revenue</td><td><ul><li>During economic downturns, income of citizens would drop and revenue generated from Salaries Tax would fall as well. If we increase the progressive element of Salaries Tax, the extent of revenue drop might be greater during economic downturns. Therefore, progressive tax rate could not help provide stable revenue. In the past 8 years, the revenue generated from Salaries Tax fluctuated by 51%.</li><li>If the progressive element of Salaries Tax increased by means of removing the Standard Rate and the tax base remained unchanged, it is estimated that additional revenue from Salaries Tax would be about $1.5 billion based on the expected salaries income level of 2006/07 (Remarks: If the Standard Rate is to be removed, the rates for Property Tax and Profits Tax might have to be adjusted for fairness).</li><li>Supposing that there is an additional tax band for Salaries Tax/Personal Assessment and the rates of the tax bands are 2%, 7%, 13% and 19% respectively, with the maximum marginal tax rate at 22% for the remainder and the Standard Rate raised to 19% as follows-
<table>
<tr><td>Tax Band</td><td>Existing rate</td><td>Proposed rate</td></tr>
<tr><td>First $30,000</td><td>2%</td><td>2%</td></tr>
<tr><td>Next $30,000</td><td>7%</td><td>7%</td></tr>
<tr><td>Next $30,000</td><td>13%</td><td>13%</td></tr>
<tr><td>Next $30,000</td><td>-</td><td>19%</td></tr>
<tr><td>Remainder</td><td>19%</td><td>22%</td></tr>
<tr><td>Standard Rate</td><td>16%</td><td>19%</td></tr>
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additional revenue is estimated to be $6.5 billion (including additional revenue generated from Salaries Tax, Property Tax and Profits Tax from businesses of sole proprietor or partnership).</li></ul></td></tr>
<tr><td>Maintaining international competitiveness</td><td><ul><li>This option would go against the international trend of reducing direct tax and affect our ability to retain and attract talent. When overseas talent consider whether to work in Hong Kong, how much tax they have to pay is one of their major considerations. Therefore, if we increase the progressive element of Salaries Tax, it would undermine their intention to take a job in Hong Kong and affect Hong Kong’s competitiveness.</li></ul></td></tr>
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**Option 3：Reduction in Personal Allowances under Salaries Tax**

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| Capacity to broaden the tax base | • This would draw wage earners currently paying no Salaries Tax into the tax net. The Salaries Tax base would be broadened. |
| Fairness | • If personal allowances under Salaries Tax were to be reduced, much of the additional revenue would come from existing taxpayers who do not pay tax at the standard rate. The tax liabilities of standard rate taxpayers would remain unchanged. |
| Provision of a stable and significant revenue | • Based on the expected salaries income level of 2006/07, reduction in personal allowances by 10%, 25% and 50% would increase revenue by \$3 billion, \$7.5 billion and \$17 billion respectively.<br>• During economic downturns, income of citizens would drop and revenue generated from Salaries Tax would drop as well. Therefore, reduction in personal allowances under Salaries Tax could not help stabilize the revenue.<br>• Hong Kong uses its personal allowances as a mechanism for providing financial relief to individuals and households with dependants. In the event of their removal, Hong Kong would need to adopt an alternative approach, such as direct government payment, similar to that used in many jurisdictions in the Organization for Economic Co-operation and Development. This would involve increased government welfare outlays and administrative expenses.<br>• To draw some wage earners currently paying no Salaries Tax into the tax net, additional revenue would not be significant. However, the Government has to incur additional administrative expenses to handle a large amount of returns lodged by the new taxpayers. |
| Maintaining international competitiveness | • With reduction in personal allowances under Salaries Tax, much of the additional revenue would come from existing taxpayers who do not pay tax at the standard rate. This would make Hong Kong less competitive in retaining and attracting talent. |

**Option 4：Introducing a Capital Gains Tax, such as tax on gains from land property or stock**

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| Capacity to broaden the tax base | • A Capital Gains Tax would be a new tax in Hong Kong. It would broaden the tax base. The extent of broadening is subject to the types of capital gains to be taxed. |
| Fairness | • This tax is fair as it applies to gains only.<br>• If we levied tax on certain kinds of capital gains only (such as property or stock), it would affect the fairness of such tax. |
| Provision of a stable and significant revenue | • Capital value is easily affected by economic cycles. During economic downturns, capital value and related transactions would drop. The Government may not be able to yield stable revenue from this tax. |
| Maintaining international competitiveness | • As Hong Kong adopts territorial source concept of taxation, investors may be encouraged to invest offshore in order to avoid Capital Gains Tax on their investment gains in Hong Kong. We also have to consider whether Capital Gains Tax would affect the status of Hong Kong as a regional financial centre.<br>• Overseas experience shows that legislation for a Capital Gains Tax is complex and this would affect the simple tax system of Hong Kong. |

**Option 5：Introducing a Tax on Interest**

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| Capacity to broaden the tax base | • Introducing this tax would increase the types of taxable income. It would broaden the tax base. |
| Fairness | • Generally speaking, the richer one is, the more savings one would have and thus the more tax on interest one would have to pay. This is in line with the "capacity to pay" principle.<br>• However, interest is not the only kind of investment income. It is not fair to levy tax on interest only but not on other kinds of investment income. |
| Provision of a stable and significant revenue | • Interest earnings will be affected by interest rate movements, investment market environment and other factors. This would affect the revenue to be generated from this tax.<br>• Moreover, under our existing source-based system of taxation, this tax would only apply to interest received from deposits located in Hong Kong. Interest would be free from tax if it is received from deposits located outside Hong Kong. |
| Maintaining international competitiveness | • As interest received from deposits offshore is free from tax, this tax might lead to savings leaving Hong Kong and hence affect the status of Hong Kong as a financial centre. |

**Option 6：Introducing a Tax on Dividends**

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| Capacity to broaden the tax base | • Introducing this tax may increase the types of taxable income. It could help broaden the tax base. |
| Fairness | • Generally speaking, the richer one is, the higher ability one would have on investment and thus the more tax one would have to pay. This is in line with the "capacity to pay" principle.<br>• However, dividends are not the only kind of investment income. It is not fair to levy tax on dividends only but not on other kinds of investment income. |
| Provision of a stable and significant revenue | • The amount of dividend income would depend on corporate policy and investment environment. During economic downturns, corporate profits would be low and dividends paid would be less. Moreover, companies can elect not to distribute dividends. Hence, this tax may not provide stable revenue.<br>• If dividends paid are associated with the profits made in Hong Kong, the profits should have been taxed. Hence, when introducing a tax on dividends, there should be corresponding arrangements to avoid dividends being double taxed under Profits Tax and tax on dividends. To avoid double taxation, dividends will generally be distributed to the shareholders together with a tax credit transfer. The tax credit will relieve the individual's overall tax burden. Therefore, the additional revenue generated through taxing dividends would not be significant. |
| Maintaining international competitiveness | • Under Hong Kong's existing source-based system of taxation, the new tax would only apply to dividends paid by Hong Kong companies. Introduction of a tax on dividends may drive investment overseas.<br>• To implement this tax, it is necessary to introduce legislation on dividend imputation systems which is generally complex and would complicate Hong Kong's tax system. |

**Option 7：Tax Worldwide Income of Businesses and Individuals**

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| Capacity to broaden the tax base | • Taxing worldwide income of businesses and individuals would extend the scope of income subject to tax. It would be able to broaden the tax base. |
| Fairness | • Foreign-sourced income would be liable for tax in Hong Kong if tax has not been levied on it in the jurisdiction where it originates. |
| Provision of a stable and significant revenue | • Revenue yield would be negligible because of the need to grant credits for foreign taxes paid. |
| Maintaining international competitiveness | • Source-based system of taxation is our traditional taxation model and also one of Hong Kong's key differentiators. In recent years, many other jurisdictions have exempted foreign-sourced income[1]. If we abandon this traditional policy and go against the international trend, Hong Kong's competitiveness in attracting and retaining local and international capital would be hampered.<br>• To maintain international competitiveness and to avoid double taxation on the same income, we need to draw up foreign tax credit legislation and comprehensive double taxation agreements with major economic partners. However, this would complicate the tax system of Hong Kong. |

[1] Singapore and Malaysia exempt most foreign-sourced company income from taxation. Ireland, the United Kingdom and Australia have also introduced similar exemptions for specified business income.

**Option 8：Introducing a Land and Sea Departure Tax**

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| Capacity to broaden the tax base | • As all persons departing from Hong Kong by land and by cruise would also fall into the tax net, this tax could broaden the tax base. |
| Fairness | • Under this tax, all persons departing by land or sea would be charged at the same rate. It has nothing to do with the 'capacity to pay' principle and income level of individuals.<br>• Presently, persons departing from Hong Kong by air and travelling to Macau or the Mainland by sea already have to pay a departure tax or embarkation fee[2]. Should this tax be introduced, all outbound travellers by sea or by land from Hong Kong would be subject to such payment. |
| Provision of a stable and significant revenue | • The revenue yield depends on the number of departing passengers by land and by cruise. In the past 5 years, the number of passengers leaving Hong Kong by land and by sea has increased by 26%. |
| Maintaining international competitiveness | • This tax may have impact on inbound tourism as well as the integration of Hong Kong and the Mainland. |

[2] At present, the Air Passenger Departure Tax and the Passenger Embarkation fee are $120 and $15 respectively.

**Option 9 : Introducing a Green Tax, such as a Tax on Electricity or Plastic Bags**

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| Capacity to broaden the tax base | • This is a new tax, which can broaden the tax base. However, the extent of broadening is subject to the coverage of the tax. If the tax is to be imposed on electricity consumers and plastic bag users, the tax base can be very broad. |
| Fairness | • Generally speaking, Green Tax will be levied on 'user pays' principle. From this angle, the tax is fair. Taking electricity tax and plastic bag tax as examples, the more one consumes, the more tax one has to pay.<br>• With reference to the proportion of tax to salaries, this tax may not be fair because people with higher income may not need to pay higher Green Tax. |
| Provision of a stable and significant revenue | • Whether stable and significant revenue can be yielded is subject to the tax coverage and the tax rate.<br>• For electricity tax, to raise a revenue commensurate with the amount of a 5% GST (i.e. $30 billion a year), the tax has to be equivalent to 80% of the electricity charge.<br>• However, according to overseas experience, the main objective of implementing a Green Tax is to change the attitude and behaviour of the community in energy consumption in order to conserve the environment. Therefore, revenue to be generated from a Green Tax would usually be deployed to other environmental protection schemes or be used to subsidize renewable energy production industries. Therefore, Green Tax may not be a viable option to solve the problem of narrow tax base and to provide stable and significant revenue. |
| Maintaining international competitiveness | • This tax is effective in enhancing public awareness of environmental protection. In the long run, it is good for environmental protection business development and helps attract talent to work in Hong Kong.<br>• However, Green Tax may increase business operating cost and affect Hong Kong's international competitiveness. |

**Option 10 : Introducing a Tax on Luxury Goods, such as a tax on valuable watches, jewellery and cosmetics**

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| Capacity to broaden the tax base | • This is a new tax which could broaden the tax base. However, the extent of broadening is subject to the coverage of the tax. |
| Fairness | • Capacity to buy luxury goods should be in proportion to consumption power. In general, the higher income one has, the higher consumption power one would have. Therefore, this tax is in line with the 'capacity to pay' principle.<br>• As different people would have different interpretations on 'luxury goods', it is difficult to define 'luxury goods' for taxation.<br>• As this tax would apply to 'luxury goods' only, businesses or persons being affected would consider such a tax unfair. |
| Provision of a stable and significant revenue | • As luxury goods are not necessities, consumption of luxury goods during economic downturns would fall significantly. This tax may not be able to stabilize revenue. |
| Maintaining international competitiveness | • Prices of taxable luxury goods may rise and this may have adverse impact on retail industry and tourism. |

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