HKGCC Budget Proposals for 2019-2020

1. As we bid farewell to what was a strong 2018, we are faced with greater uncertainty due to a variety of factors, which include a tightening credit market, an unfolding trade war, rising protectionism, weaker emerging markets caused by a stronger US dollar, and looming geopolitical issues in the European Union. Across the border, the Chinese economy is also facing international headwinds, as well as domestic challenges that could stall or reverse the trajectory of growth that we have enjoyed thus far.

2. According to the WTO's World Trade Outlook Indicator issued in late November 2018, trade growth is expected to slow in the fourth quarter of 2018. At 98.6, the latest reading is less than the baseline value of 100, which points to a weakening in global trade. Other indicators such as the Nikkei Hong Kong Purchasing Managers' Index and the Chamber's annual Business Prospects Survey also point to diminishing prospects, as private sector activity continues to contract.

3. As an economy that is heavily dependent on trade, the prospect of a global slowdown could weigh on Hong Kong's economic performance going forward. Although it is too early to ascertain the degree to which Hong Kong would be affected by such declining fortunes, it is imperative that we are well prepared for the challenges that are threatening to cut the proverbial legs from under a global economy that has not quite recovered from the Global Financial Crisis a decade ago.

4. To counter waning external developments, there is the need to dedicate greater efforts to improving operating conditions in Hong Kong. The measures put forward by the Chief Executive in her last Policy Address, which are directed towards the three key bottlenecks of land, labour and overzealous regulation is therefore very much welcome. We are hopeful of progress in the areas of land and labour given such developments as the "Lantau Tomorrow Vision" initiative, as well as remarks by the Secretary for Labour and Welfare on the willingness to consider favourably the importation of labour for sectors that are suffering from chronic manpower shortages. We look forward however to bigger and bolder measures on the review of legislation as a means to honing Hong Kong's competitiveness and maintaining our attractiveness as a place to live, work and do business.

Ensuring regulations are fit for purpose

5. We continue to **stress the need for the incorporation of a proper regulatory impact assessment (RIA) scheme as part of the policymaking process**. As had been pointed out in our previous submissions, the benefits from doing so are considerable, and can have positive knock-on effects that extend beyond the business sector to also encompass social and livelihood matters.

6. By adopting a systematic and evidence-based approach to regulating, the Government would be better placed to explain its rationale and objectives to the public, stakeholders and legislators on new laws that are being considered. An RIA would help reduce or alleviate the friction currently associated with the legislative vetting process, while enabling the Government to provide a strong and defensible account of its decisions.

7. As proposed in our earlier submissions to the Policy and Budget Addresses, **government intervention can only be justified if there is objective evidence that there is the need to (1) address market failure, (2) advance "public interest", (3) assist in the transition to a competitive market, and (4) support the economy in difficult times.**

8. A proper RIA system would not necessarily require major institutional changes or the creation of complex organisational regimes. Rather, and as pointed out in our submission to the Chief Executive's maiden Policy Address last year, refinements and augmentations to the Government's "Be The Smart Regulator" Programme would suffice in introducing a full-fledged RIA system in Hong Kong. We also reiterate our proposal for the establishment of a government working party, comprising private sector representatives, to address defective and/or outdated legislative measures.

9. There are a number of areas that would benefit from an RIA but one stands out in particular against the backdrop of international trade, which dictates to a large extent our economic well-being; It is in Hong Kong's overall interest to ensure that the domestic wheels of trade and commerce continue to operate smoothly. Inefficiencies and waste caused by artificial factors such as arcane and complicated legislation must therefore be subject to objective scrutiny from time to time. In this regard, we would like to reiterate our call for **a review of the Import and Export Ordinance to eliminate trade declaration charges, streamline permits system, and review import and export processing requirements, among other legislative and administrative arrangements to facilitate intermodal transhipments and strengthen Hong Kong's role as a gateway for the Chinese market.**

Enhancing Hong Kong's role and position in the Greater Bay Area

10. Hong Kong's ties with the Mainland have become increasingly important as our nation assumes greater prominence and stature on the international stage. The Greater Bay Area (GBA) Initiative, which emphasizes the inclusion of Hong Kong and Macao in national planning, therefore represents the logical next step for putting in place a regional cooperation framework that will help contribute to the Mainland's economic development and further opening-up, as well as in global economic cooperation and competition.

11. As one of the four core cities in the national development strategy for GBA, Hong Kong is expected to enjoy support from the Central Government in enhancing its comparative advantages in the areas of international finance, trade, and transport. The recent commissioning of the Hong Kong-Zhuhai-Macao Bridge, the Hong Kong Section of the Guangzhou-Shenzhen-Hong Kong Express Rail Link and Liantang/Heung Yuen Wai Boundary Control Point will further improve connectivity within this enlarged metropolitan region. In the area of the finance, Hong Kong should continue to play a leading role in channelling foreign investment into the Mainland and as a key player in the global supply chain.

12. For GBA to truly work, there should be conscious efforts to ensure that cross-boundary exchanges can be carried out seamlessly. One of the key considerations involve incentivising the flow of people. In this regard, **we suggest replicating across the GBA the programme implemented in the Qianhai and Hengqin Economic Zones, where Hong Kong residents are able to enjoy a rebate that would effectively place them in a preferential/lower IIT bracket that corresponds to a stay of less than 183 days, even when the taxpayer's time in China exceeds that duration. This arrangement could be**

rolled-out progressively across the GBA, subject to agreements reached between the Hong Kong Government and its respective regional counterparts. An enhanced arrangement to this effect would be beneficial in attracting international talent to, and promoting people flows within, the GBA.

<u>Strengthening the Tax Policy Unit</u>

13. The establishment of the Tax Policy Unit (TPU) in April 2017 was a welcome testament to the current Administration's commitment to sustaining Hong Kong's comparative advantage in the area of taxation. The TPU has contributed immensely to paving the legislative groundwork on tax concessions for research and development (R&D) expenditure, as well as the two-tiered profits tax, proposals that were championed by the Chamber.

14. Given the TPU's mandate and specialised capabilities, we suggest that it consider the following fiscal initiatives for its agenda going forward.

<u>Fiscal Initiatives</u>

- ***Incentivise the establishment of regional headquarters***

15. Hong Kong is already a premier location for regional headquarters (RHQs) in Asia. Hong Kong's advantage lies in its well-developed financial infrastructure, including (but not limited to) its deep and liquid foreign exchange and money markets, absence of capital restrictions, and stable exchange rate. Furthermore, Hong Kong possesses a simple and competitive tax regime, a common law system, and an excellent well-educated labour force and pool of business professionals. More importantly, its proximity to Mainland China makes Hong Kong an ideal location for setting up RHQs.

16. Although Hong Kong possesses all the right attributes for attracting RHQs, there is growing competition from other jurisdictions, which have introduced tax concessions for the express purpose of attracting RHQs. For instance, Singapore offers a concessionary corporate tax rate of 0%, 5% or 10%, respectively, on income derived from qualifying activities, under its Pioneer Certificate Incentive and Development and Expansion Incentive. There is also competition from across the border. The Shanghai Municipal government has been encouraging MNCs to establish regional headquarters in Shanghai since 2002 and launched a package of incentives to further incentivise the incorporation of new RHQs in the city. Closer to home, Dongguan, Sanya and Haikou have also unveiled their own incentive measures to compete for a slice of the RHQ pie.

17. We believe that **the introduction of tax concessions for RHQs represent a logical next step following the introduction of incentives for Corporate Treasury Centres (CTCs) back in 2016 as multinational corporations often co-locate their CTCs with RHQs. The granting of a tax perk to RHQs would play to Hong Kong's advantage by helping drive corporate decisions to locate here thereby reinforcing our standing as an international financial centre and contributing to economic growth**.

- ***Institute an innovation and technology-friendly tax regime***

18. The Government's decision to introduce super-tax deduction for R&D expenditure has been lauded as an important step towards its objective of transforming Hong Kong into a centre for innovation and technology. Combined with enhanced funding and government procurement measures announced in the Chief Executive's latest Policy Address, as well as the institution of a new listing regime for new economy industries such as biotechnology companies, these have helped underscore the Administration's commitment to diversifying Hong Kong's economy beyond the traditional industries that we have come to rely upon.

19. However, more needs to be done if the shared vision of remaking Hong Kong into an innovation and technological hub is to be fulfilled. For instance, there have been calls to moderate the eligibility criteria for R&D super-tax deduction to enable easier access to the tax concessions introduced last year and allow R&D activities conducted outside of Hong Kong, and specifically in the GBA, to qualify for such concessions. These calls are based on four pragmatic considerations, namely, proximity to operations where there is an abundance of critical resources such as land, facilities and skilled labour, which are in short supply in Hong Kong. **To encourage more R&D activities under the GBA initiative that would also benefit Hong Kong, we suggest extending entitlement for the deduction to include Hong Kong-based companies with wholly-owned subsidiaries that are engaged in R&D in the GBA.** Such an arrangement would be consistent with the Government's policy goal of enhancing connectivity and ease of doing business in the region.

20. **There should also be an assessment of the various government funding schemes to gauge their effectiveness in providing monetary support to R&D activities in Hong Kong or by Hong Kong-based entities. We understand the rationale behind the need to ensure that taxpayers' money is well spent. On the other hand, overly stringent conditions will prevent such funds from fulfilling their intended objectives and will not further Hong Kong's aspiration to become a world class centre for innovation and technology.** We understand that the Government is looking into the application process with a view to making refinements and look forward to proposals on concrete measures to better enable access to public funds.

21. Furthermore, there should be a review of existing supporting and/or legislative measures to ensure that these are conducive to or consistent with the stated policy objective of promoting innovation and technology, which includes encouraging companies to undertake R&D activities in Hong Kong. A practical example concerns the taxation of Intellectual Property (IP) developed in Hong Kong and licensed for use domestically or abroad in return for a license fee or royalty. In cases where IP is used by a foreign client, the Hong Kong company concerned is likely to be subject to double taxation as a result of the requirement to pay a license fee or royalty-withholding tax in the jurisdiction where the foreign client is located, as well as Hong Kong profits tax. Although foreign tax credit is useful in eliminating double taxation, under existing legislation this is claimable only if the jurisdiction concerned has entered into a double taxation agreement (DTA) with Hong Kong. It is worthwhile to note that Hong Kong does not currently have DTAs with some of its major trading partners such as the US and Australia. In this respect, we **propose that changes be made to the tax code to allow claims for foreign tax credit for taxes paid or payable to overseas jurisdictions by adopting a unilateral foreign tax credit system in our tax legislation that allows foreign tax credit to be claimed irrespective of a DTA**.

22. Aspirations in becoming an innovation and technology centre is not unique to Hong Kong and, as such, there is serious international and regional competition to nurture and attract high value, new economy industries. As mentioned earlier, the various initiatives introduced by the Government are most encouraging although it is critical that these be subject to regular scrutiny in the interest of maintaining Hong Kong's attractiveness to technology companies regardless of size and stage of development. We cannot stress enough the importance of ensuring that policy measures achieve their intended objectives of providing support, removing barriers and creating opportunities. In this regard, **consideration should be given to additional fiscal measures that would contribute to bolstering Hong Kong's standing as the preferred destination or base for new economy companies. This could involve the implementation of a Patent Box as a competitive tax regime to support the conception and commercialisation of patents and R&D in Hong Kong**. The Patent Box initiative has proven to be an effective strategy in attracting international IT companies as in the case of Ireland, the UK and other EU states and should also form part of the Government's policy efforts to promote Hong Kong as an innovation and technology hub.

- ***Promote Hong Kong as a base for global trading***

23. Apart from traditional external merchandise trade, Hong Kong also engages in other forms of trading called "offshore trade", where the goods involved do not enter or leave Hong Kong. According to the Trade Development Council, the value of offshore trade handled by Hong Kong was estimated to be worth US$544 billion (HK$4,244 billion) in 2016.

24. The territorial concept has been fundamental to the treatment of profits tax in Hong Kong. Under this approach, only profits that originate in Hong Kong are taxable, while profits sourced elsewhere are not subject to Hong Kong tax. However, profits stemming from offshore trade are regarded as being derived in Hong Kong and are therefore taxable in Hong Kong because contractual agreements for such activities are effected in Hong Kong.

25. In 2001, Singapore introduced the Global Trader Programme ("GTP") to encourage international trading companies to establish their regional or global trading operations in the island-state. GTP companies enjoy a concessionary tax rate of 5% or 10% on qualifying trading income (including offshore trading income) for three or five years instead of being subject to the headline profits tax rate of 17%. As well as the creation of jobs, GTP has contributed to the growth of key ancillary services such as finance, logistics and insurance.

26. We **suggest that serious consideration be given to introducing a concessionary tax rate for established companies engaged in international physical trading, to maintain our competitiveness and appeal as an international trading centre**.

- ***Review the spirits tax***

27. Since 1994, liquor with an alcoholic strength of 30% or above is the only dutiable commodity in Hong Kong to be taxed at 100% based on its declared import value. Hong Kong operators face one of the heaviest tax burdens on spirits relative to the rest of the region. For example, the total tax payable (which is defined as the import tariff and excise tax chargeable as a percentage of declared import value for spirits with 40% alcohol by volume (ABV) and a retail value of around HKD200/75cl bottle) in Mainland China and Macao are respectively 33% and 40%. Further afield, this is 39% in Taiwan and 43% in Japan.

28. In February 2008, Hong Kong removed the excise duty on wine and since then the SAR has become Asia's leading wine trading and distribution centre, particularly for the Mainland. This has led to such iconic regional events such as the annual beer festival and the Wine & Dine Festival, which have helped attract local and overseas visitors and supported the growth and expansion of the tourism, food and beverage, hospitality and entertainment businesses in Hong Kong.

29. We **suggest that a similar review be carried out for the existing ad valorem tax on liquor with an ABV in excess of 30% - which taxes a product's value - in favour of specific taxation that is based on alcohol content regardless of import price.** This taxation system has been adopted by many economies including the EU, the US, Japan, Singapore, Malaysia, Taiwan, New Zealand and Australia (except wine) and would have the virtuous benefit of promoting competitiveness and economic growth across the value chain very much like that experienced with the removal of the wine tax.

Conclusion: Preparing for Uncertainty, Sustaining Competitiveness

30. The general economic prognosis going forward appears to be one that is fraught with risks given ongoing circumstances elsewhere and it is unclear how long these problems would last. As the trend for inward looking policies and protectionism grows, it is more important than ever for Hong Kong to gird itself against external events that bring uncertainty and create market volatility. The substantial fiscal reserves and unparallel relationship with the Mainland China that we enjoy will serve as potent buffers against any adverse outcomes brought on by external developments. We should also act proactively to sustain our standing as one of the most competitive and business-friendly places in the world and would urge the Government to give serious consideration to our recommendations as given above.

HKGCC Secretariat
24 January 2019