SYMPOSIUM ON SALES TAX

The Hong Economic Association sponsored a public forum entitled "A Sales Tax for Hong Kong?" on February 28, 1989. The speakers were Mr. Eric Li of the Taxation Committee of the Hong Kong General Chamber of Commerce, Mr. Stephen Fan of Fan, Mitchell & Co., and Dr. Y.C. Wong and Dr. L.S. Ho of the Chinese University of Hong Kong. The Association wishes to thank them for their permission to publish their presentations below.

RICHARD Y.C. WONG

A Sales Tax is Just Another Tax

In recent years, tax reforms have become popular in many industrialized countries. One of the most important outcomes of these reforms has been to move away from direct taxation of incomes towards indirect taxation of expenditures. These initiatives reflect a general dissatisfaction among these countries with their tax system. Their complexity and high rates are now recognized as major factors in causing slow economic growth and low productivity, but contributing to a big and inefficient government. A general tax on expenditures appears as an attractive remedy for a poor tax system. Hong Kong has fortunately been spared this predicament in having a simple tax system with low tax rates.

Nevertheless, the Financial Secretary has reiterated for a number of years in his annual budget speeches, the need to introduce a Sales Tax, the purpose of which is presumably to reduce the dependence of the Hong Kong budget on sources of revenue which are most vulnerable to the vicissitudes of the economy. The responsibilities of his office naturally oblige the Financial Secretary to be concerned about the state of public finances. But the rise and fall of government revenues leading to temporary imbalances in the budget due to economic fluctuations is a common phenomenon and is not unique to Hong Kong. It is certainly not an economic problem that has to be attended to. The stated reason for introducing a Sales Tax is therefore puzzling.

The Financial Secretary may be concerned about the possibility of a long-term slow-down in the performance of the economy leading to a dwindling of government expenditures. But if this is the concern, then the established economic policy and practice of limiting the growth of the public sector to that of the economy would suggest that the appropriate response would be the phased privatization of suitable government activities and functions rather than the introduction of new taxes.

Public commentaries have focused on a number of important issues relevant to the introduction of a Sales Tax: its inherent lack of progressivity, its supposed fairness in broadening the tax base, its alleged perverse effect on inflation, its presumed benefits in improving more efficient resource allocation, and the like. These are important issues but I shall only deal with them briefly since they have been considered elsewhere by others. Instead I shall concentrate on two questions which have not been touched upon as such: first, on understanding the issue of year to year imbalances in the government budget, and second, on the causes and consequences of introducing a Sales Tax in Hong Kong at this time.

Is a Sales Tax Desirable in Itself?

A Sales Tax is a tax on expenditures. This almost automatically qualifies it as being much less distortionary than all existing forms on income taxes. A tax on employment earnings distorts work incentives and investments in human capital. The combination of taxes on profits, interests, dividends, properties, bequests, and capital gains often lead to serious distortions in the incentive to save and invest. The equity effects of these income taxes are also suspect because final incidence is often difficult to ascertain.

Existing income tax systems are often infested with loopholes, and this is what makes a broad-based tax on total expenditures appear fair and attractive. The tax burden would be borne by the whole population, more or less in proportion to their spending. This feature of a tax on expenditures has often been criticized by those who believe that the poor should not be forced to pay taxes. If the poor spend proportionately more of their income than the rich, the tax could be regressive in some sense. The problem is not, however, a serious one and could in principle be remedied by providing an income supplement to the poor. In practice, this is not usually done because aside from rhetoric the political process in effect favours organized special interests. A well-known dictum of Director's Law of Public Income Redistribution says that the political process tends to redistribute income away from the poor and the rich towards the middle-income groups.[1]

The distortionary effects of a tax on expenditures is minimized if all items are taxed at the same rate without exemption. In practice this is often difficult to achieve because of political lobbying for exemptions and differential rates. Once this is allowed to occur, a tax on expenditures could be enormously wasteful as private efforts are channelled into unproductive pursuits. Differential rates also distort the allocation of resources. In practice, a tax on expenditures is more difficult to implement on services than on goods, which means that some degree of distortion would be unavoidable.

The introduction of a tax on expenditures does not necessarily imply the removal of other forms of taxation. Taxes on income would coexist with taxes on expenditures. It is difficult to assess if the net result is to increase or decrease the total amount of distortion in the economy. We are dealing with second-best arguments all the time. In practice, the efficiency gains of introducing a tax on expenditures are probably overrated, unless one could do away with other forms of taxation and implement it on a broad base of goods and services. Hybrid tax systems combining both taxes on income and on expenditure are common but bad things to have.

It has been alleged that the introduction of a tax on expenditures would fuel inflation. There are two problems with this argument. First, inflation is defined as the sustained increase in the price level. A one-time introduction of a Sales Tax cannot fuel a sustained increase in the price level. Second, it is possible for a Sales Tax to be deflationary if it results in a reduction in aggregate demand. Aggregate supply is unlikely to be affected if there is full employment of resources.

My own belief is that a Sales Tax is probably a good tax in principle. Its good qualities disappear in practice. The compelling case for introducing a Sales Tax exists only in economies where the existing system of taxation is poor to start with or if one is prepared to adopt it and abandon other forms of taxation.

Balancing the Budget

Balancing the budget is an old practice which was unfortunately abandoned when governments discovered deficit financing and Keynesian economists made it respectable. The best thing about a balanced budget is that it made governments responsible for their expenditures. New spending had to be financed through new taxes which had to be approved by the public. Representative government is to a large measure a system based on the idea that there should be no taxation without representation. But deficit financing made it possible for government to finance spending out of taxes on future generations who are not on the current registry of voters. The idea of representative government was subverted in democracies for short-run objectives. The old practice is now regaining respectability as the public is becoming alarmed at the astronomical amounts of public debt that governments acting irresponsibly were accumulating. The demise of Keynesian economics and the growing recognition that governments can fail too and often with even more disastrous results than market failure has undoubtedly contributed towards this shift in public opinion. Hong Kong has fortunately been spared the tyranny of having a government living beyond its means, at least until now.

It is important to note that in balancing the budget, governments need not keep them in balance from year to year. The presence of year to year imbalances will be the rule, unless fluctuating economic conditions affect government expenditures and revenues to the same extent. In Hong Kong, government expenditures have generally been more stable over the economic cycle than revenues in the past two or so decades. We therefore find budget surpluses during economic booms and deficits during economic busts. In practice and as a matter of policy the Government can only balance the budget over the long run, for example, from the peak of one economic cycle to its next. And this is all that the Government needs to do. There is no economic reason why the Government should balance its budget from year to year. Indeed to do so, if it is at all possible, would introduce a costly element of uncertainty into the budgetary process since economic cycles cannot be predicted with certainty.

In budgetary matters, the Government should be concerned with the problem of whether government expenditures are spent on the appropriate items and in the appropriate amount. Economic principles and empirical observation tell us that almost every government today in the world overspends and spends inappropriately. Fortunately for us, the Hong Kong Government has a considerable reputation for being prudent in these matters and is widely admired for being so. Having determined the appropriate level and mix of expenditures, the Government should be concerned about raising adequate revenues to finance them through a tax system which is predictable and simple. Common sense and public accountability should be sufficient safeguards to ensure that such a tax system will be fair to all. Elaborate and obscure tax systems are frequently the most effective means of denying the public such accountability by making it difficult to exercise common sense. What appears to be a highly progressive system on the surface often contains loopholes that are designed to be exploited by those who can afford the services of expensive accountants and lawyers. Again Hong Kong is fortunate in having a simple tax system.

In balancing the budget it is necessary to ensure that the rate of growth of government expenditures and revenues should be the same over the long run. In technical terms, this means that the long-run elasticity of government expenditures with respect to Gross Domestic Product should be equal to that of government revenues with respect to the same. Year to year fluctuations in government expenditures and revenues, represented by their short-run elasticities can be different and Government should not be concerned about it. The following table gives figures for these elasticities over the two periods: 1949-1985 and 1961-1985.

Table 1

Elasticities of Real Government Expenditures and Revenues
with Respect to Real Gross Domestic Product[2]

	1949-1985		1961-1985	
	Long Run	Short Run	Long Run	Short Run
Total Revenue	1.15	0.43	1.19	0.57
Direct Tax	1.34	0.48	1.34	0.49
Indirect Tax	0.89	0.37	0.90	0.38
Non-Tax	1.19	0.28	1.33	0.54
Total Expenditure	1.16	0.41	1.18	0.44

These figures indicate that over the periods 1949-1985 and 1961-1985 the elasticities for total revenue and total expenditure were equal in the long run. Therefore balancing the budget over the economic cycle poses no problems under normal circumstances. Notice also that the long-run elasticities are significantly larger than unity in both periods (between 1.15 to 1.19), implying that the public sector has been growing relative to the economy. This suggests that there is room for reducing both government expenditure and revenue growth in order to stabilize the relative size of the public sector over time. Indeed a significant slowdown of the economy may well be a blessing in disguise if it succeeds at reducing the long-run elasticity of total revenue with respect to Gross Domestic Product.

An examination of the long-run elasticities of the three components of total revenue – direct tax revenue, indirect tax revenue and non-tax revenue – shows that in both periods the long-run elasticities for direct tax revenue, (1.34 and 1.34), and non-tax revenue, (1.19 and 1.33) to be significantly higher than that for indirect tax revenue, (0.89 and 0.90). This means that over time the share of indirect tax revenue in total revenue would decline unless there is a broadening of the base of indirect taxation.

The short-run elasticity for total revenue exceeds that for total expenditure only in the more recent period 1961-1985. This implies that the dependence of revenue sources on the vicissitudes of the economy is a more recent phenomenon.

The figures also indicate that in both periods the short-run elasticities for direct tax revenue, (0.48 and 0.49), and indirect tax revenue, (0.37 and 0.38), are the same, but that for non-tax revenue had risen considerably in the more recent period (from 0.28 to 0.54). Non-tax revenue consists almost exclusively of receipts from land sales and appears to be responsible for year to year imbalances in the government budget in the more recent period.

The long-run and short-run figures together indicate that the increased volatility of total revenue over time results from the low long-run and high short-run elasticities of indirect tax revenue. Clearly it is possible to reduce the overall short-run elasticity of total revenue by increasing the share of indirect tax revenue in total revenue. But the issue is why should we be worried about smoothing year to year imbalances in the government budget? Given the very high long-run elasticity for total revenue, there is also little cause for concern about dwindling government revenues due to the possibility of a long-term slowdown of the economy.

The Political Economy of the Sales Tax

One of the economic advantages of the Sales Tax is that when it is implemented on a broad base it can be a least distortionary tax. By spreading the tax over the whole population it can also be fairer than various income taxes with their many loopholes. Since the tax is spread over the whole population, a small change in the tax rate would lead to a substantial increase in the total tax revenues, even though each household pays for only a small fraction of the total tax. From the point of view of a revenue maximizing government this is an ideal tax. It is, however, the main disadvantage of the Sales Tax.

A well known result in the theory of collective action demonstrates that organized political action against tax increases is more effective when the same amount of tax revenue has to be paid by a small well-identified group then when it is spread over a large diffuse group.[3] The gains from getting organized is higher when each victim has to pay a larger share of the increase in tax revenue and the costs of getting organized is lower when the victimized group is smaller and well-identified.

A Sales Tax allows a government to raise a given revenue with less political opposition. When the cost of raising revenue is lowered, a highly likely outcome is that government expenditures will rise. This may come about as a result of the natural propensity of government bureaucracies to expand or due to the demand of politicians and interest groups.

In contrast, raising direct taxes faces immediate opposition from organized interests. Taxes on businesses will be opposed by merchants and industrialists. Taxes on salaries will be opposed by income groups who are most affected by it. In Hong Kong, the effective rates of taxation on salaries are limited at the upper end by the "standard rate", currently set at 15 percent of taxable income. Although less than a tenth of the taxpayers pay the standard rate, they have in recent years contributed more than a half of the total yield.

Notice that between 1987 and 1989 the total estimated number of taxpayers increased from 517,000 to 790,000. This meant that two years ago only a third of all households had to pay salaries taxes; today half of them had to pay taxes. Improved economic conditions and inflation induced bracket creeping of marginal tax rates led to a 53 percent increase in the number of people that were brought into the tax net. The number of taxpayers who were paying taxes at the standard rate of 16.5 percent in 1987 was 43,000. Their numbers increased to 57,500 in 1989 when the standard rate was lowered to 15 percent. The rise was 33 percent and would have been lower if the standard rate had not fallen.

This meant that many more households were paying taxes for the first time and the majority of those who had been paying taxes before were now in a higher marginal tax bracket. During this period, the opposition of the so-called "sandwiched class" to the existing salaries tax structure was becoming increasingly vociferous. The demand for tax relief became adamant. The call for separate taxation for married women gained widespread support as politicians successfully articulated a formula for providing tax relief to households.[4] It was clear to the Government that the "sandwiched class" was a political force to be reckoned with.

It seems to me that the real issue in introducing a Sales Tax has probably little to do with the economic merits of a tax on expenditures. What the Government wants is to increase revenues so that government expenditures would be safe from the vicissitudes of the economy. While a larger revenue would provide a better safety net for meeting government expenditures, it also increases the temptation to spend it less wisely. Besides, why should we be concerned about the effect of economic fluctuations on year to year imbalances in the budget so long as they are balanced over the economic cycle? Experience has shown that few governments do not spend what they can tax. Indeed our own Government had succumbed to this temptation in the late 1970's and early 1980's.

In a period when political society is in transition, it is all the more imperative that the Government should hold a steady course in economy policy. The sound budgetary policies and practices of the past should not be allowed to founder and should not be perceived to be foundering. The introduction of a Sales Tax may well signal the beginning of a downward slide from a sound budgetary policy and practice. A tax on expenditures was introduced by many countries as a cure for their own poor tax system. Hong Kong runs the risk of introducing it to replace a fine tax system.

Notes

1. See George Stigler, "Director's Law of Public Income Redistribution", *Journal of Law and Economics*, April 1970.
2. The elasticities are estimated by regressing revenues or expenditures against its one-period lagged value and gross domestic product. The results are interpreted using a Koyck lag structure based on which we can calculate both short-run and long-run elasticities.
3. See Mancur Olson, *The Logic of Collective Action*, Cambridge, Harvard University Press, 1965.
4. On a previous occasion the Government had introduced a working wife allowance under somewhat similar circumstances. Subsequently it was removed by providing more generous allowances and widening the tax brackets. Clearly the real issue was tax relief and not fairness in the treatment of working women.