2016-17 Policy Address cum Budget Submission

Hong Kong General Chamber of Commerce

The HKSAR Chief Executive recently declared that the Government should adopt an "appropriately proactive" approach in its policies. The Chamber does not dispute that there are areas in which the Government could do more in sharing its vision and providing clear direction on what it intends to achieve. **Government policy support is of particular importance where fostering a favourable and predictable business environment to facilitate our long-term economic development is concerned**.

Vision and Long-term Planning

2. We remain steadfast believers of free market principles and we have good reasons for doing so. It should be pointed out that the Government's active involvement in the private sector has, more often than not, failed to yield positive results. There is a high opportunity cost associated with intervention, which involves inefficient and misdirection of public resources. Hong Kong has seen its competitiveness slip in the international stakes despite the slew of well-meaning social policies of late. The operating environment in Hong Kong has continued to stagnate while neighbouring jurisdictions vie aggressively for a bigger share of regional opportunities through establishing a more liberal regulatory framework, a well-trained workforce and introduction of more business-friendly policies and programmes such as lowering taxes. As we submit below, a rigorous regulatory impact assessment ("RIA") needs to be carried out for new and existing regulations, and intervention should only be justified if the benefits clearly exceed the costs.

3. It is important to have the Government lead the way and articulate a clear vision and plan for the community to rally around and to share in its implementation. The divisiveness in LegCo that spilled over into society has exacted a high price on progress and development in Hong Kong. Constant bickering and finger-pointing have replaced the "can do" spirit that Hong Kong was renowned for. To assume our proper place in the forefront of economic development, we require a cohesive society that is united in its pursuit of a better Hong Kong.

4. The Government's recent plans to increase both land and housing supply should be commended. This display of decisiveness and leadership in long-term planning is exactly what our society looks for in the Government. The Chamber thus also welcomes the publication of the Government's energy saving plan for Hong Kong's built environment earlier this year, aiming at a target 40% reduction in energy intensity by 2025. Our members would like to see more support for customers to achieve greater

energy efficiency and conservation, encouragement of smaller distributed renewable energy projects where practicable, and progressive installation of smart metering by the energy companies to allow customers to better control their energy usage, helping businesses manage energy costs and reduce Hong Kong's overall energy intensity and carbon footprint. The Government should also continue their dialogue with the Pearl River Delta governments for the establishment of a PRD Emissions Control Area to improve air quality in the region, cement Hong Kong as a leader in environmental development while at the same time levelling the playing field and protecting Hong Kong port's competitiveness in the long run.

5. Hong Kong's labour force is expected to peak at 3.648 million in 2018, and we shall experience a shortage of some 118,000 in 2022. The situation will worsen in 2064 when the total labour force is forecasted to shrink to 3.108 million. Any consideration of a universal pension is going to require a re-evaluation of the services the Government provides and the means by which we pay the bills, since more people will be claiming money, yet fewer people will be contributing amid a slowing economy. We need to be extremely careful before we create permanent and long-term spending obligations. It is therefore imperative that **a more progressive population policy be introduced not only to address the issues brought on by an aging population, such as labour supply, talent development, healthcare, retirement planning, immigration policy and housing**, **but also to get hold of the opportunities arising from such developments and soaring technological advances**.

Opportunities

6. "Smart City" is one such area which may serve as a driving force for Hong Kong's economic development in the near future. The designation of East Kowloon as a pilot Smart City testing ground in last year's policy address is an encouraging first step in the transformation of Hong Kong in this meaningful undertaking which will allow us to eventually equal the achievements of other cities that have been engaged in similar initiatives. Hong Kong possesses many intrinsic qualities that lend themselves to the development of the SAR into such roles as a regional e-commerce business hub.

7. **The territory's high smartphone penetration rate, densely populated urban areas, fast adoption of new technology, free flow of capital and information, and business flexibility and adaptability make it very straightforward for Hong Kong to embed many of the smart city applications** across most if not all of its functions, especially in addressing our congestion and pollution issues. Nevertheless, the less than meaningful amount spent on R&D relative to other economies does not support a sustainable development in this direction. As with any new business, a proper cost and

benefit analysis is necessary in determining the viability of new technologies. We feel that although it should be left to the marketplace to conduct such filtering, it is also important that the Government provides a base from which to nurture and grow a new crop of industries, and to encourage private sector involvement such as angel funds and incubators. (Please refer to Appendix-I for some innovation and technology and smart city recommendations.)

8. Amidst the global economic downturn after the financial crisis, the relatively decent growth in the Chinese economy has been the single bright spot, helping ease directly and indirectly the difficult situations in many developed and developing economies, and making up for the void left by the struggling Western countries. Despite recent slowdown in the Mainland economy, **the 13th five-year plan and national strategy of belt and road should not only help sustain its continued growth momentum, but also provide great opportunities for Hong Kong to find new development directions**. In particular, the Asian Infrastructure Investment Bank is expected to involve heavily in the economic development of the belt and road economies. There have been ongoing infrastructure projects along the two routes, and more mega projects should be coming.

9. **With our expertise in financial, logistics, maritime, aviation, legal and other professional services, Hong Kong is in an advantageous position to take part directly in major belt and road projects or provide essential services to such projects**. Also, the belt and road projects often involve two or more jurisdictions so that disputes may sometimes arise. Our experience in and knowledge of business operations in most of the belt and road economies (especially Mainland China), our adherence to international standards and rules of law, abundance of experienced legal experts and reliable legal system make **Hong Kong an ideal place to offer arbitration services to handle such dispute**.

10. To maintain Hong Kong's status as a regional hub in financial, aviation, maritime and logistics services and ride on the national belt and road initiative, we need to strengthen our international character. For instance, **the Government should continue to put forward proactive measures to improve air quality and waste management so as to establish a sustainable environment. We may also need to work on other areas to attract more multinational corporations to set up regional headquarters in Hong Kong, such as ensuring enough international school places for children of incoming families**. In fact, the introduction of an affordable international curriculum with English as the primary teaching medium will be an important factor in maintaining our international character and attracting both talent and companies from overseas. At the same time, our rule of law, international networks, free flow of information,

proximity to the Mainland market and other established strengths could enhance the **development of Hong Kong into a regional corporate treasury centre hub**.

11. With a series of ongoing and upcoming major infrastructural projects in Hong Kong, the Government may **consider other financing alternatives to help develop the domestic bond market, such as taking the lead in employing debt financing to fund those projects**. The development of a local bond market should facilitate the development of a more diversified investment market and help attract foreign investment to Hong Kong. Besides, the Government should also set up a sovereign wealth fund, which together with the continued development of offshore RMB business in Hong Kong, will further strengthen our role as the largest offshore RMB market and regional financial centre. This in turn should help expedite the RMB internationalization process. The sovereign wealth fund could be totally separate from the monetary base needed to support the economy. It should be transparent, professionally managed by asset management experts, and aim to protect and grow assets for the benefits of Hong Kong citizens.

12. **Startups, particularly startups in financial technology (fintech), could become a major engine for Hong Kong's future economic growth**. Whilst many of our competitors quickly establish a favourable regulatory environment to accommodate those so-called pure-play disruptors, there remain quite a number of barriers hindering their development in Hong Kong. It is believed that innovation and technology can help nurture market breakthroughs. This will need the introduction of new laws, regulations and rules or amendments to existing ones to cater to startup development. Therefore, a priority agenda item of the newly established Innovation and Technology Bureau is to **revamp our outdated regulatory framework, including our tax code, so that it could catch up with the ever-changing environment brought about by technological advancements**. In addition, the Government may consider **providing tax concession to relieve the tax burden of startups** and to encourage aspiring individuals to start their own business, as well as facilitating the development of an IP and aircraft leasing hub in Hong Kong via proactively engaging in discussion with our international partners.

Challenges

13. When we are ready to embrace Smart City as the future of Hong Kong, do we have enough engineers and computer specialists to keep our city running smartly? Human capital is perhaps the single most important asset that has helped Hong Kong weather economic storms and achieve miraculous milestones one after another. However, we are currently facing serious manpower and talent shortages caused by a tight labour market. This problem is not limited to construction sites but also extends to the healthcare and

property management sectors, to name the more obvious. In today's global environment, governments are chasing after talent, and they are offering lucrative incentives and easy immigration policies to lure gifted professionals to reside in their jurisdictions. It is therefore crucial that **we develop a talent-focused immigration policy and that other policies should be formulated with this objective in mind**.

14. The local education system also requires changes to facilitate the development of Smart City and other initiatives. As aforementioned, manpower issues could be covered under the long-term population policy. Nonetheless, the immediate labour shortage problem, if unaddressed, will seriously affect the progress of upcoming infrastructural developments and hence our economic future. **The Government should introduce more large-scale sector-specific labour importation initiatives to further enhance the enhanced Supplementary Labour Scheme which has not been effective**.

15. Smart governance is a key area for the development of Smart City. Attempts by the Government to introduce new initiatives which required cross-bureau cooperation in the past failed to take off often because of miscommunication between public agencies. For the bureaucratic machine to run smoothly, efficiently and effectively, they have to agree to the same policy priorities, work in unison and communicate with each other, balancing stakeholders' interests. We have not seen this happening very often so far. The lack of an overarching coordinating authority may lead to releases of policy measures not thoroughly thought through during the formulation stage, resulting in unintended and even conflicting outcomes, e.g. competition law and minimum wage.

16. **The Chamber champions a rigorous and comprehensive RIA of new and existing regulations and legislation, covering not only intended results but also unintended consequences**. New regulations should only be introduced if the benefits clearly exceed the costs. RIAs should also be carried out on a regular basis for <u>existing</u> regulations, and they should be withdrawn if the benefits do not clearly exceed the costs. The Government has a stated policy of conducting such RIAs (see the "Be the Smart Regulator" initiative), but in our experience it has been inconsistently applied. For example, while the Government has engaged consultants to conduct a business impact assessment in respect of section 33 of the Personal Data (Privacy) Ordinance, no RIA was conducted before deciding what sort of competition law would be appropriate for Hong Kong, or for the SFC's proposed "Principles of Responsible Ownership". In both cases, the proposed intervention seems to have been driven more by a desire to emulate other jurisdictions, rather than Hong Kong's own needs. Over-regulation adds compliance costs to businesses' burden, undermines their flexibility and damages Hong Kong's long-term competitiveness. The double stamp duty on commercial property transactions is a good example. The implementation of the measure has only added cost

to an already high cost element of business expenses. The Government may want to consider eliminating commercial DSD which has been adversely affecting business costs, expansion plans and investment decisions.

17. Retail and tourism performance has witnessed a downward trend since the third quarter of this year. This can be attributed to a number of factors, such as the strong Hong Kong dollar, our neighbours' new theme parks and their generally more aggressive policy to attract tourists, especially Mainland visitors. It is time for the Government to **develop a long-term plan as well as immediate measures to boost the attractiveness of Hong Kong as a tourist destination**. Another area of concern is the widening gap of service quality between our industry practitioners and those overseas. In particular, at the current O2O (online-to-offline) age, consumers expect a more integrated and personalized experience (seamless experience between web sites, mobile apps and physical stores), which many SMEs in the industry have been slow to comprehend. We commend the Government's earlier measures to aid SMEs in employing technological products, but more effort will be needed.

18. There has been a long-held tradition of building consensus in the community through stakeholder engagement, i.e. extensive consultation and advisory committees, before the Government acts. However, in recent years there is a perceptible decline in the effectiveness of the system. The many rounds of lengthy consultations on some subjects often appear to be little more than an exercise in stalling actual decision making. The Chamber urges **the Government to review the stakeholder engagement process to ensure that genuine two-way communication is maintained throughout and stakeholders' views and concerns are considered and integrated in final policy decisions**.

Competitiveness Building

19. Whilst our competitors are relaxing their regulations to encourage investment and enhance competitiveness, we are facing more and more regulations, especially on the labour front. The business community does not object to regulations, provided that they are good and necessary. However, the enactment of recent new laws have simply added significant compliance costs to business while not necessarily maintaining a level playing field in the marketplace. **It is of critical importance that businesses are provided with a stable and predictable operating environment. In this regard, the Government may refer to the UK Government's "one in, two out" principle to law-making.** Under this approach, for every one pound of compliance cost incurred by a new piece of regulation, at least two pounds of savings must be achieved through revising or removing portions of or entire pieces of legislation.

20. The high cost of doing business has become a fact of life in Hong Kong. When times are good, businesses would find it less difficult to cope with high operating costs. When there are fewer market opportunities, every penny counts. It is particularly tough on SMEs who do not have the big corporates' deep pockets. **Statutory minimum wage and its knock-on effects as well as compliance with major hard-to-understand legislations such as the Competition Ordinance certainly impose additional cost burden on SMEs. They will suffer from further burdens if standard working hours were implemented and/or MPF offsetting was abolished.**

21. To help ease SMEs' cash flow problem, we continue to advocate **the introduction of a 2-tiered profits tax**. It represents a simple modification of the existing tax system and would provide much needed relief to SMEs during hard times. Of course, to maintain our competitive tax advantages, another easily implementable strategy for the Government to consider is to lower the corporate tax rate back to 15% as promised by the previous Administration. (Please refer to Appendix-II for proposed measures to enhance our tax competitiveness, including the 2-tiered tax system.)

22. **The Chamber supports the proposed approach of clear and unambiguous specification of working hours, overtime arrangements and payment in employment contracts**. According to the survey conducted by the Standard Working Hours Committee, over 93% of employees interviewed agreed to this approach. During economic downturns in 2001 and 2008, the shrinkage in average working hours was bigger than the decline in employment. This illustrates the flexibility of businesses cutting working hours rather than reducing jobs. Adopting standard working hours will undermine such flexibility for businesses to adapt to market changes as well as our long-term competitiveness. In today's tight labour market, employees unsatisfied with employment terms have the freedom of choice to switch jobs. We should allow supply and demand to function in an unfettered manner in Hong Kong's free market economy.

23. The Government disclosed in May this year that it had not conducted any assessment of the impact on the economy, business environment and employers should the MPF offsetting arrangement be abolished. We call on the Government to conduct a proper and thorough regulatory impact assessment. It is noteworthy that the offset mechanism was a key condition for the business sector's support to MPF then. The current overture to remove the offset mechanism goes against the Government's undertaking to businesses before the implementation of MPF. Besides, abolishing the offsetting arrangement will impose a double burden on employers, especially SMEs who may be forced to close down. At the end of the day, **the Government should conduct a comprehensive review of the entire MPF system, including its fees and returns, instead of singling out the offsetting mechanism for adjustment.**

<u>**Conclusion**</u>

24. All in all, now is the time for the Government, business community and general public, to work together towards the same goal, i.e. embracing the national belt and road strategy, promoting the development of fintech and other startup businesses, meeting the manpower challenges with a long-term progressive population policy, and strengthening our competitiveness.

3 December 2015

Appendix I – Innovation and smart city recommendations

(A) For the development of the local innovation and ICT industry

1) To increase the percentage of overall local R&D spending over GDP to over 1%.

2) To encourage R&D activities of the private sector by incentives such as tax exemption or reduction, e.g. doubling the Government's existing R&D Cash Rebate Scheme from 10% to 20%.

3) To promote the development of innovation and technology industries and to improve the quality of our human capital by allowing a super tax deduction of 150% for employee training costs paid to accredited providers of training services.

4) To improve the financial assistance, training and other supports provided for local entrepreneurs, startups and ICT practitioners, for example, to support life-long learning of ICT practitioners by increasing the maximum amount of reimbursement for reimbursable courses (currently $10,000) and maximum number of claims allowed (currently 4) of Continuing Education Fund.

5) To create an ecosystem of innovation for public information and infrastructure, such as the new Smart ID Card to be launched in 2018.

6) To nurture and train more ICT talent for different industries by improved school education and vocational training, including teaching coding in elementary education.

7) To increase the competitiveness of Hong Kong enterprises by encouraging investment in technologies such as Cloud Computing, Big Data, and Internet of Things in a timely and proper manner.

(B) For the development of Smart City in Hong Kong

1) To establish an institutional framework for Smart City related policies and measures to facilitate the communication and collaboration of different Government agencies, and to provide guidance on policies and implementation mechanisms of Smart City development.

2) To build a Spatial Data Infrastructure (SDI) as a foundation for the development of Smart City applications. It will be an important resource for entrepreneurship in digital economy. A top-down and cross-departmental SDI policy and necessary institutional arrangements should be established.

3) To carry out a comprehensive study to identify solution spaces for the development of Smart City. Consensus views need to be reached between the Government and citizens before a project is determined to roll out. Objectives of different stages should be set and prioritized based on the needs of citizens and the society. Digital platforms are preferred for public engagement because of the fact that Hong Kong citizens are very digital savvy.

4) To encourage the development of various Smart City services and applications through cooperation of the public and private sectors.

5) To improve the service quality and performance of public free Wi-Fi service, such as increasing the connection speed to Gigabit per second and implementing single sign-on capability, which can facilitate the flow of information and promote the utilization and development of Smart City applications.

6) To promote walking and healthy lifestyle in Smart City, through networks of covered walkways for both general pedestrians and wheel chair users. It is desirable for the networks to connect all high demand and popular destinations including different buildings, shopping malls, parks, public amenities and public transport nodes. Mobile apps can be developed to guide citizens and suggest optimum routes to walk around and get to various destinations.

Appendix II – Tax competitiveness

(A) Two-tiered profits tax system

The Chamber continues to advocate for **a very simple and competitive two-tiered profits tax structure**. We propose **reducing the rate imposed on the first $2 million of taxable profits to 10%**. We can afford to invest our excess income in the future of our SMEs, and this is the way to do it.

2. To make implementation easier, we suggest that **the revised system be applied fully and indiscriminately to all businesses registered in Hong Kong**. This means that other than small companies, their larger counterparts will also be subject to this graduated approach to taxation although the primary beneficiaries will be SMEs (or about 80% of taxpaying companies earning not more than $2 million in assessable profits based on 2013-14 data). We submit that a wholistic application of the proposed two-tiered system is consistent with the existing tenet of simplicity in taxation by eschewing clumsy criteria or parochial prerequisites, while also upholding the overarching principle of a level playing field without favouring specific sectors or industries.

3. We believe that the amount forgone in government receipts to be inconsequential even during periods of economic downturn, given the insignificance of such revenues as a share of the total revenue derivable from profits tax. Based on our calculations, the estimated loss in income to be $4,748 million based on 2013-14 figures. On the other hand, to SMEs the savings would be crucial as many of them are facing serious cash flow problem under the current unfavourable environment.

4. The resultant loss in government revenues from the implementation of a two-tiered taxation system could be offset by the positive potential effects of stronger economic growth, increased job opportunities, and higher incomes. This is because companies are more likely to re-invest their tax savings.

5. A two-tiered system will also improve Hong Kong's standing in the global tax competitiveness league. We are especially mindful of developments in our backyard, namely, the notable rise of free trade zones in Guangdong immediately across the border and in Shanghai, Fujian and Tianjin further to the north. Much like other jurisdictions around the region, these new free trade zones are doing their utmost to catch up with the economic performance of Hong Kong. Moreover, our tax proposal also allows Hong Kong to compete on equal footing with other jurisdictions such as Macau and Singapore that already offer progressive taxation.

6. A sustained and recurring approach through the two-tiered system is preferable and vastly superior to one-off, random rebates because the former provides certainty and clarity, and is demonstrative of the Government's commitment to helping and supporting businesses, especially SMEs.

7. We strongly suggest that the two-tiered system be given serious consideration for early implementation because:

- It will not complicate our simple tax system;
- It benefits all businesses but is especially helpful to the more than 78,000 corporations with taxable profits of less than $2 million, namely, SMEs forming the backbone of our economy;
- It is conducive to Hong Kong's tax competitiveness; and
- It does not result in significant revenue loss or narrowing of the tax base.

8. We also suggest that the two-tiered system be applied across the board to all companies because:

- It avoids the issue of paid-up capital;
- It does not require adopting a definition of SMEs;
- It avoids distorting incentives; and
- It discourages shifting small business profits to personal income taxable at 15%.

(B) Diversification of Hong Kong's economy through the development of an IP and aircraft leasing hub

In his last Budget Address, the Financial Secretary announced that he would consider extending the current scope for tax deductions in respect of capital expenditure incurred on the purchase of patents and industrial knowhow, registered trademarks and designs, and copyrights to cover other types of intellectual property (IP) rights. However, he made no mention on what other types of IP he had in mind. In this regard, we hope that he would consult the Chamber and the industry to extend the coverage to those types of IP that can best promote Hong Kong as an IP hub, through such means as allowing costs for developing or purchasing an e-commerce platform.

2. The Financial Secretary also stated in the last Budget that *"aerospace financing is crucial to the development of high value-added aviation services."* It is understood that he was referring to the aircraft leasing business when making such a statement. Aircraft leasing has, in recent years, been a high growth industry offering attractive investment returns. However, companies in the trade find Hong Kong unattractive due to an anomaly contained in the tax code. Under the Inland Revenue Ordinance (IRO), rental income derived by a Hong Kong lessor from leasing aircraft to overseas airlines may be fully chargeable to Hong Kong taxation. At the same time, the lessor would normally be unable to claim any tax depreciation allowance in respect of the cost incurred on the acquisition of an aircraft. Denial of tax depreciation allowance under such circumstances can be ascribed to Section 39E of the IRO.

3. The combination of high investment costs associated with aircraft procurement, denial of tax depreciation allowance, and Hong Kong's restrictive interest deduction rules, do not lend themselves to the promotion of Hong Kong as a base for aircraft leasing. This is despite Hong Kong's comparatively low corporate tax rate of 16.5% (which we propose to lower to 15%) and its proximity to major aircraft-user markets such as Mainland China and India. As such, the Government should revise Section 39E for the purpose of granting tax depreciation allowance for acquisition costs incurred on aircraft and relax the tax deduction rules for interest. The Government may also consider providing concessionary tax rates in respect of aircraft leasing profits, so as to make Hong Kong competitive vis-à-vis Singapore and Ireland.

(C) Group loss relief and loss carry-back

Companies new to the region may give greater weight to headline tax rates when selecting a regional operating centre, but those already here know that it is the effective tax rate that matters. For Hong Kong, the lack of group loss relief and loss carry-back raises our effective rate, thereby undermining our competitive position. In the light of the well-recognized fact that introducing group loss relief results in little foregone revenue, there seems no reason not to modernize our tax regime. A potential concern is that companies might evade taxes, but we believe that Article 61A is more than adequate to ensure that tax evasion is identified and punished. If there is any question about that, then it should be dealt with directly by amending the IRO.

2. We believe worrying about some small, theoretical loss of revenue misses the forest for the trees, as was shown to be the case in the elimination of the estate tax and the reduction in the wine duty. If we recognise that group loss relief and loss carry-back are about competitiveness, rather than revenue, the choice is clear. To alleviate the

immediate financial burden of companies, especially those suffering under the ‘fair value’ accounting rules, the loss carry-back measures should be introduced as soon as possible. Under the ‘fair value’ accounting rule, the IRD taxes unrealized gains or losses but these gains may turn out to be losses when the underlying assets are disposed of. Without the loss carry-back provisions, an unfair situation arises when taxpayers must pay tax on profits they did not make. We believe a three-year loss carry-back would be appropriate.

3. We are familiar with the IRD’s objections, but those concerns have been convincingly refuted, not only by tax professionals here in Hong Kong but also through the experience of other jurisdictions which have adopted similar measures.