

# Tax Reform:

Positive Directions for a Better World

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# Desirable Qualities of Taxes

- Least distortionary: an efficient tax: both in the static sense (resource allocation for production of final products) and in the dynamic sense (do not tax investment and hurt growth)
- Easy to tax: an administratively easy, low compliance and low enforcement cost
- Follows the ability to pay principle: a fair tax
- Corrects failed price signals.

# Taxes are not equally distortionary

- Better tax economic rent. Taxing pure economic rent will not distort at all.
- Some tax bases/tax base ranges are more “rent-intensive” and should be taxed more.
- Scarce factors, like land in prime locations, sought-after minerals, rare skills, unique personal backgrounds, in a competitive world earn economic rent.
- Pure “economic profits” do not exist in a competitive world in which entrepreneurs have to pay top rates to get the service of superior scarce factors; profits that exist generally reflect a return to entrepreneurship and that should not be taxed.

# Implications 1.

- The Profit Tax should be abolished.
- Results of abolishing the profit tax:
  - Big boost to investment and entrepreneurship
  - Big savings in terms of tax effort, since corporations are very active using tax havens to avoid taxes and there is no shortage of tax havens
  - Lost revenues and be made up by taxing dividends and realized capital gains

# Implication 2

- Personal tax rates should be highly progressive with low tax rates on competitive labor-intensive income ranges and much higher rates on rent-intensive income ranges
- Results of widening tax bands and raising marginal rates on income levels beyond labor-intensive income ranges:
  - Effectively lower tax rates for most people who earn their living in competitive labor markets;
  - Much higher marginal tax rates for those who collect their incomes through royalties, rents, capital gains, top talking fees;

## Huge fees for the world's most renowned public figures and athletes:

- A speech by Tony Blair costs roughly \$8,600 a minute, says the [Times](#) of London. Bill Clinton, according to Hillary's Senate ethics reports, earned \$31 million in speaking fees between 2001 and 2005.

[http://www.huffingtonpost.com/2010/05/25/the-highest-paid-public-s\\_n\\_588816.html#s93157title=Bill\\_Clinton\\_15000045000](http://www.huffingtonpost.com/2010/05/25/the-highest-paid-public-s_n_588816.html#s93157title=Bill_Clinton_15000045000)

- Tiger Wood leads the pack to earn USD78.1 million dollars; soccer player, at 100<sup>th</sup> place, makes USD16.4 million

<http://www.forbes.com/athletes/list/>

# Why Tax Dividends?

- If profits are not taxed, then there will be no objection about double taxing.
- Taxing dividends is not motivated by the “bash the rich” sentiments that some people share. It is motivated by considerations of efficiency, equity and ability to pay, and simplicity of compliance and enforcement.

# Li Ka-shing's dividends not counting capital gains

- Asia's richest person Li Ka-shing added US\$5.5 billion to his fortune as shares of his biggest holdings, Cheung Kong, Hutchison Whampoa and Husky Energy, all jumped 10% or more. He scooped up another \$860 million in dividends in 2012.
- <http://www.forbes.com/profile/li-ka-shing/>



# Taxing Capital Gains

- The proposal is to tax realized capital gains after an inflation allowance to avoid taxing illusory gains.
- All taxable capital gains (after inflation allowance) and dividends are to be taxed as personal incomes.
- Gains within \$100,000 per year may be exempted. This will save compliance cost for small investors.

# How progressive?

- The proposal is for those earning less than HK\$2 million a year to pay no more taxes than they currently do now, but those earning HK\$2 million to pay higher marginal tax rates until the marginal rate reaches 50% for incomes exceeding HK\$10 million.

# GST?

- Actually potentially a non-regressive tax if complemented by a lump sum refund that is proportional to a permanent resident's stay in HK in the year;
- Following the Scheme \$6000 of 2012 we have now the institutions ready for the refund.
- GST will cover otherwise untaxable incomes that should have been taxed.
- GST was supported for the wrong reasons (should not be to stabilize revenues nor to widen the tax net) and was not complemented with the necessary tax refund.

# Higher Marginal Tax Rates on Incomes?

- Yes, but only after widening the tax bands. The much higher marginal tax rates could go to as much as 50% and a marginal rate of 25% should apply to personal incomes over \$2 million a year and the top rate for those with incomes over \$20 million.
- Incomes excessively high usually carry a large component of economic rent taxing which should not cause inefficiency.
- Dividends and Realized Net Capital Gains are to be treated as personal incomes.

# Capital Gains Tax?

- Entirely warranted, especially when corporate profits tax is lowered. But two measures are necessary.
- First, capital gains within 10% per year should be exempted. This will avoid taxing illusory, inflationary gains.
- Second, for gains on shares:

# SSD/BSD/DSD?

- SSD should be abolished right away as it is a big transaction cost. Big transactions costs always reduce efficiency. SSD may penalize the unfortunate who have to sell under financial stress. BSD as it stands discriminates against foreigners who live and work in Hong Kong. DSD taxes investors and destroys the dream of relying on rental income to support retirement.

# Transactions Taxes, Tobin Taxes

- All transactions taxes are distorting and should be minimized, but a tiny, tiny rate on huge transaction volumes is not distorting, and help reduce the distorting effects of consumption taxes and income taxes.

# Paying Taxes; Collecting Taxes

- Taxes are to be collected only as long as the marginal benefit of the services they fund is at least as big as the marginal cost of the taxes including the distorting effects.
- This has to be considered carefully through MB/MC comparisons of taxes and programmes and there should be no presumption that the size of the government sector should be no more than X% of the GDP.
- Governments that are clean and efficient attract more tax compliance. Those that are corrupt and ineffective will attract little tax compliance.



Dollars

