Evolution & Innovation

Building Solid Foundations for the Future

Hong Kong Society of Accountants

BUDGET PROPOSALS 2004/05

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EVOLUTION AND INNOVATION
"Building Solid Foundations for the Future"

1. OVERVIEW

1.1 Introduction

Confidence in Hong Kong is showing signs of turning the corner, after an extended economic slump following the onset of the Asian financial crisis in 1997, international events which reverberated around the world, in particular the attack on the World Trade Centre towers in New York in 2001 and its repercussions, and more recently the outbreak in the Mainland, Hong Kong and elsewhere, of the Severe Acute Respiratory Syndrome (SARS).

With increasing confidence in markets around the world and, locally, the signing of the Closer Economic Partnership Arrangement between Hong Kong and the Mainland, the feeling is that the worst is over. While SARS dealt a short-term blow to the economy, it appears that we have now largely put it behind us. In a speech in the Legislative Council on 22 October 2003, the Financial Secretary (FS), Mr. Henry Tang, revised upwards the forecast GDP growth for 2003 from 2% to around 3% and the revised the trend growth rate from 3% to 3.5%. This projection was later reinforced by the third quarter economic results, released at the end of November, which showed 4% growth in GDP in July-September compared with the same period last year. Retail sales are also showing positive growth in value and volume and the unemployment rate is also beginning to fall. Tourist numbers have picked up again with arrivals in September the highest ever September figure and the overall passenger traffic at Chek Lap Kok airport close to normal. The stock market is more bullish and the property market has been taken off the "critical list". In October 2003, the international credit rating agency, Moody's Investors Service, raised its foreign currency debt rating for Hong Kong by two increments.

These are the positives but Hong Kong is starting from a low ebb in terms of confidence. While deflation appears to be easing, it has nevertheless been continuous for five years, and unemployment remains historically high levels, at 8% in the three-month period August-October 2003, notwithstanding the recent drops in the rate. In addition, we continue to face what is generally accepted as being a structural budgetary deficit. Partly as result of these economic difficulties, and partly also because of the focus and priorities that have long been regarded as norms in Hong Kong, the overall quality of life for a significant proportion of the population remains unsatisfactory. These are problems that still need to be addressed and, in our view, new ideas and progressive evolutionary changes in approach are necessary to ensure that Hong Kong is able to meet these challenges; hence the title of the Society's Budget Proposals for 2004/05, "**Evolution and Innovation –** ***Building Solid Foundations for the Future***". We believe that the Hong Kong SAR Government ("the Government") needs to be seen to be taking positive action to stabilise revenues, control expenditure, enhance the business environment, and improve the overall quality of life.

As regards the fiscal deficit, in the 2003 Budget Speech, the then FS projected a deficit of HK$67.8 billion in 2003/04. He argued that this needed to be addressed and the Government intended to take measures to achieve fiscal balance by 2006/07. However, given the adverse effects on the economy of SARS, and the additional cost of the package of support measures, his successor has come to the view that this target is no longer realistic and has revised the target for fiscal balance to the financial year 2008/09. He has also raised the estimate of the 2003/04 deficit to HK$78b plus or minus HK$5b.

Given the increasing size of the gap between revenues and expenditure, the Government should be considering ways to raise more revenue and establishing sources of revenue that are less susceptible to changes in the economic cycle. It should also be examining ways in which to make the existing system a more efficient mechanism for revenue collection, by for example focussing on improving rates of compliance. We believe that every member of the community is a stakeholder in Hong Kong's future and that this involves looking at ourselves afresh and appreciating the need to strike a realistic and achievable balance between rights and expectations and responsibilities. We offer some tax-related suggestions in this regard in Parts A and D of this submission. Meanwhile, Part B considers some more immediate ideas for revenue-raising.

It is important that the Government make major efforts to contain public expenditure. Each 1% reduction in total public expenditure would mean a saving of around HK$2.9 billion. Possible measures to reduce public expenditure would include, e.g. improving efficiency in the delivery of government services, varying the level of services, increasing private sector participation in the delivery of services and reducing civil service costs. This subject is touched on in Part F of this submission.

While there is a need to address the deficit situation, the Society nevertheless considers that there needs to be enough flexibility in the system to be able to consider the merits of introducing limited specific tax concessions in order to maintain our competitive edge. These should be aimed at enhancing Hong Kong's appeal to investors as an international financial and commercial centre and springboard for entry into the Mainland and other markets in the region, and at encouraging more employment. Our proposals in this regard are contained in Part C of this submission. Part E considers certain more technical matters for improving Hong Kong's tax legislation and administration.

1.2 Economic Outlook

Hong Kong's economy, after decreasing by 0.5% in real terms in the second quarter over a year earlier, picked up in the third quarter of 2003. The growth impetus continued to come from the external sector. On a year-on-year comparison, GDP accelerated to 4% growth in real terms in the third quarter of 2003. The overall figure for 2003 is now expected to be around 3%.

However, consumer price deflation has continued unabated for five years, with the Composite Consumer Price Index (CPI) falling a further 2.7% in October 2003, and 3.2% for the three months ended October 2003, compared with the same periods a year earlier. For the 12 months ended October 2003, the Composite CPI was on average 2.7% lower than in the preceding 12-month period.

The unemployment rate fell to 8% in the period August - October 2003, down from 8.3 % in July – September 2003 and 8.6% in the previous three-month period. This translates to around 282,000 people out of work. The under-employment rate also decreased from 3.6 % to 3.5 % in the period August-October 2003.

While Hong Kong's open economy is constantly vulnerable to factors beyond our control, especially the performance of the economies of the United States (US), the Mainland and elsewhere, and the impact of world events, the signs at present are positive. The US recovery appears to be solidly based with growth recorded at 8.2% in the third quarter and no inflation. The Mainland economy, meanwhile, continues to demonstrate a fundamental strength, achieving growth of 9.1% in the third quarter of 2003.

1.3 Fiscal Position

As suggested above, the deficit in 2003/04 is now expected to be higher than HK$67.8 billion estimated in the 2003 Budget with overall effect of SARS, including the relief package and the freeze on land sales. In October, the FS revised the deficit forecast to HK$73b – $83b for the year. For the first six months of the fiscal year, the gap between income and expenditure reached HK$74.3 billion, compared with HK$70.8 billion for the same period in 2002 and HK$6.7 billion in 2001. In October the deficit increased a further HK$6.7 billion to over HK$81 billion.

Fiscal reserves stood at HK$234.4 billion on 31 October 2003, compared with HK$300.1 billion one year earlier. Although the current level of the reserves is due partly to the difference in timing between the main periods of public expenditure and income, if the final deficit is within the range now being predicted, the reserves will be between HK$232.4 – 242.4 billion by March 2004. At this level they could fall below 11 months of government expenditure and below the revised target threshold set by the FS in the 2002 Budget Speech, which was the equivalent of 12 months of government expenditure, or around HK$257 billion at current estimated expenditure levels. Although in the 2003 Budget Speech, the FS projected reserve levels over the period 2003/04 – 2007/08 to fall below the revised threshold, and to be maintained at 9-11 months government expenditure, clearly this is not a desirable situation. It points to the real need to reconcile the ongoing mismatch between revenue and expenditure in order to ensure long-term confidence and stability in Hong Kong's economy.

As at 31 October 2003, the foreign currency reserves held by the Exchange Fund stood at US$112.4 billion compared with US$110.6 billion at 30 October 2002. Hong Kong is currently the world's fifth largest holder of foreign currency reserves, after Japan, Mainland China, Taiwan and Korea.

1.4 Summary of Proposals

Part A – Building Solid Foundations

1) Given the fiscal deficit, the structural changes in the economy and the narrowness of the tax base, there is a need for the Government to broaden the tax base and stabilise future sources of revenue. The Society supports the strategy of introducing a goods and services tax (GST) at an appropriate time. The Government should specify a timetable for implementing a GST, including conducting a full consultation with the public.

2) In order to ensure that Hong Kong retains its "business friendly" reputation, it is important to maintain clarity, certainty and consistency in the interpretation and enforcement of Hong Kong's tax regime. To this end, legislation should be introduced to give greater clarity to the determination of offshore profits and the Inland Revenue Department (IRD) should consider adopting the practice of various other jurisdictions by publishing the assessors' manual.

3) In order to encourage future compliance and the disclosure of past irregularities, the implementation of a one-time tax amnesty should be considered, accompanied by a clear statement of intent from the Government that after the amnesty it will increase penalties relating to future discoveries of tax evasion for the period covered by the

amnesty. Experience in other jurisdiction demonstrates that the more successful amnesties have also served as a means of generating significant tax revenue for the government concerned.

4) Given the noticeable deterioration in Hong Kong's environment over the past decade, which affects the overall quality of life and imposes additional costs on the community, through lost days at work and demands on an over-burdened health service, there is a case for implementing a more co-ordinated "green tax" policy in Hong Kong. This should be done in conjunction with a public education campaign, and closer co-operation on environmental issues with other relevant governments in the Pearl River Delta area.

5) Consideration should be given to issuing government bonds for infrastructure projects (e.g. the Hong Kong-Zhuhai-Macau Bridge) which will help to improve control over cash flow and to develop a stronger debt market in Hong Kong.

6) While partial privatisation of government assets should not be relied upon as a means of dealing with the recurrent budget deficits, it should continue to be considered as a way of improving efficiency and subjecting certain government-controlled entities to the discipline of the market. Consideration could also be given to encouraging greater private sector participation in non-profitable entities, with a view to improving their efficiency, thereby reducing public expenditure and, potentially, turning non-profitable services into profitable ones.

<u>Part B – More Immediate Options for Revenue-raising</u>

7) If it is necessary to raise additional revenue, the option of a further review of personal allowances could be considered, pending the introduction of a GST.

8) If it is necessary to raise additional revenue, the option of a moderate increase in rates on tenements may be considered, pending the introduction of a GST.

9) In view of the Government's fiscal position, it would be reasonable, and it would also be equitable, to reconsider the merits of a Boundary Facilities Improvement Tax with a view to implementing it in the near future.

10) There should not be any further changes in the basic salaries and profits tax rates. Once all the changes announced in the 2003/04 Budget are fully implemented, in 2004/05, we believe that the rates will be sufficiently high.

<u>Part C – Improving Hong Kong's Competitive Edge</u>

11) In order to give further support to the implementation of the Mainland/Hong Kong Closer Economic Partnership Arrangement (CEPA), consideration should be given to granting a profits tax exemption for three years to qualifying businesses that have located their manufacturing processes in Hong Kong in order to take advantage of CEPA.

12) Consideration should be given to extending the "Arrangement between Mainland China and Hong Kong SAR for the Avoidance of Double Taxation on Income" to cover passive income such as interest and royalties earned by Hong Kong companies.

13) Various measures should be introduced to enhance Hong Kong's competitiveness as a location for regional offices and group companies, such as:

- Provision for group relief, which is available in a number of developed tax jurisdictions.

- Provision for the carrying back of losses incurred in the current year of assessment for one year, to be offset against assessable profits in the previous year.

- A 100% profits tax exemption should be granted to regional headquarters/offices in respect of management and consultancy income derived from associated entities overseas.

- Deductions should be allowed for interest incurred or paid on money borrowed at arm's length from overseas associates for the production of assessable profits.

14) Various measures should be introduced to encourage the further development of Hong Kong's "core businesses", such as financial services; for example the following:

- A 50% reduction in the rate of profits tax in relation to fees earned by fund managers and trustees providing management services in relation to mutual funds, unit trusts and similar collective investment vehicles, to ensure that Hong Kong maintains a critical mass of financial service providers in key financial services sectors.

- Extending the existing profits tax exemption for overseas mutual fund corporations investing in Hong Kong to large reputable funds that may not meet the tests of being widely-held, but which are regulated by an acceptable overseas regulatory authority.

- Further reducing stamp duty on transactions in company stocks.

- Abolishing estate duty to encourage more personal wealth to return to Hong Kong and enhance Hong Kong's position as a major financial centre of the region; or at least exempting bank deposits in Hong Kong from estate duty, to promote Hong Kong as a private banking hub.

15) To give support the continuation of a limited manufacturing base in Hong Kong and provide employment opportunities to a range of workers, consideration should be given to granting a time-limited 50% profits tax reduction to local manufacturers of goods, for a period of, for example, five years.

16) To encourage innovation and invention in Hong Kong, the tax deduction on the expenditure on scientific research currently allowed to approved institutions should be increased to 150%. The initial allowance in relation to buildings and structures that are used for scientific research should also be increased to 25% and the annual allowance increased to 25% for three years.

Part D – Community Measures to Provide Assistance and Improve the Quality of Life

17) To encourage the recruitment of unemployed persons, who have been actively seeking work in Hong Kong for a period of, for example, one year or more, an extra 50% deduction of their salary costs should be granted to their employers for the year of assessment 2004/05.

18) Employees should not be taxed on any redundancy/severance payments from their employers of up to twice the statutory limits.

19) Stamp duty on property transactions should be reduced to give some support to the signs of a revival in the property market.

20) To further encourage charitable donations, the following measures should be considered:

- The present ceiling for allowable deductions should be increased from 25% to 50% of assessable profits/income, with a view to removing the ceiling altogether as a longer term objective.

- Any unclaimed donations should be allowed to be carried forward.

- Deductions should be allowed for donations in kind, if the goods are properly valued.

21) To improve the arts and cultural environment in Hong Kong, and encourage more private sector support, consideration should be given to allowing corporate sponsors of "approved" events to claim deductions of 150% of actual expenditure.

Part E – Streamlining and Improving the Tax Regime

22) Consideration should be given to the abolition of estate duty, which would encourage the further development of private banking and so enhance Hong Kong's position as a major financial centre. However, if it is retained there should be a detailed review of the existing legislation, covering, amongst other areas, bank deposits held in Hong Kong financial institutions (see item (14) above); the relief available for residential properties; the rates of duty and the interest charged on unpaid duty.

23) A review of the Inland Revenue Ordinance (Cap. 112) should be undertaken which should include significant redrafting to simplify and clarify its provisions. One specific area that needs to be considered in any review is the provisions on cross border transactions, in relation to which a clearer set of rules would enhance clarity and certainty.

Part F – Government Fees and Charges and Costs

24) A detailed review of the level of duties and fees levied by the Government should be undertaken and the "user pays" principle should be adopted. However, this should be part of a larger framework of accountability on the part of the Government for its costs, and a willingness to examine ways to deliver services more efficiently and cost-effectively.

25) Given the current mismatch between its income and expenditure, the Government needs to critically review the various areas of public expenditure, including the costs in relation to the provision of existing services, any plans for new services or expansion of existing services as well as capital expenditure projects. Reports issued by the Director of Audit suggest that there is scope for improving productivity and efficiency generally within the public sector.

26) With a view to cutting capital expenditure, the Government should encourage more private participation in major capital projects.

2. DETAILED PROPOSALS

PART A – BUILDING SOLID FOUNDATIONS

Building a shared sense of responsibility: towards stabilising sources of revenue

2.1 Preparing for the Introduction of a Goods and Services Tax

Given the magnitude of the fiscal deficit, the structural changes in the economy and the historically narrow tax base in Hong Kong, we believe there is a clear need for the Government to broaden the tax base and to stabilise its future sources of revenue. Controlling public expenditure is important, but equally important is the need for the Government to recognise and deal with the defects on the revenue side.

We note that the FS regards a broad-based consumption tax as reasonable and equitable way to smooth out the irregularities in the revenue stream, even though he has indicated that he would not introduce such a tax in a deflationary environment. The Society endorses the strategy of introducing a Goods and Services Tax (GST) at an appropriate time. It is generally believed that once a policy decision has been taken to implement GST, the earliest implementation date could still be some years – possibly three or four years – into the future. The setting up, earlier this year, of the Government internal taskforce to study the feasibility of a GST for Hong Kong is to be welcomed. We believe that, given lead time required, preparatory work should proceed without delay and we urge the Government to specify a timetable for implementing a GST.

With the intense public interest in the question of whether a GST should be introduced in Hong Kong, we believe that Government should conduct a full and open consultation with the public. Businesses will face some implementation and on-going costs associated with GST. However, the level of compliance costs faced by businesses could be minimised if proper consultation is conducted on the administrative system to be adopted for Hong Kong. For example, we recommend Government to work with the retail sector to alleviate any concerns they may have regarding GST. Similarly, it would be important for the views of the tourist sector to be heard on the most appropriate refund mechanism to be adopted for tourist purchases.

At the time of introducing a GST, we recommend that consideration be given to direct tax reductions, such as a reduction in the rate of profits tax and salaries tax. Many overseas jurisdictions that have introduced a GST have included reductions to direct taxes in their overall tax reform package; these include Australia in 2000 and Singapore in 1994. Reducing the profits tax and salaries tax rates would reduce the overall tax burden borne by the minority of citizens who actually pay the bulk of the direct taxes and would be a tax base broadening measure if done in conjunction with the introduction of a GST. Of course, in practice, the possibility and the size of any reductions in other taxes would depend on the financial position of Government at the time a GST was implemented.

Set out in Appendix 1 are the Society's views on the key basic design features on a GST for Hong Kong. In summary, we recommend:

- The GST adopted to be the credit-invoice type.
- A single low rate of GST, not to exceed 3-5%.
- The destination principle whereby imports are taxed and exports (including tourist purchases) are zero-rated.
- The GST to be kept simple and hence broadly-based, with minimal zero-rating or exempt items.
- Special considerations to be given to certain specific sectors, including the financial and property sectors.
- A high registration threshold in the interest of cost-effectiveness.
- Appropriate compensations to be given to low-income households.

2.2 Improving levels of tax compliance – implementing a tax amnesty

Maintaining the "3 C's" – clarity, certainty and consistency

One of the strengths of the Hong Kong tax system has traditionally been the fact that Hong Kong's tax legislation has been relatively straightforward and easy to understand. From time to time contentious areas have arisen in interpretation of the tax law but clarification has been obtained by reference to court decisions, the use of Departmental Interpretation and Practice Notes ("DIPN") or, if necessary, changes to the legislation. This certainty of interpretation has enabled taxpayers to have greater confidence in their submissions to the Inland Revenue Department ("IRD") and has encouraged full disclosure in compliance matters and the belief that their affairs will be dealt with on a consistent basis.

These elements of clarity, certainty and consistency have been fundamental to Hong Kong's reputation as a place to do business. It is important, therefore, that in the future we continue to give priority to the maintenance of these "3 C's", as Hong Kong faces increasing competitive pressures from other international cities in the region.

Two key areas on which we need to focus our efforts to protect Hong Kong's business-friendly reputation are (a) interpretation of the Inland Revenue Ordinance (Cap. 112) ("IRO") and (b) enforcement.

Interpretation

Given the reliance of Hong Kong's tax system on the principle of source of profits and the relative ease with which businesses nowadays can, for example, establish operations in one jurisdiction, subsequently physically segregate and relocate specific processes or activities, or indeed relocate the business as a whole, one of the major areas of concern regarding interpretation is the question of offshore profits claims, and in particular the question of offshore manufacturing profits. Ensuring clarity, certainty and consistency in this area is of paramount importance, otherwise Hong Kong could lose business to other jurisdictions where the legislation regarding the taxation of such profits is clearer. We therefore recommend that, to protect Hong Kong's commercial advantage in this area and to establish greater certainty in this area, legislation be introduced to clarify the position regarding offshore profits, particularly in the case of manufacturing and trading profits.

We would also encourage the Government to consider following the approach adopted by revenue authorities in various other jurisdictions by publishing the IRD assessors' manual. This would help to promote consistency and to provide an additional level of clarity for taxpayers, regarding both interpretation and their compliance obligations – not only for the source of profits but for all tax matters.

Enforcement

A key element in the Government's fiscal discipline is the efficient use of resources by the IRD in enforcing compliance with Hong Kong tax legislation, so as to ensure collection of the taxes that are properly due. One of the more effective uses of resources in the IRD has been the establishment of field audit teams, which have resulted in significant revenues for the Government that may not otherwise have been collected. In addition to the tax assessed as a result of both field audits and investigations, these activities have also generated further revenues in the form of penalties that have been imposed as part of the settlement with delinquent taxpayers.

Penalties are normally seen as,

- encouraging future timely compliance with the relevant legislation;
- providing financial compensation for loss of revenues in delinquent cases; and
- acting as a deterrent to tax evasion.

While penalties in the case of tax evasion are normally punitive and/or involve prosecution, the indications are that increasingly heavy penalties are also being imposed in cases of voluntary disclosure by taxpayers, who may have, inadvertently or otherwise, made an error or omission in their tax returns, and in cases where anti-avoidance measures, such as under section 61A of the IRO, are invoked.

The levying of punitive penalties in cases of voluntary disclosure is generally believed to be counter-productive. In their 1986 paper on "Amnesty, Enforcement and Tax Policy", H.B. Leonard and R.J. Zeckhauser point out that some people become tax delinquents by mistake. Such individuals may be willing to remedy their behaviour and become honest citizens if they are not confronted with punishment mechanisms, such as prosecution and penalties. Thus a mechanism for voluntary disclosure without undue penalties or prosecution will encourage tax delinquents to make a full disclosure of their under declared income.

A survey conducted by Richard Simmons and T.Y. Cheng in Hong Kong suggests that small scale tax evasion may be widespread in Hong Kong. Under the circumstances, we would propose that the Government should encourage voluntary disclosure of both tax evasion and errors in reporting by providing that those making full voluntary disclosure do not face high penalties and/or prosecution, but are instead subject to fiscal restitution through the use of interest payments.

Tax amnesty

As an extension of this, the Government should consider encouraging both future compliance and the disclosure of past irregularities by taxpayers, through the introduction of a one-off tax amnesty, giving taxpayers a limited and specified period of time in which to bring their tax affairs in order.

This amnesty could be coupled with increased penalties for cases of subsequent discovery of non compliance relating to the period covered by the amnesty.

More detailed information on tax amnesties and their effects when implemented in other jurisdictions is set out in Appendices 2 and 3, from which it will be seen that a one-time amnesty offered for a short period of time, coupled with stricter fiscal penalties after the expiry of the amnesty, is generally effective.

Tax amnesties in other jurisdictions have tended to be in operation for two to six months. In our view, a reasonable duration for an amnesty in Hong Kong would be three months. It should cover all cases of under reporting for all open tax years, which would mean extending back for up to six years, excluding any cases currently under investigation or field audit.

The practicalities of such an amnesty would be to encourage voluntary disclosure during the amnesty period with no penalties or prosecution, but with interest charged at a commercial rate covering the period from the original due date of payment, had the tax had been properly paid, up until the actual date of payment. This approach provides the required element of financial restitution and also prevents taxpayers who have all along been fully compliant from considering they have been unfairly treated compared with those taking advantage of the amnesty.

In the absence of a general tax amnesty, the Government should seek to encourage full voluntary disclosure of errors or mistakes in tax filings, and any omissions to declare taxable income. This may be achieved by ensuring that while taxpayers making such disclosures are required to pay all the tax due, together with interest for late payment, as a means of financial restitution, they should not suffer punitive penalties or prosecution, which are seen as being counter-productive.

Building a shared sense of responsibility: towards improving the environment

2.3 Environmental taxation

Recently again we have seen days with extremely high levels of air pollution when one side of the harbour is not visible from the other. Given what appears to be a much higher incidence of asthma and other respiratory ailments in Hong Kong than a decade ago, and the consequent losses in terms of absences from work, places of study etc., and costs to an already over-burdened health service, pollution in Hong Kong is a concern both for public health and the economy.

Among the lessons to be learned from the outbreak of SARS is the importance of maintaining a wholesome, hygienic and healthy lifestyle and ensuring that our living conditions are conducive to doing so. The impact of SARS on Hong Kong's image overseas was evident and the actual and potential loss of business was very worrying. We should not forget this lesson now and should be trying to ensure that internationally Hong Kong is seen as placing a high priority on standards of environmental cleanliness and hygiene. However, this is not easy to do while the visible signs are that this is a city with a major pollution problem. We should also not underestimate the effect of a poor environment on the willingness of overseas personnel to work and have their families transferred here, the desire of some tourists to visit and the development of potentially new forms of tourism, such as ecological tourism, in Hong Kong.

Over the last decade in particular we have experienced a noticeable deterioration in the environment. Air-borne pollutants from road transport, power stations, industry and our careless disposal of waste are having a direct negative impact on our health. In the past, when building the economy and providing basic necessities, such as housing and education, for a growing population was understandably at the centre of policy-making little attention was given to quality of life issues. However, as Hong Kong has become more affluent, the community's expectations have changed and increased.

Around the world, "green taxes" have become an additional effective tool of environmental policy, alongside public education programmes, the provision of technical and financial assistance to foster industries engaged in environmental protection or which use new environmentally-friendly production techniques, and the imposition of punitive sanctions for polluters.

There are various arguments for green taxes. Firstly, market prices do not always reflect the external cost (e.g. the social cost) of an economic activity. Environmental taxes will encourage economic players to use resources more efficiently. Secondly, green taxes are not only an efficient way for governments to raise revenue (though the amount might not always be substantial) but they also are more acceptable than income taxes because they are justified on the basis of the "polluter pays" principle. The revenue is to cover the recurrent cost of cleaning up pollution and to fund environmental and other social programmes. Thirdly, a green tax will encourage taxpayers to alter their behaviour and practices more easily and cheaply. Other taxpayers, who cannot afford the adjustment, will simply pay the tax. Pollution will thus be reduced to the least cost to the whole society. In general, however, green taxation will help to increase attention on the whole issue of sustainability.

We believe that in addition to the existing measures that have been taken in recent years, such as reducing sulphur dioxide emissions from power plants, requiring petrol-driven vehicles to switch to unleaded fuel, and encouraging taxes and public light buses to convert to the use of liquefied petroleum gas ("LPG"), there is a good case for implementing a broader green tax policy in our fiscal system. A green tax package could be implemented through various market mechanisms and incentives, including the introduction of specific "eco taxes".

Environmental and taxation policies can be made not only compatible but also mutually reinforcing. Although various political, technical, economic and social issues would need to be addressed, implementing comprehensive green tax reforms should be a long-term goal for Hong Kong's fiscal tax system.

Broad areas that could be looked at would include the introduction of such measures as emission taxes, taxes on polluting inputs, credits for emission reduction, permits to emit a specified amount of a pollutant, waste disposal charges, deposits/refunds and public sector procurement policies. More specific measures could embrace, for example, fuel duties, electronic road pricing, air and water pollutant taxes, landfilling charges, taxes in respect of the disposal of plastics, glass, batteries and vehicles; taxes on polystyrene foam and plastic bags or other non-biodegradable matter and a refund system to encourage recycling; carbon and energy taxes (on electricity, coal, gasoline, etc.) and other resource consumption taxes; and refund mechanisms to reward the control of pollutants and efficient use of energy. In addition, tax incentives could be offered for e.g. investment and spending in environmental protection equipment, machinery or systems; grants (such as low/no interest loans) to small and medium sized enterprises (SMEs) which may have insufficient capital to acquire environmental protection equipment, machinery or systems could also be considered.

A co-ordinated public education and awareness campaign on environmental issues should also be undertaken. At the present time the community should be more receptive than ever towards taking long-term preventative measures against further outbreaks of diseases as well as towards a more extensive implementation of polluter pays measures. That is not say there would be universal support which is why education and awareness should be stepped up.

The Government also needs to work closely with the relevant authorities in the Mainland to lay down a long-term plan to achieve international standards in environmental protection in Pear River Delta area. Control of the emerging smog pollution requires collaboration in relation to legislation, rules and enforcement, between all the local governments in the Pearl River Delta. Given its rapid economic development and recent accession to the WTO, the Mainland will also benefit from this initiative as it will need to work on strategies to develop the necessary infrastructure and regulations to deal with an influx of new industries.

<u>Improving public sector cash flow control and developing the debt market</u>

2.4 Government borrowing: issuance of bonds

Issuing bonds is a common method for raising capital in mature capital markets and it is a measure often undertaken by governments around the world. In the past, the Hong Kong Government has not generally needed to borrow money from the capital markets, and so it has issued bonds only on three occasions. However, with the ongoing concerns over public finances, the question has started to be debated. In the 2003 Budget Speech, the FS indicated that the Government was open-minded about issuing bonds.

We believe that consideration should be given to the issuing of government bonds for infrastructure projects, such as the proposed Hong Kong-Zhuhai-Macau Bridge. Although, as the FS noted, the issuing of bonds cannot cure the underlying problem of the deficit, it can improve control over cash flow. Is should also help to develop a stronger debt market in Hong Kong. It is clear, from the interest in bonds issued by government-controlled corporations, that there would be a demand from institutional and other investors for Hong Kong Government bonds. Since the establishment of the Mandatory Provident Fund Scheme, the development of a more extensive local debt market has been among the Government's stated objectives and, as a global financial centre, Hong Kong should continue to explore ways to develop its financial markets.

Bond financing should also help to improve corporate governance in relation to the management of the infrastructure projects, as debt covenants normally require proper management of the projects.

For the above reasons, this would be an opportune time for the Government to consider the detailed mechanics and timing of proceeding with further bond issues in Hong Kong.

<u>Improving efficiency: subjecting government entities to market discipline</u>

2.5 Privatisation of government assets

In the 2003 Budget Speech, the FS indicated that the Government planned to sell or securitise a total of $112 billion worth of assets in the next five years. The Government announced in August 2003 its intention to proceed with the part-privatisation of the Airport Authority and indicated that the required legislation would be introduced into the Legislative Council in 2004.

The Society believes that whilst partial privatisation should be considered as a means of improving efficiency and subjecting certain government-controlled entities to the discipline of the market, privatisation of government assets should not be relied upon as a means of dealing with the recurring budget deficit. In addition to partially privatising profitable entities, consideration could also be given to encouraging greater private sector participation in non-profitable entities, with a view to improving efficiency, thereby reducing public expenditure and, potentially, turning non-profitable services into profitable ones.

PART B – MORE IMMEDIATE OPTIONS FOR REVENUE-RAISING

2.6 Broad based measures to raise revenue if required

In its report to the Government in February 2002, the Advisory Committee on New Broad Based Taxes ("Advisory Committee") recommended that Hong Kong adopt a GST to raise additional revenue to deal with Hong Kong's structural fiscal problem. However the Advisory Committee also recognised that it would take time to implement a GST regime in Hong Kong and accordingly recommended other measures that could be used to broaden the Hong Kong tax base in the short to medium term, pending the introduction of GST. The Advisory Committee identified three areas where measures could be adopted to broaden Hong Kong's tax base namely:

- Reduction in personal allowances for salaries tax purposes;
- The land and sea departure tax (Boundary Facilities Improvement Tax); and
- Rates on tenements

2.6.1. Adjustments in personal allowances

Commenting on the personal allowances for 2000/01, the Advisory Committee indicated that an across the board reduction in personal allowances in 10%, 25% and 50% would, at that time, yield additional revenue of $2 billion, $6 billion and $14 billion respectively. In the 2003 Budget Speech, the FS announced reductions in the level of personal allowances for a single person and married person (and also the rate of single parent allowance) of approximately 3.75% for the Year of Assessment 2003/04 and a further 3.75% for 2004/05. Thus the level of personal allowances effective from 2004/05 represents a decrease of 7.5% in comparison with the same allowances in 2000/01. The reductions announced in the 2003 Budget also did not affect all the allowances. Child allowances and dependent parent allowances, for example, were not reduced. In fact child allowances for the third to ninth child were increased from $15,000 to $30,000 per child.

In the Society's Budget Proposals for 2003/04, it was noted that, using 1994 as the base year, the net increase in the CPI by 2002 was 10.61%, whereas over the same period a single person's personal allowance had increased by 50%. With a further 10 months of deflation, the net increase in the CPI between 1994-October 2003 would be around 8.2%. On the bare figures, therefore, it would not be unreasonable to consider the possibility of a further reduction in personal allowances, if this proved necessary.

2.6.2. Boundary Facilities Improvement Tax

The Advisory Committee also recommended a land and sea departure tax, as this would provide a steady revenue source to the Government. It would also be equitable as, if it were introduced, all passengers departing from Hong Kong by land or by sea would pay a tax. Passengers leaving by air are already subject to a departure tax.

The Government announced the decision to go ahead with a "Boundary Facilities Improvement Tax" in the 2002 Budget Speech. The suggested level of tax to be levied, in respect of departure by land and by sea, was HK$18 on persons and HK$100 on the owners of specified motor vehicles. In the 2003 Budget Speech, the FS announced that legislation would be introduced in the second quarter of 2003 and that the tax would generate additional revenue of over HK$1 billion per year. More recently, however, the Government has announced its intention not to introduce a Boundary Facilities Improvement Tax at this juncture.

We recognise that there have been conflicting opinions on the tax. However, on the principles of equity, and in view of the Government's fiscal position, we believe that the proposed tax should be implemented. As indicated above, persons leaving Hong Kong by air are already charged a departure tax and it is logical that travellers departing by land and by sea should be treated similarly. Imposition of the tax is also in line with the "user pays" principle, a common international practice that the Government is making efforts to implement locally.

We believe that at the rate proposed, it should not have a significant impact on the cross-boundary activity. Exemptions to special groups, such as full-time students, crew members of passenger ships and drivers operating land transport vehicles, and subsidies to social welfare recipients, would help to minimise any financial hardship on daily commuters and provide relief to more vulnerable members of the community.

We would therefore propose that the FS should reconsider the merits of this tax with a view to implementing it in the near future.

2.6.3. Rates on tenements

The third suggestion of the Advisory Committee related to rates on tenements, which is a broad based tax having a substantial revenue productivity. Whilst the Committee did not recommend that increased levels of rates should be used as a long-term revenue measure to cover the fiscal needs of the Government, it indicated that the Government should consider a moderate increase in the level of rates in the short to medium term as a means of broadening the tax base. In this respect it should be noted that the Advisory Committee found that rates on tenements, as well as being broadly based, have a degree of fairness because they are levied on the rental value of the landed property and are equitable in impact, because generally persons occupy accommodation that is commensurate with their ability to pay.

An increase in rates also scores highly in terms of effectiveness and efficiency in that increasing rates is an effective way of enhancing revenue yields, as landed property owners (either directly or indirectly through tenants) cannot avoid paying increased property rates. In addition, once the legislation has been enacted, increases in rates are a very effective way of collecting additional revenue as there are no additional administration or collection costs for either rates payers or the Government.

We consider that there is merit in the Advisory Committee's recommendation that a moderate increase in rates could provide a reasonably broad based source of additional revenue, if such revenue is required pending the introduction of a GST.

2.6.4. Tax rates

As to the basic rates of salaries and profits tax, i.e. given the adjustments in (i) salaries tax, announced in the 2003 Budget, in respect of the marginal tax rates (the incremental steps increased from 5% to 6%) the tax bands (the band width reduced from HK35,000 to HK$30,000) and the standard rate (increased from 15% to 16%) and in (ii) the profits tax rates (increased from 16% to 17.5% for corporations and 15% to 16% for unincorporated businesses), some of which are to be introduced in two stages over 2003/04 and 2004/05, we do not propose any further changes to the tax rates at this time. We believe that the new tax rates will be sufficiently high and that further increases could adversely affect Hong Kong's competitiveness as an international business centre.

PART C – IMPROVING HONG KONG'S COMPETITIVE EDGE

2.7 Strengthening Hong Kong's "core businesses"

2.7.1. Measures to support the Closer Economic Partnership Arrangement (CEPA)

Introduction

The signing of the Mainland and Hong Kong Closer Economic Partnership Arrangement ("CEPA") on June 29, 2003, and its annexes on 29 September 2003, marked a new era in the economic co-operation between the Mainland and the Hong Kong SAR. With a view to further strengthening the economic bond between these two places, CEPA broadly covers three areas, namely trade in goods, trade in services and trade and investment facilitation.

As to trade in goods, the Mainland will apply zero import tariffs from 1 January 2004 for imported goods meeting the "Hong Kong origin" rules in 273 Mainland product codes. The exemption from import tariffs, which could be as high as 35 % on some of the specified products, such as jewellery and metallic ornaments, will provide incentives for both local and overseas manufacturers to shift their high-value-added manufacturing operations to Hong Kong. More goods types of Hong Kong origin will be imported free of import tariffs into the Mainland by 1 January 2006 upon application by local manufacturers.

In the services sector, CEPA provides for liberalisation of market access to the Mainland in 18 sectors. The liberalisation allows earlier access to certain categories of Hong Kong service suppliers to the Mainland market, ahead of the timetable under China's World Trade Organisation commitments. As there are a number of requirements to be fulfilled in order to be eligible to be a Hong Kong service supplier, including the maintenance of a business office in Hong Kong, employment of over 50% of staff in Hong Kong and the requirement that the company should be subject to Hong Kong profits tax etc, we see that the position of Hong Kong as a services centre for local and foreign investors entering into the Mainland market will be reinforced.

Both sides also agree on promoting co-operation in seven areas, namely (1) customs clearance facilitation, (2) quarantine and inspection of commodities, quality assurance and food safety, (3) SMEs (4) chinese medicine and medical products, (5) electronic commerce, (6) trade and investment promotion, and (7) transparency in laws and regulations. Further cooperation and development in these areas will help strengthen the economic activities between the Mainland and Hong Kong.

With such concessions on the part of the Mainland, we believe that the CEPA reaffirms Hong Kong's position as the main gateway to the Mainland and that the Hong Kong Government must grasp this hard won opportunity to capitalise on the potential benefits. To reap the economic benefits that CEPA could bring to the business economy of Hong Kong, it is essential for the Government to formulate proper and timely strategies including promulgation of appropriate taxation policies and incentives to selected industries and enterprises.

With the fiscal deficits suffered by Hong Kong in the past few years, we believe that the financial well-being of Hong Kong in the future will depend, to a significant degree, on its successful economic partnership with the Mainland.

Trade in goods

In the area of trade in goods, as CEPA provides incentives for both local and foreign manufacturers as 273 items, which satisfy the country of origin requirements of Hong Kong, can be imported to the Mainland free from customs duty.

Taking the advantage of zero import tariffs on selected goods, in particular, those that are presently burdened with high import tariffs by the Mainland, incentives exist to locate certain parts of the manufacturing processes to Hong Kong. As the supply of land and labour in the Mainland are abundant, and are available at a much cheaper rate than in Hong Kong, it is expected that processes that are labour intensive and which do not involve high technology will continue to remain in the Mainland. Generally, manufacturers would consider only those processes that involve modern technology and provide high value as suitable for (re)location in Hong Kong.

Government policy should therefore be aimed at attracting this form of manufacturing-related processes into Hong Kong, to help foster Hong Kong's potential in high technology, and as an intellectual property development and protection centre, within the region. This is also in line with Hong Kong's evolution into a knowledge-based economy, which is a part of the Government's vision for the future and a recurring theme in the Chief Executive's Policy Addresses.

Taxation incentives

Whilst the higher set up and running costs in Hong Kong can be compensated to an extent by the reduction in import tariffs and better intellectual property protection, the taxation policy can be refined to further reinforce government policy. A possible way is to provide profits tax incentives to both local and foreign enterprises that have located their manufacturing processes in Hong Kong to enjoy benefits under CEPA. In this connection, we recommend that the Government considers granting a 100% profits tax exemption for three years to those qualifying taxpayers after their (re)location to Hong Kong. This would also help to offset any relocation costs and initial testing and running costs.

Although some profits tax would be foregone by granting the above tax incentive, we believe that the economic benefits that would accrue from the establishment of targeted manufacturing processes in Hong Kong would outweigh the tax cost. The temporary sacrifice of profits tax from this source would be compensated by an increase in salaries tax as a result of more employment in Hong Kong, a modest rise in profits tax collections as a result of the overall increase in industrial and commercial activities within Hong Kong, and also, in the long run, by the development of Hong Kong into an intellectual property centre.

We believe the above complementary economic and taxation policies, if carefully considered and implemented by the Government, could help revive our economy and relieve the fiscal deficits.

Trade in services

The benefits in the services area will arise mainly from the opportunity for early access to the Mainland market by Hong Kong service providers from specific sectors and from the reduction of the threshold requirements for entering into the market.

Professionals in Hong Kong can get an early start in the Mainland market, ahead of the timetable to which the Mainland is committed for granting market access to the rest of the world. By acting as a bridge between the Mainland and the outside world, Hong Kong professionals can play a part in assisting the Mainland to increase exchanges with gain access to other parts of the world, and to align with international practice. Business opportunities therefore exist for both inbound and outbound professional services. Hong Kong can be further developed as a strategic two-way platform for businesses between the Mainland and the international business community.

The definition of Hong Kong service suppliers under CEPA would also help to promote Hong Kong as the services centre for supporting business activities in the Mainland.

In particular, we see that the following benefits would accrue to the economy of Hong Kong: (1) merger and acquisition activities amongst Hong Kong companies should increase to cope with CEPA's requirements and in order to the pool expertise in doing business in the Mainland; (2) more Hong Kong companies will be incorporated, which should in turn, increase employment and demand for professional services in Hong Kong; (3) the office rental market should receive a further stimulus, resulting from more businesses being carried on in Hong Kong.

In general, the level of business activities in Hong Kong should increase, helping to improve economic wellbeing, which should in turn lead to an increase in revenue from profits tax and salaries tax.

The Government has a role to play in promoting the importance and value of the excellent professional services that Hong Kong can offer, in particular under CEPA, e.g. through the overseas branches of Trade Development Council and Invest Hong Kong, and by co-operating with professional bodies and trade associations in the development of their services in the Mainland.

Tax incentives

In order to enjoy the benefits under CEPA, a qualified Hong Kong service supplier will need to employ 50% of its staff in Hong Kong. This could help create more employment opportunities in the local market. In this connection, to encourage the recruitment of unemployed persons, who have been in the Hong Kong job market and actively seeking work for, say, one year or more, we suggest that an extra 50% deduction of their salary costs be granted to their employers for the year of assessment 2004/05.

Again, we believe the shortfall in profits tax would be compensated by an increase in collection of salaries tax when more people are employed in Hong Kong to fulfil the criteria prescribed for "Hong Kong companies" under CEPA.

2.7.2. Facilitating business between Hong Kong and the Mainland

Double taxation relief arrangements

Based on the Arrangement between Mainland China and the Hong Kong SAR for the Avoidance of Double Taxation on Income ("the Arrangement"), signed in 1998, double taxation relief on profits derived from business activities in the Mainland is available to companies resident in Hong Kong.

However, the Arrangement does not apply to passive income, such as interest and royalties earned by a Hong Kong company.

In view of Hong Kong's closer relationship and increased economic integration with the Mainland, particularly with the implementation of the CEPA, we suggest that the Government should seek to expand the scope of the Arrangement to cover other items of income, such as interest and royalties. A broader agreement of this kind, given Hong Kong's geographical proximity to China, will further induce multinational companies to set up holding companies in Hong Kong for Mainland investments, and will enhance the competitiveness of Hong Kong.

2.7.3. Measures to enhance Hong Kong's position as a regional base

2.7.3.1. Group relief

We have advocated some form of group relief in a number of our Budget Proposals submissions in the past in order to avail ourselves of similar tax treatment to that provided in many developed tax jurisdictions around the world. We continue to support the introduction of group relief in Hong Kong.

As in previous submissions we propose that, if full group relief is not introduced, arrangements be introduced to allow the transfers of losses within a group of companies in the event of the loss-making companies going into liquidation. For the definition of "group", section 45 of the Stamp Duty Ordinance (Cap. 117) could be adopted, namely the test of beneficial ownership of a minimum of 90% of the issued share capital. All relevant companies should be chargeable to profits tax in Hong Kong, although they need not be locally-incorporated. Procedures relating to notification, etc. would need to be formulated. We would propose that only losses occurring after the introduction of such relief and upon the liquidation of a company should qualify.

2.7.3.2. Loss carry-back

The ability to carry back losses for a given year of assessment against the assessable profits of a previous year would be a very useful benefit in this period of economic transition for Hong Kong. We have previously proposed an arrangement for loss carry-back, in particular for single companies upon cessation of business in Hong Kong, which, for the sake of administrative simplicity, could be limited to one year's carry-back only. We believe that such a measure would help to ensure equitable tax treatment for all companies by reducing the likelihood that an individual company is in practice required to pay more than the standard rate of profits tax over the life-time of the company. As such we would suggest that loss carry-back should be available to single companies regardless of whether or not group relief or arrangements for the group transfer of losses are introduced.

2.7.3.3. Regional headquarters/offices

We continue to propose that a 100% profits tax exemption should be granted to regional headquarters/offices in respect of management and consultancy income derived from associated entities overseas. (The term "associated entities overseas" will need to be suitably defined, e.g. beneficial ownership of at least 50% of the share capital by the group).

2.7.3.4. Deductibility of interest paid to overseas associates

Section 16(2) of the IRO should be amended to allow deductions for interest incurred or paid on money borrowed from overseas associates for the production of assessable profits. The current position of the IRD, which is to deny the deduction of this interest entirely, acts as a disincentive to the establishment of regional headquarters and offices and other (group) operations in Hong Kong. It also distorts the normal commercial decision-making process of large group businesses, as the restrictions make it preferable to borrow from banks rather than from within the group.

We appreciate that it may be necessary to introduce some restrictive criteria as a safeguard against possible abuses and have previously suggested the following possible criteria:

- the interest should be paid at a commercial or arm's length rate;
- the overseas associate should hold equity in the Hong Kong borrower;
- the funding from the overseas associate must be to promote, establish and/or expand the borrower's business in Hong Kong; and
- the recipient of the interest should be subject to profits tax, or tax of a similar nature, in its home jurisdiction.

2.7.4. Measures to encourage the further development of financial services

We believe that the signing of the CEPA should prompt an assessment of how the tax regime can be further enhanced to signal to investors the continuing advantages of using Hong Kong as a base and stepping stone for doing business in the Mainland, including in respect of the provision of financial services. We believe that specific incentives should be offered to attract business here as part of an overall package to promote Hong Kong's particular benefits to overseas investors.

The financial services sector is one in which Hong Kong excels and the industry here already enjoys a high reputation internationally. A considerable amount has been done to improve the financial infrastructure and standards of governance in the industry. This work must continue, as financial services will remain a core sector in the economy.

2.7.4.1. Concessionary profits tax rate for fund management and trustees of funds

We propose that consideration be given to granting a 50% reduction in the rate of profits tax in relation to fees earned by fund managers and trustees providing management services in relation to mutual funds, unit trusts and similar collective investment vehicles. While that this would single one of the many financial services industries operating in Hong Kong, fund management is regarded as a key industry, as supporting financial services and infrastructure tend to congregate where the fund management industry is concentrated. The aim of the proposal would be to ensure that Hong Kong maintains a critical mass of financial service providers in the fund management sector, particularly in the light of increasing competition from other jurisdictions.

2.7.4.2. Extension of exemption for mutual fund corporations

The existing exemption from profits tax for overseas mutual fund corporations and similar vehicles is restricted to those corporations that are widely-held and subject to the supervision of an acceptable overseas regulatory authority.

Many overseas mutual fund corporations, promoted by reputable overseas financial institutions for their overseas private clients, are neither widely-held nor subject to regulatory supervision, and as such do not fall within the exemption. Nonetheless, they are often self-regulated to high standards and have substantial investment potential. As they are not specifically exempt from Hong Kong tax there is a concern that by locating fund managers and/or investment advisers in Hong Kong, depending on their functions here, which very often cannot be predetermined with precision, the mutual fund corporation may be exposed to Hong Kong profits tax. While very often such exposure may be considered to be primarily technical in nature, it must nevertheless be identified and formally advised to potential overseas investors in the Initial Offering Document for the fund. As a result of the uncertainty that this can create in the minds of investors, promoters of the funds are often deterred from locating the related fund management activities here.

Under the circumstances, we urge the Government to expedite the legislation first announced in the 2003 Budget Speech to clearly exempt offshore funds from Hong Kong profits tax, and to ensure that the legislation will extend to funds of the nature described above.

Furthermore, we would suggest that units in all mutual funds of the above type should be exempted from Hong Kong estate duty, as currently applies to such funds when issued in the United Kingdom, Luxembourg and other major financial service centres.

2.7.4.3. Reducing stamp duty on share transactions

To ensure that Hong Kong's stock market remains competitive vis-à-vis other markets in the region, we propose that the stamp duty on transactions in company stocks be further reduced. In 2000, we saw another step in the progressive reduction in the duty with a cut from 0.225% to 0.2%. The Society recommends that the process of decreasing the stamp duty on share transfers be continued in the next budget.

2.7.4.4. Exempting bank deposits from estate duty

We believe that the abolition of estate duty would encourage more personal wealth to return to Hong Kong and would in turn enhance Hong Kong's position as a major financial centre of the region. Short of total abolition, to promote Hong Kong as a private banking hub, we recommend that bank deposits held with Hong Kong financial institutions in any currency should be exempt from estate duty. This would complement the exemption from the payment of profits tax on interest from deposits placed with authorised institutions as a means to encourage bank deposits to remain in Hong Kong.

2.7.5. Promoting manufacturing in Hong Kong

As a broad and general measure, we suggest that consideration be given to granting a time-limited 50% profits tax reduction to local manufacturers of goods, for a period of, say, five years. The idea behind this suggestion is to create a competitive taxation environment for the local manufacturing sector, as well as to provide employment opportunities to a range of workers, e.g. the low-skilled sector, which should help alleviate the high rates of unemployment and under-employment.

2.7.6. Research and development

To encourage innovation and invention in Hong Kong, we have previously suggested that the tax deduction of 100% of the expenditure on scientific research currently allowed to approved institutions be increased to 150%. Furthermore, we propose that the initial allowance in relation to buildings and structures that are used for scientific research should be increased to 25% and that the annual allowance be increased to 25% for three years, in order to provide profits tax incentives in this regard.

PART D – COMMUNITY MEASURES TO PROVIDE ASSISTANCE AND IMPROVE THE QUALITY OF LIFE

2.8 Measures to assist the unemployed

2.8.1. Non-taxability of redundancy payments

Lump sum redundancy/severance payments within the statutory limits under the Employment Ordinance are non-taxable. However, amounts above these limits may be treated by the IRD as potentially taxable, which can result in uncertainty and lead to prolonged exchanges. The statutory limits meanwhile are hardly overly-generous and where employees have previously suffered salary cuts due to the recession, they may be hit with the double blow of having their tax-exempt redundancy money, which is based on their final salary, correspondingly reduced. We propose therefore that it be made clear that employees' redundancy/severance payments from their employers of up to twice the statutory limits will automatically not be taxed. This will be of benefit not only to provide a greater cushion if such persons remain unemployed for an extended period, but it could also help to provide some unemployed persons with financial wherewithal to consider starting up a business of their own. Consideration could in fact be given to allowing even larger amounts of redundancy money to be tax-exempt where a certain proportion of it is invested in a new business.

Secondly, we propose that where an employee's salary has been reduced due to the recession, etc. and the employer subsequently pays a long-service/severance payment based on the previous higher salary, then the difference between the long-service/severance payment based on the final salary and the actual payment made by the employer should also be deductible by the employer.

2.8.2. Employers' tax concession to encourage hiring of the long-term unemployed

In order to help relieve the high rate of unemployment in Hong Kong, we propose generalising the measure discussed under CEPA in relation to trade in services (see section 2.7.1. above), that is, we suggest that an extra deduction of 50% on the salary costs of employing unemployed persons who have been actively in the job market in Hong Kong for one year or more, be granted to employers in the year of assessment 2004/05. Measure to prevent abuse would need to be introduced, e.g. any new employees should be additional to the existing workforce.

2.9 Measures in respect of the property market

Reducing stamp duty on property transactions

The property market has seen a substantial fall since its peak in 1997. Lower property prices per se are not necessarily a bad thing and if property has become more affordable for the average family, this should in principle be regarded as a positive situation. However, the problems with the situation over the past few years are, firstly, the demoralising effect on those who are living in a property that is worth significantly less than the outstanding mortgage on it and, secondly, the fact that the market has been relatively stagnant has meant that even though property is more affordable, there have been few interested buyers because of the uncertainty over whether there will be further declines in prices in future. Although, interest in the market for new property appears to be reviving to some extent, it is not clear whether this will be sustained or whether it will extend to the secondary market.

We believe that continuing improvement in sentiment in relation to the property market will assist in a more general improvement in Hong Kong's economic climate. At the same time, we consider that, at the present time, the increases in stamp duty introduced in the 1999 budget may be an impediment to further sustainable interest in the market. Under the circumstances, we propose a reduction in the duty as a measure to support a revival. We also suggest that the increments be rationalised. The following rates are proposed:

Property consideration	Present rate	Proposed rate
Up to HK$1M	HK$100	No change
HK$1M - $2M	0.75%	0.5%
HK$2M - $3M	1.50%	1.0%
HK$3M - $4M	2.25%	1.5%
HK$4M - $6M	3.00%	2.0%
HK$6M and above	3.75%	2.5%

2.10 Measures to encourage business participation in community activities and improve the quality of life

2.10.1. Charitable donations

Due to the economic downturn, charities have found it difficult to raise funds to support their activities. Besides, funding for universities, cultural activities and other social services provided by the Government is reducing because of the budget deficit. Charitable donations should be further encouraged in order to develop a more socially-conscious community in difficult economic times. We suggest increasing the present ceiling for allowable deductions from 25% to 50% of assessable profits/income, with a view to removing the ceiling altogether as a longer term objective (in conjunction possibly with the introduction of a stronger framework for the regulation of charities).

We propose, in addition, allowing the carrying forward of any unclaimed donations and also deductions for donations in kind, such as donations of equipment for medical research, if the goods are valued by a qualified third-party.

2.10.2. Sponsorship of arts and cultural events

An important ingredient in the mix of what makes the world's great cities such vibrant and exciting places is a rich and diverse artistic and cultural life. Diversity and commercial success do not necessarily go hand in hand and most of these cities provide subsidies in some form to the arts and culture, whether this is to municipal museums or artistic performances and exhibitions, etc. This is, however, an issue that is often hotly debated and some people argue that if such activities cannot pay for themselves, then they should not be supported by public funds. The debate surrounding the Harbour Fest clearly illustrated this point.

It is the Society's view that the further development of the artistic and cultural environment will help to enhance the quality of life in Hong Kong, offer benefits to Hong Kong residents, as well as improving Hong Kong's reputation internationally. In this regard, business sponsorship can offer a viable, and perhaps more generally acceptable, alternative to public funding for artistic and cultural events. While corporate sponsors of arts and cultural events should already be able to claim the promotional expenses of their sponsorship, we would suggest consideration be given to allowing deductions on the basis of 150% of actual expenditure in relation to sponsorship of "approved" artistic and cultural events and activities.

PART E – STREAMLINING AND IMPROVING THE TAX REGIME

Technical improvements/enhancing the regime

2.11 Changes to the estate duty regime

As indicated above (section 2.7.4.4.) we would suggest that consideration to be given to the abolition of estate duty, which we believe would encourage the further development of private banking and so enhance Hong Kong's position as a major financial centre of the region.

However, if it is considered that estate duty should be retained, we nevertheless propose a detailed review of the existing legislation and specifically the following exemptions and changes.

Bank deposits

As indicated above, we recommend that bank deposits held with Hong Kong financial institutions in any currency should be exempt from estate duty.

Residential properties

At present, the only relief available for residential properties is the matrimonial home relief whereby the matrimonial home is exempt from estate duty if ownership passes on death to the surviving spouse. We believe that this relief is too narrow and fails to take into account modern day relationships or arrangements. For example, it does not apply in the situation where the matrimonial home is held by a company that is owned only by the spouses. It also does not apply if the principal place of residence is passed onto other family members rather than to the spouse of the deceased.

We recommend this relief to be replaced by a more generic exemption for the principal place of residence of the deceased in Hong Kong. The exemption would operate irrespective of the relationship between the deceased and the beneficiary. It should also apply where the dwelling house is owned via a company that is owned only by the deceased and the beneficiaries.

Rates of duty

At present, estate duty is payable at the rate of 100% in certain circumstances. This arises as the existing three rates of duty are not progressive and thus under marginal relief, the value of the estate which is slightly in excess of a particular rate band, would be taxed at 100%. Specifically, the relief is such that where an estate is valued slightly in excess of the upper limit of a band, the duty payable as a result of moving to a higher rate of duty is limited to 100% of the excess above that limit plus duty at the lower rate below that level. We do not believe that an effective rate of 100% on any portion of the estate is consistent with Hong Kong's low tax principle. We recommend this anomaly to be removed by imposing estate duty as a progressive tax with rates of 5%, 10% and 15%.

Interest on unpaid duty

Currently, interest starts accruing on unpaid duty from the date of death as follows:

(i) at the rate of 4% per annum for the first six months after the date of death; and
(ii) at the rate of 8% per annum after six months from the date of death to the date of payment of duty.

It is insensitive and unreasonable to expect the executor, administrator or any other person accountable for the estate duty to pay the amount due on the date of death.

Even though the liability to estate duty arises on the date of death, we recommend a grace period to be given before interest on unpaid duty starts accruing. A period of six months could be considered which is the current time limit given to an executor to deliver the affidavit or accounts to the Commissioner.

2.12 Review of the Inland Revenue Ordinance

2.12.1. Review of the Inland Revenue Ordinance

While the IRO has served Hong Kong well over the years, it has its origins in a different time and economic environment. There have, of course, been numerous amendments, but these have more often been made to introduce specific concessions or anti-avoidance provisions rather than, more generally, in response to changing economic environment or business practices. We feel that there are, for example, areas of the IRO which are unclear or difficult to apply properly or meaningfully in the current environment. Accordingly, the Society is of the view that a complete review of the IRO should be undertaken, which should include significant redrafting to simplify and clarify its provisions.

2.12.2. Cross-border transactions

One specific area that should be considered in any review of the IRO are the provisions on cross-border transactions. We would suggest that the existing provisions on cross border activities be enhanced to create a clearer set of rules. This approach is compatible with international practice and is necessary in view of the increasingly sophisticated and multinational cross-border business and pricing arrangements, which operate both across the Mainland border as well as in other Asian countries. An enhanced set of rules would not only offer clarity and certainty, but would also safeguard against any unfair allocation of profits between related companies under different jurisdictions and prevent the leakage of profits tax due to blatant cross-border business mechanisms. The removal of ambiguities would also reduce default risks and ease business concerns that might otherwise result in the relocation of operations to areas outside Hong Kong.

PART F – GOVERNMENT FEES AND CHARGES AND COSTS

2.13 Government fees and charges

We propose that a detailed review of the level of duties and fees levied by the Government should be undertaken and that the "user pays” principle should be adopted. It is reasonable, in principle, that fees and charges that have not been adjusted for some time should progressively be brought into line with changes in the price index over the period, and that the public should have a greater appreciation of the real costs of providing the relevant services. However, this should be seen as part of a larger framework, which would also involve greater accountability on the part of the Government for its costs and a willingness to examine how the same level of services might be delivered more efficiently and economically.

2.14 The scope for cost cutting

Total public expenditure in 2003/04 is estimated to reach $286.5 billion which, when calculated as a percentage of GDP would amount to 22.3%. In the 2003 Budget Speech, the FS set a target of containing public expenditure at no more than 20% of GDP. This target is to be achieved by an overall expenditure reduction affecting all government departments.

The Government should critically review the various areas of public expenditure, including the cost in relation to the provision of existing services, any plans for new services or expansion of existing services as well as capital expenditure projects. We consider that where cuts need to be made they should not simply be implemented across the board. In our view a proper study of wastage within the civil service should be undertaken. In this regard, we note that reports issued by the Director of Audit are able consistently to point to areas of inefficiency and inadequate use of resources in the operation of government services. This suggests that there is scope for improving productivity and efficiency generally within the public sector. Consideration should also be given to engaging an independent body to recommend any head-count changes.

Recurrent expenditure

The Government has already undertaken a number of measures to slim down the civil service, such as the freezing of recruitment from 1 April 2003, launching a second round of voluntary redundancy and aiming to reduce the number of civil service personnel to 160,000 by 2006/07. Accords on pay reductions have also been concluded recently with the respective civil service trade unions. While it is recognised that direct comparisons between the civil service and private sector emoluments are not always straightforward, there may nevertheless be some further scope for reviewing the level of civil service benefits, including arrangements for automatic pay increments.

In addition, opportunities may exist for streamlining the delivery of services and reducing layers of bureaucracy and possible overlaps of responsibilities. In this connection, we note, for example, that the Government published a Report on the Review of Institutional Framework for Public Housing in June 2002, which recommended a streamlined organisation with a single line of responsibility for housing matters. A general direction towards streamlining of this kind is to be welcomed.

Capital expenditure

With a view to cutting capital expenditure, the Government should encourage more private participation in major capital projects. While the option of issuing of bonds, as indicated in section 2.4 above, would not directly reduce expenditure, it should help to improve control over cash flow requirements.

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Appendix 1

Proposed Key Basic Design Features for a GST

Given the magnitude of the fiscal deficit, there is an urgent need for the Government to generate revenue to replace former sources of revenue which have considerably reduced. Controlling public spending is important but it only provides part of the answer to the deficit problem. Equally important is the need for the Government to recognise and deal with the defects on the revenue side. In this regard, we refer to the comments made by the FS in the 2003 Budget Speech, that it is necessary in the long term to introduce a GST to broaden the tax base and secure a stable source of public revenue.

The GST is not the only possible form of general consumption tax. Alternatives include the Retail Sales Tax ("RST") and the wholesale Sales Tax ("WST"). As the RST and the WST are turnover taxes levied at only one stage of the distribution chain, both would have a narrower tax base than a GST. In practice, it is hard to ensure that the RST does not fall on business inputs leading to the problem of the cascading of tax at intermediate stages of production and distribution. The WST has a similar problem of tax cascading. In addition, the WST would not usually extend to services, which would be a serious disadvantage for a service-oriented economy such as Hong Kong's. For these reasons, we believe that the GST is a better general consumption tax than the RST or the WST.

The Advisory Committee on New Broad-based Taxes ("Advisory Committee") estimated that once a policy decision has been taken to implement GST, the earliest implementation date could still be some years – possibly three or four years – into the future. We note the setting up in June 2003 of an internal taskforce within the Government to look into the implementation of a GST, which is due to report towards the end of 2004. This is an initiative that is to be welcomed and we hope that the taskforce will proceed with it s work with the requisite sense of urgency.

Set out below are our views on the key basic design features for a GST in Hong Kong.

Basic Structure

We recommend a GST to be adopted in Hong Kong should be the credit-invoice type. That is GST is collected at each stage of the chain of production and distribution. Each party charges GST on its outputs (known as output tax) but can claim credits for all tax paid on the goods and services when received (known as input tax). Although the collection of GST is via businesses, because of the credit-invoice offset mechanism, the burden of the GST falls on the final consumer. Due to the multi-stage taxing and crediting, it is relatively difficult to evade the tax. Further, a credit-invoice type GST should avoid cascading in the system.

Rate of GST

A well known competitive feature of Hong Kong is our low and simple tax regime. If we are to maintain our position as a low tax regime, the GST rate to be adopted should be at the lowest end of the GST rates adopted by other economies. Prior to its rate increase on 1 January 2003, Singapore at 3%, was the lowest rate in the world (Netherlands Antilles also at 3%). On 1 January 2003, the Singapore GST rate was increased to 4%, which will be further increased to 5% on 1 January 2004.

The GST rate will also depend on the fiscal position and revenue needs of the Government at the time of introduction. According to estimates of the Advisory Committee, each percentage point of GST will raise HK$6 billion in additional revenue. Given the recent international developments, Hong Kong should be able to protect its position as a low tax regime if the GST rate adopted is below 5%.

As regards the number of GST rates, although there is a debatable equity argument for the adoption of multiple rates, from the simplicity and efficiency perspectives, a single positive rate should be adopted. It is worthy of note that the vast majority of countries that have introduced a GST / VAT over the past decade have opted for a single rate.

Destination versus origin principle

The destination principle of GST is adopted by almost all countries that have a GST. Under this principle, imports are taxed and exports are zero-rated.

An alternative to the destination principle is the origin principle, under which imports are exempt but exports are taxed.

As the international norm is the destination principle, logic dictates that Hong Kong should follow this principle. However, the adoption of this principle will require radical changes to Hong Kong's existing customs administration. The amount of work in this area should not be under-estimated. It may be possible to reduce the impact by introducing a "temporary import regime" where goods in transit through the territory would not be reflected for GST purposes.

Zero-rating and exemption

The international norm is to zero-rate or exempt certain goods and services. When goods are zero-rated, output tax will be nil as the rate is set at 0%, but input tax can be reclaimed. When goods are exempt, no output tax needs to be charged by the vendor but the input tax cannot be reclaimed.

In a simple system, usually only exports (including tourist purchases [1]) are zero-rated. International transportation would be included in this category because the consumption technically does not take place in the jurisdiction of supply. Given the importance of external trade and tourism to Hong Kong, we support zero-rating of exports.

Similar to the experience of other jurisdictions, it is likely that interest and political groups will lobby for specific categories of goods to be zero-rated or exempt from GST. As a political issue, arguments will likely be put forward for merit goods, for example food, to be zero-rated for equity reasons. However, zero-rating and exemption will introduce administrative complexities and will drive up compliance costs. Classification of items can lead to confusion and debate, for example, what should be the definition of food?

In terms of design, we believe that the GST should be kept simple. By keeping it broadly-based, GST would provide certainty which would minimise costs for business. However, it is important for the additional tax burden from the GST on low-income groups to be alleviated. But this could be more effectively achieved by targeted compensations rather than seeking exemptions for particular industries or categories of consumption.

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[1] In general, a tourist refund scheme requires initial payment of GST as part of the purchase price to the retailer, with the tourist reclaiming a refund on departure. Some countries (e.g. the United Kingdom, Korea) also allow retail shops to make arrangements for the goods to be picked up by tourists after they have gone through immigration; in this case, tourists do not have to pay GST upfront, but there will be additional cost for the shops (e.g. arranging for handover of goods at airport).

Financial services

The basic problem with GST on financial services is that their values are often incorporated into interest rate spreads and cannot be easily ascertained on a transaction-by-transaction basis.

In Singapore, most financial services with explicit fees are taxed (except when the services are exported, in which case they are zero-rated), and all others are exempt. Singapore then allows financial institutions to reclaim a large portion of their input taxes on the basis of a fixed percentage that is specific to the type of the institution, but is independent of a particular institution's actual composition of output (i.e. no account needs to be taken of proportion of taxable, exempt, or export supplies).

The IMF has suggested that Hong Kong could follow Singapore's example or go one step further to allow full input tax recovery by financial institutions. The latter approach would be equivalent to taxing all financial services for which explicit fees are charged (except for export services, which are zero-rated) and zero rating all other supplies. We support the IMF's suggestion.

Property sector

In practice, taxing the implicit rental values of owner-occupied building is not feasible. Even if a value could be imputed, it would still be administratively infeasible to subject residential rental payments to tax, since this would require the owners of such properties, who are final consumers, to register for and collect GST. In view of this, it would be necessary to exempt residential rental payments so as to avoid creating a distortion between rental and owner-occupied residential properties.

The implications for other property–related transactions should be carefully considered to ensure that the framework is suited to conditions in Hong Kong.

Registration threshold

A characteristic of GST is that the bulk of its revenue is normally collected from a relatively small proportion of taxpayers. In the interest of cost-effectiveness, it has been suggested that the registration threshold should be set at quite a high level. The Advisory Committee estimated that with the threshold set at HK$5 million, 50,700 businesses would need to register for GST, based on March 2001 figures. They represent 25% of all businesses filing tax returns in 1999/2000 or 8% of all entities with business registration i.e. including dormant businesses and shelf companies.

Exempt businesses below the threshold that transact mainly with taxable businesses may be put in a disadvantageous position relative to their taxable competitors. Therefore, consistent with the international norm, optional GST registration for businesses below the threshold is recommended with a minimum registration period to be imposed.

Compensations

A major political argument against GST would be its perceived regressivity, in other words it bears more heavily on those that are less well off. Therefore, appropriate compensations for low-income households must be incorporated in the GST design.

As explained above, we believe that targeted compensations are superior to introducing zero-rating or exemption of particular items of consumption. There are a number of directly targeted compensations which could be considered, including the following:

i) Adjustments to salaries tax rates or allowances for lower-income groups;
ii) increases in CSSA payments;
iii) reduction in rental on public housing;
iv) reduction in rates;
v) targeted cash payments.

Appendix 2

Tax Amnesties

In a paper on "Citizens' Attitudes Towards Tax Evasion in Hong Kong", Richard Simmons and T.Y. Cheng undertook a survey of 654 persons and concluded that Hong Kong citizens have different attitudes to tax evasion dependent upon the size of the evasion relative to income. Evading tax on all of one's income was thought to be unacceptable. Similarly evading tax on a large part of one's income was also considered unacceptable but much less so than evading tax on all of one's income. However, the survey concluded that in general Hong Kong taxpayers found that evading tax on a small part of their income was an acceptable activity and, in fact, seemed to be more acceptable in Hong Kong than borrowing money from a friend and not repaying it, stealing a car, or even taking stationery from one's office for private use.

Simmons and Cheng concluded that attitudes towards tax evasion in Hong Kong vary considerably according to the portion of income on which tax is evaded. What was an unacceptable activity when it involved a large part of a taxpayer's income became acceptable when it involved a smaller part. This was despite the fact the tax evasion is an illegal activity in Hong Kong no matter how relatively the small the amount involved. The survey indicated that the most common explanations for negative attitudes towards tax compliance in other countries, namely that citizens found their tax burdens too high, unfair, or that government expenditure was inappropriate, were not applicable in Hong Kong. However, the study stated: "It would seem that the payment of at least some of the tax citizens owe is sufficient to satisfy consciences and rationalise the acceptability of tax evasion ….. These findings suggest that tax evasion may be widespread in Hong Kong."

Simmons and Cheng found a close relationship between citizens' experience of tax evasion as a common activity amongst the people they knew and their attitudes towards tax evasion and also that, in general, respondents believed that tax evasion was common amongst people they knew. They therefore concluded:

> "It does ….. suggest that if the Inland Revenue were to intensify efforts to improve voluntary tax compliance through, for example, appeals to conscience or campaigns to educate the population on the relationship between taxation and public spending, any success may build on itself in that improved compliance by some may influence others to copy their example."

A further finding was explained thus:

> "Also expected was our finding that citizens' acceptance of tax evasion was related to their belief that the penalties for tax evasion are too high, on the basis that if one finds a certain activity acceptable, one is unlikely to be sympathetic to government attempts to penalise it."

This finding suggests that increasing levels of penalties alone will not encourage future compliance and voluntary disclosure of unrecorded income or tax liabilities is unlikely to take place if punitive penalties and/or prosecution are thought to be a likely consequence. If, as Simmons and Cheng suggest, tax evasion is widespread in Hong Kong, some alternative must be found to encourage voluntary disclosure of unreported income in tax filings, and to encourage increased compliance.

The Government should encourage voluntary disclosure of tax evasion in reporting by ensuring that those making full voluntary disclosure do not face high penalties and/or prosecution but are subject to fiscal restitution through the use of interest payments.

As an extension of this, the Government should consider encouraging both future compliance and the disclosure of past irregularities by taxpayers by introducing a one time tax amnesty for a limited and specified period of time. As part of an amnesty, no punitive penalties or prosecutions should be levied. Instead the tax involved should be assessed together with a reasonable level of interest to run from what would have been the original due date of payment of the tax to the date on which the tax was finally paid. This would be an efficient use of IRD resources involving little need for discovery by IRD officers.

This amnesty should then be coupled with increased penalties in the case of subsequent discovery of non compliance relating to the period covered by the amnesty.

There have been numerous examples of tax amnesties in both the developed and developing world. Within the OECD, there have been amnesties in Austria, Australia, Belgium, Finland, France, Greece, Ireland, Italy, Portugal and Switzerland, as well as more than half of the states in the United States of America. In developing countries they have been employed (sometimes repeatedly) in Argentina, Bolivia, Chile, Columbia, India, Pakistan, Panama, Peru, Mexico and the Philippines.

See Appendix 3 for examples of such amnesties.

However whilst a tax amnesty can, in the short run, generate an increase in tax revenue, reduce administrative costs in terms of collection and also encourage evaders to become compliant in terms of their tax liabilities, particularly where the under-reporting was due to a mistake in the first instance, it is recognised that there are also disadvantages to tax amnesties. For example honest citizens can view an amnesty as unfair and feel less motivated to comply in the future, particularly where amnesties are seen to occur on a regular or semi-regular basis, so that taxpayers who were previously honest may, anticipating further amnesties, reduce their level of tax honesty.

In their paper "Tax Amnesty and Political Participation", Benno Torgler and Christoph A. Schaltegger found that tax amnesties appeared to be more effective in generating tax compliance when undertaken in combination with an increase in future enforcement parameters compared with amnesties that were offered without changes in the enforcement factor. An increase in enforcement regime subsequent to the amnesties (e.g. greater penalties) may address the concerns of honest taxpayers by indicating that the Government is willing to find solutions to tax evasion and to increase prosecution and/or penalties for non-compliance in the future.

It also appears that the effect of a second or subsequent amnesty does not significantly improve tax compliance, and the anticipation of repeated amnesties reduces the positive effect of an amnesty. For example, in the case of Ireland, where there were two amnesties, one in 1988 and one in 1993, the second amnesty did not generate the level of compliance that was experienced in the case of first amnesty.

A tax amnesty in Hong Kong could take one of three main approaches to penalties and financial restitution.

a. The taxpayer could make a voluntary disclosure of his undeclared income and pay the resulting tax with no penalties, prosecution or interest.

b. The taxpayer could make a voluntary declaration under the amnesty with no penalties or prosecution but would be subject to interest at a reasonable rate, running from the original due date of payment to the actual date of payment. This provides an element of financial restitution and also prevents honest taxpayers from concluding that they have been unfairly treated.

c. The taxpayer could make a voluntary disclosure but could be subject to punitive penalties without prosecution.

Of the three alternatives the first does not encourage honest taxpayers to comply in future, as it generates a feeling of unfairness. The third does not provide any significant monetary incentive for delinquent taxpayers to come forward, although it removes the threat of prosecution. However, the second alternative would appear to be the most likely to have the desired effect of encouraging declarations under the amnesty whilst providing financial restitution, especially when coupled with the threat of increased punitive penalties in the future.

It would therefore seem that a one-time amnesty, accompanied by a clear statement of intent from the Government that after the amnesty it will increase penalties relating to future discoveries of tax evasion for the period to which the amnesty relates, could be an effective means of generating tax revenue for the Government by enabling taxpayers to voluntarily disclose under-declared income without fear of prosecution or punitive penalties.

Appendix 3

Examples of Tax Amnesties Around the World

Country	Amnesty Year	Main taxes cover	Collection (US$ Million)	% of tax revenue
Argentina	1995	General tax amnesty	3,900	N/A
France	1982	General tax amnesty	19	0.007
India	1997	General tax amnesty	2,500	8.5
Ireland	1988	General tax amnesty	700-750	4
Ireland	1993	General tax amnesty	Significantly lower than 1988	N/A
Italy	1982	General tax amnesty	100	N/A
Italy	1984	Entrepreneurs and self employed	5,000	N/A
New Zealand	1988	General tax amnesty	18 (this was considered a good response)	N/A
United States -New York -New Jersey	 1985/86 1996	 General tax amnesty General tax amnesty	 401.3 359	 2 2.6

(N/A = not available)

In addition to the above, in the period from 1982 to 2002 various other states in the United States of America have run tax amnesty programme with mixed results. The United Kingdom has also recently implemented an amnesty in relation to value added tax.

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