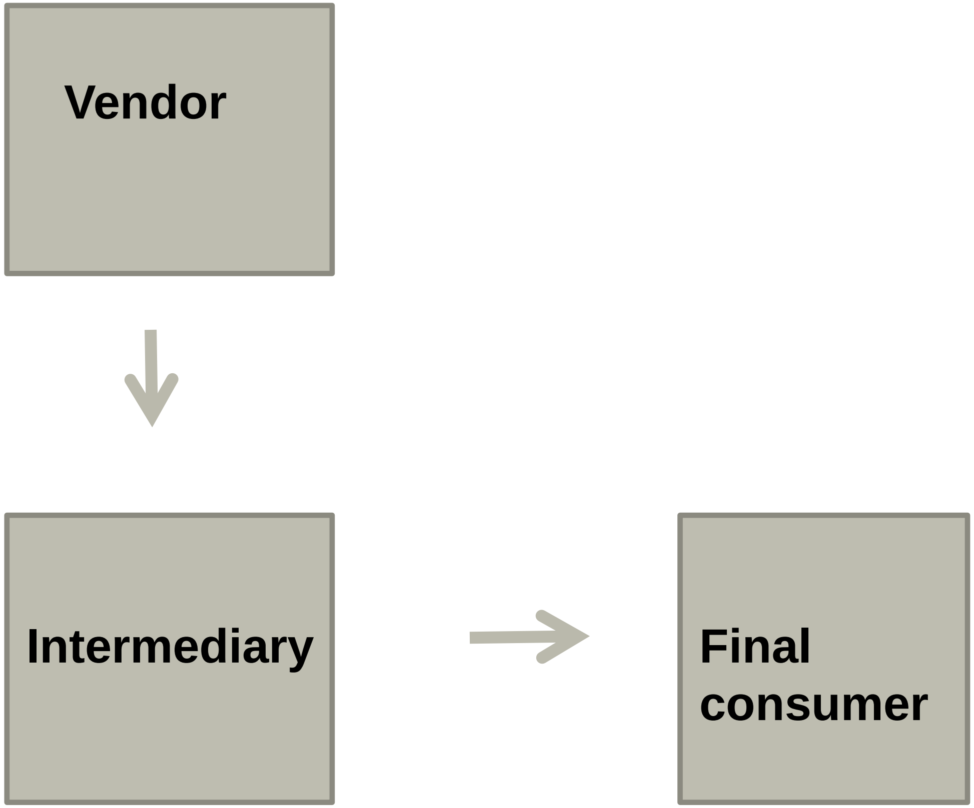
GST Revisited: Why the World Like It and Should Hong Kong Have it?

Christine Peacock

E-mail: christine.peacock@rmit.edu.au

(1) Concept



(2) International Trend of GST/VAT

- Most widespread general consumption tax in world
- Rapid growth, particularly over last two decades
- Limited to 10 countries in late 1970s, it has now been implemented in 157 countries
- Principal form of taxing consumption in 33 of 34 OECD member countries
- 30% of all revenue collected by governments across OECD
- IMF is strongly encouraging the introduction of VAT in developing countries

(3) Special Treatment

- Low income persons consume higher proportion of their income than high income earners

- Ways of dealing with this-
  - Exempting basic needs
  - Applying a high rate on luxury items
  - Compensating assistance

- Once a pure GST is modified in this way it becomes more complex

Different types of exemptions

Exempt supplies	Zero-rated supplies	Reduced rates
• GST not charged on outputs of business • Business not entitled to claim GST on inputs (tax credits) • So business may pass on the effect of paying GST to final consumer in terms of price • Eg- Financial services, real property	• No GST charged on outputs of business • Business entitled to claim tax credits on inputs • Eg- Activities of public interest such as medical care, school education	• Eg- European Union

Criticism of all approaches

- Gives rise to definitional issues
- IMF has recommended exemptions be kept at a minimum
- OECD research has indicated better to widen tax base and limit reduced rates and exemptions

Financial services

- In almost all countries with a GST, financial services are exempt
- Rationale-
  - It is often difficult to identify and measure the value added to many financial services on a transaction by transaction basis
  - Also, financial services are usually only the means by which entities fund consumption activities, rather than a consumption activity itself

Bank bears GST imposed on its business inputs used in providing loan

Bank's position	**Business user**	**Customer**
Can encourage banks to provide needed services in-house rather than purchasing from outside suppliers	• To recover GST cost bank may charge a higher interest rate • Does not receive a GST invoice from bank, so cannot recover credit	Cost of financial services is likely shifted to customers in price, an increase over what would be payable if services were taxable

Financial institutions render both taxable and exempt financial services

- It can be difficult to distinguish between the two
- Financial institutions must allocate their input tax between taxable and exempt services
- Controversies regarding approach to this

Option: Zero-rating

- Bank can get input tax credits
- Supplies not subject to GST
- 2006- Hong Kong Government proposed zero-rating supplies of financial services
- New Zealand and Singapore directly or indirectly zero-rate B2B supplies and treat B2C supplies as exempt

Real estate transactions

- Residential property – All countries with a GST use prepaid method

- Effect-
  - First sale generally taxable
  - Later sales generally exempt
  - However- GST may be passed on in price

EU – Exemption method

- Real estate transactions generally treated as exempt without entitlement to input tax credit from first sale

- However- The following real estate transactions are subject to GST-
  - Supply of residential premises before first occupied
  - Short term land uses
  - Building materials and construction work, and work relating to the alteration and maintenance of existing housing stock

Expanded tax base- Tax method
eg- New Zealand, Canada, Australia

- Use of real estate is fully taxable from first sale

- Construction, alteration and maintenance of residential premises will therefore generally be taxed

- However the sale or lease of used residential premises is exempt after the first time premises are occupied

Threshold for small firms

- Most countries with a GST have a threshold below which they are compulsorily or voluntarily not required to charge and collect VAT
- 29 out of 33 OECD countries allow small businesses to exempt their supplies on the condition that they do not deduct input tax
- Rationale

There are 2 main kinds of thresholds

Registration thresholds	Collection thresholds
Relieve suppliers from both the requirement to register for GST and to collect GST	All taxpayers are required to register for GST, but those below the threshold are relieved from collecting the GST until they exceed the threshold

Overseas approaches

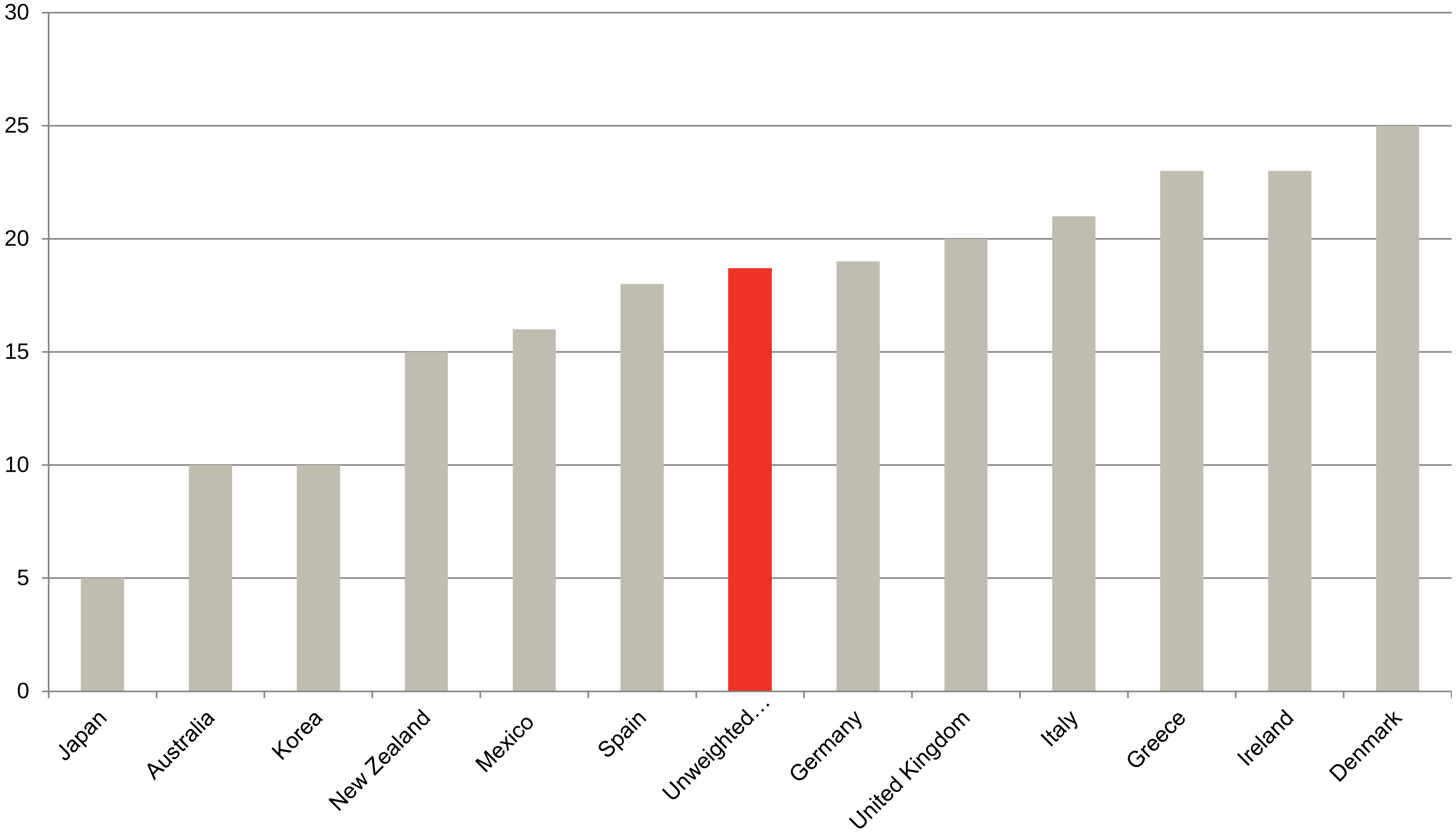
- Different governments have reacted differently to taxing services and intangibles

- EU-
  - Has attempted to set out clear rules for taxation of cross-border trade
  - Consumption is taxed at the time of supply
  - Goods- Place of supply is generally where the customer is located
  - Services- Place of supply is generally the location of the supplier
  - Non-EU suppliers who sell downloadable services into the EU have to register with the tax department in one of the EU member states and levy that state's GST on all internet sales into the EU
  - The member states then distribute the taxes to the countries where the actual sales are made

Levels of thresholds vary significantly across OECD countries

15 member countries	Relatively high threshold (More than 232,371 HKD)	Australia, Austria, The Czech Republic, Estonia, France, Hungary, Ireland, Italy, Japan, New Zealand, Poland, the Slovak Republic, Slovenia, Switzerland and the United Kingdom
14 member countries	Relatively low threshold between 11,618 and 232,370 HKD	Belgium, Canada, Denmark, Finland, Germany, Greece, Iceland, Israel, Korea, Luxembourg, the Netherlands, Norway, Portugal, Sweden
4 member countries	No general exemption threshold	Chile, Mexico, Spain, Turkey

(4) Rates Setting



(5) Trade Issues

- Services account for approximately 20% of total exports and imports of goods and services in OECD countries
- Use of e-commerce is growing
- Emergence of multinational corporations that render services in a large number of jurisdictions through complex structures
- Software, advice services, intellectual property

OECD

- Exports of goods to destinations outside the EU are eligible to be zero-rated for GST
- Reflects the destination principle- Exports are free of GST, while imports should be assessed according to rules in the local jurisdiction of consumption
- Difficult to work out location where consumed, necessary to use proxies
- OECD Guidelines-
  - For B2B transactions- Place of consumption deemed to be jurisdiction in which recipient has established its business presence
  - B2C- Jurisdiction in which recipient has his or her usual place of residence

(6) Potential Impacts on Domestic Economy and Individual Welfare

- Could be used to widen existing tax base
- Equity

- However:
- Effect of regressive tax/ equity concerns
- Increased administration costs for Government
- High compliance costs for business people, shop keepers
- Tourism
- Fears GST rate would be increased after introduction

Questions?