3 January 2001

Sir Donald Tsang Yam Kuen, K.B.E., JP.
Financial Secretary
Central Government Offices,
West Wing
Ice House Street
Hong Kong

Dear Sir,

2001/2002 BUDGET PROPOSALS

We are very pleased to know that the current financial year is drawing to a close with impressive growth. As you are formulating the fiscal plan of Hong Kong SAR for the next year, we would like to bring you our views on what may be of interest to our community.

We would summarize our submission in the first place with more detailed discussions in the ensuing paragraphs.

Summary

Key points of our recommendations are summarized as follows:

1. Our Operating Environment

- We recommend that Hong Kong should have a slightly expansionary budget strategy for the next year.
- We agree that Hong Kong should maintain a balanced budget, but a deficit within 1% of our GDP should still be regarded as a balanced budget, and a non-recurring small deficit is a necessary investment to keep the acceleration of our economy.
- Our budget should contain an expenditure program that can ease off the immediate pressure on those struggling on the verge of subsistence and a longer term program that funds the strategy for re-positioning our industries that provide the future engine of growth and job creation.

2. Re-positioning for Opportunities

- The government should encourage the building of capital intensive industries, high skill requisite industries as well as high technology content industries. In the short run, the development of high value-added service industry is a realistic and promising choice.

- We recommend the government to re-focus the training and education programs for the building of the right talent; to formulate pro-active policies and inducements for the development of high value-added industries; and to provide leadership in the study of the long term development strategy for the development of capital-intensive and high skill requisite industries.

3. Reaffirming the Principle of Small Government

- The government should continue its adherence to the principle of controlling the growth of government expenditure and that, over time, expenditure growth should not exceed the growth of the economy.

- We understand you are contemplating restructuring the revenue base. If your objective is to improve the quality of our revenue base rather than increase the revenue, we would support. Otherwise, we would beg to differ. We hope you will clarify the revenue objective of your plan in the forthcoming budget.

4. Revenue Sources, Tax Base & Rate Structure

- While the government is shifting to user-based fees and charges as another source of revenue, we would suggest the government to conduct a detailed study to assess the impact of taxes, user fees, charges and transferable costs on the distribution and disparity of household disposable income.

- While we applaud the government's decision to undertake detailed study to monitor the correlation between government recurrent income and economic growth, to critically examine the viability of our existing tax regime and investigate the suitability of introducing new types of broad-based taxes, we take the view that this moment may not be the right time for the introduction of any new taxes as it could reverse the recovery process and activate the chain effects of economic contraction. We would like to point out that the introduction of mandatory savings such as Mandatory Provident Fund contributions will reduce the financial burden of the government and, in economic sense, is already one of the means to expand the government's revenue base.

- If we do have to restructure our revenue base, we would like to have more information from the government whether or not we are facing a structural deficit problem and how the impact of such restructuring will be distributed among the various sectors and our households.

5. Tax Competition and Employment

- We recommend a more liberal interpretation from a policy perspective of some existing tax law, such as source of profits, to attract investments. The desirable policy considerations should be formalized under the Inland Revenue Rules.

- The provisions of the Inland Revenue Ordinance on transfer pricing should be enriched to provide better guidance to taxpayers with multi-jurisdiction operations.

- As tax considerations do affect the migration of capital and jobs, we would urge the government to remove undesirable tax implications for the front office and back office operations of those companies in the manufacturing industry whose factories are already in China.

6. Incentives for service industries

- The government should support further development of the service industry by providing incentives for building up talents and for upgrading the productivity skills of their human resources.

- Our submission is to allow a tax deduction for qualifying training costs at 150% of the expenses incurred.

- In addition, we also suggest allowing the deduction of interest expenses paid to overseas companies for borrowings used to fund their regional service centres in Hong Kong where such borrowings are obtained in *genuine business circumstances*. The current deduction rules designed with anti-avoidance considerations could deny the deduction of genuine business expenses.

7. Personal allowances & income tax rates

- We recommend no changes to be made to personal allowances and the income tax rate structure.

1. Our Operating Environment

Last year, you encouraged Hong Kong people to “turn adversity to opportunity”. Obviously, our nimble-minded entrepreneurs and hardworking labour have strived to achieve the remarkable growth. Old firms have managed to advance after two tough years of consolidation; new start-ups are trying hard at the frontier of the economy; workers are learning to acquire new means of living; and consumers are spending.

Our outlook on 2001 is somewhat mixed. The growth we have been enjoying will hopefully continue but there are uncertainties ahead. If some downside factors turn out to be more serious than what we expect, our growth may slow down significantly. While Hong Kong seems to be making a good recovery, it is high time for us to re-assess our environment, and re-define our position to better meet the coming challenges and opportunities.

1.1 New Opportunities and risks

Mainland China is our most important partner in almost every respect and the main destination of our investments. Hong Kong must capture the opportunities arising from China's impending entry to WTO and re-define our position to allow us to develop necessary comparative advantages or else the tide of changes will go against us.

At business level, Hong Kong is facing competition, not only from the usual competitors from other countries in Asia, but also from within the Mainland. We cannot assume Hong Kong will retain the benefits of its role as a westernized gateway between China and the rest of the world. Hong Kong's ports and transportation industry now compete directly with their counterparts in the major cities and ports in China. There is an increasing trend for enterprises in China to ship directly from its own ports and this trend will grow further after China's entry to WTO as by then the Chinese market will be open up to the whole world. We also see strong competition in the areas of financial, business and professional services, which we rely on very much for export and growth. Therefore, we should establish and build up our own unique core competence that can re-affirm our importance to China's further economic modernization and to secure a firm position in the world economic arenas.

1.2 Internal constraints

Hong Kong has a small domestic market. With the return of confidence and deflated prices, local consumption has experienced a mild increase; however, consuming in Hong Kong is still expensive compared to other cities in the region such as Shenzhen, the immediate cross-border city, which has drained part of our local consumption.

While Hong Kong is a free market. Capital is free to move to capture opportunities in any part of the world, but labour is by nature much less mobile. As a result, the benefits of our economic growth have not been able to permeate every stratum of the community through interactions among all participants in the economy. The Asian financial crisis and the restructuring of the local economy have increased the income disparity and hastened the deterioration of the living standard of those not able to adjust to the structural changes that Hong Kong is undergoing. Despite the impressive turnaround of the economy in the past year, many of the less fortunate are still unable to benefit and some remain at the verge of subsistence. On the other hand, notwithstanding the deflated costs, operating costs still remain high in Hong Kong. This would continue to drive the back office and even the front office operations of our businesses out of Hong Kong, adding pressure to the less mobile labour, in particular those over the age of 40 and do not have a high or professional education background.

1.3 External effects

Hong Kong has a relatively small export-oriented economy with a GDP of approximately $1,230 billion for 1999. Our economic performance depends inevitably on the economic conditions of our major trading partners, such as the USA, Japan and Europe, apart from Mainland China. There are signs that the US economy is weakening. This will affect worldwide economy including Hong Kong. The slow recovery of the Japanese economy and the much weakened Euros will continue to hamper our exports to Japan and the European countries. Although better economy in Europe is generally expected in 2001, we do not anticipate deriving significant benefits. The close link of Hong Kong's economy with other external economies means their uncertainties overcast ours. Increasing globalization and interdependence also render Hong Kong's economy more volatile, unpredictable and result in greater exposure to external effects.

In view of the general operating environment as explained, we therefore recommend that Hong Kong should have a slightly expansionary budget strategy for the next year. We agree that Hong Kong should in general maintain a balanced budget approach; a deficit within 1% of our GDP should still be regarded as a balanced budget, and a small deficit is a necessary investment to keep the acceleration of our economy. Our budget should contain an expenditure program that can ease off the immediate pressure on those struggling on the verge of subsistence and a longer term program that funds the strategy for re-positioning our industries that provide the future engine of growth and of job creation.

2. Re-positioning for Opportunities

The challenges and opportunities arising from globalization, from China's further opening to new economic orders and from the New Economy have urged Hong Kong to start its search for excellence: a new strategic position that would allow us to capitalize on our competitive advantages and to better serve the global economy. Moving towards a service-based and knowledge-based economy seems to be the direction widely discussed. However, what needs to be done is still unclear and needs to be better explained.

For example, a high-tech development project has been criticized by many as a property development rather than seeing it as an inducement for developing our high-tech industry. The government's re-training program focuses more on helping the unskilled workers adjust to the economic transition than upgrading the value-adding skills of the better educated. The former is necessary more for social reasons; it is the latter that should be emphasized for improving productivity.

Having considered the endowment of Hong Kong, its high operating costs and its relations with the rest of the world, we believe the new position for Hong Kong lies in the building of some industries with high value-added output, that can employ a wide spectrum of our labor. By definition, high value-added means high return on capital and high wages payment for labour.

Accordingly, we suggest the government should encourage the building of capital intensive industries, high skill requisite industries as well as high technology content industries. There should also be some industries that provide support for the development of such industries and employment for labour with more general skill sets. In the short run, high value-added service industry is a realistic and promising choice. In the long run, capital intensive and high technology content industries are the areas worth investing.

Our view is based on the following considerations.

Firstly, Hong Kong with its small domestic market, will remain an export-oriented economy, but the emphasis should now be moving towards intangibles such as services and skills. Many cities in the region are capable of providing cheaper land and labour. It would be unwise for us to meet them head-on by merely lowering our operating costs. We should work with them using our own advantages. Hong Kong has a fully-fledged and mature financial market and convertible currency, highly developed communications and infrastructure network and the freest economic system. These are our comparative advantages and they are yet to be matched by our counterparts in the Mainland and elsewhere in Asia.

Secondly, we have to admit that currently there is a big gap between the supply of and demand for local talent. The development of high-tech industries cannot in the long term rely on the import of talent. Hong Kong must take steps to develop its own talent pool. But it takes time to do so. Therefore, in the short run, the development of high value-added industries can only be focused on the service sector in which we have already established a stronger foothold such as professional services, banking and financial services, business services, telecommunication, design and logistic management etc. Our role after China's WTO entry should be shifted towards the provision of these high-end value-added services in the global market. Our edge lies in our experience, efficiency and convenience.

Thirdly, productivity of our existing workforce is sub-optimal due to the lack of the skill-upgrading training. One simple example is that even the most commonly available software package in a desk-top computer is only utilized at not more than half of its full functionality. This comment is based on the observation that many fresh university graduates can only use the simple functions of a computer for basic presentation, word processing and calculation works, apart from Internet communication and entertainment. The analytical power of a computer has largely been unexplored! This means a waste of resources and a loss of productivity and efficiency. On the other hand, many in management position are oblivious of the advance of technology and how new skills and computerization could help them to maintain their competitive edges. As we are moving towards a technology-intensive era, even traditional businesses have to blend well with IT and other advance technologies to improve productivity and efficiency. Businesses should be encouraged to invest in upgrading its human resources.

We believe Hong Kong's next opportunity largely rests on the export of high value-added intangibles, such as professional services, software for business applications, financial products and on the development of high technology content and capital intensive industries. This can only be realized when we have built up a pool of right talent.

In this regard, we have the following recommendations:

- re-focus the training and education programs to the development of our human resources possessing the necessary capabilities that support the building of our high value-added industries;

- formulate proactive policies and inducements for the development of the high value-added industries including the provision of well defined concessions to attract investments from the world's leading high-tech multi-national enterprises so that our workforce can learn by working with the most experienced;

- provide leadership in the study of strategies for the development of capital-intensive and high technology content industries and explain the strategies to the public;

- reinforce our existing strengths in the financial and business service industries by providing inducements for the building of new skills and capabilities.

3. Reaffirming the Principle of Small Government

We are aware of the problem of increasing income disparity and some people are facing a diminished standard of living. This phenomenon raises a lot of concerns in the public and needs to be addressed. However, fighting against poverty and raising the standard of living are the responsibilities of the entire society, not that of the government alone. We expect the government to lead and fight with all, but not to expand its role to cover what should be the responsibilities of the individuals.

For years we have a relatively small but highly efficient government concentrating on a few things for the general welfare and advancement of our society. The government should continue to do so, providing vision and leadership, raising our society to a higher level of civilization, allowing individuals to do their best of their own free will. Only when necessary should it offer relief and hope to the less fortunate needy.

Amidst demands for expanding our social programs, you should reaffirm the principle of small government. In saying so, we are not insensitive to those who are in need of help. The needy should be helped; it is just a matter of how we may do so in the interest of all. Minimum intervention, small public sector and free economy has blended well with the gumption and nimble entrepreneurial spirit of Hong Kong people that create the economic miracle and success of Hong Kong. Therefore, the principle of small government should be upheld. Our policies should aim at stimulating the economic environment and vigour instead. Through real economic growth and efficient redistribution, the needy will be benefited from the flow of wealth created.

We understand you are contemplating restructuring the revenue base. If your objective were to improve the quality of our revenue base rather than increase the revenue, we would support. Otherwise, we would beg to differ. We hope you will clarify the revenue objective of your plan in the forthcoming budget.

In this relation, the government should continue its adherence to the principle of controlling the growth of government expenditure and that, over time, expenditure growth should not exceed the growth of the economy.

4. Revenue Sources, Tax Base & Rate Structure

In the last budget, you have done a thorough review of our fiscal system and the future public financial position. We would like to look at this subject from a different perspective.

Firstly, our direct tax is only imposed on income from business, employment and property. We have a flat rate system supplemented with a progressive rate structure and generous personal allowances. Most investment incomes are not taxed.

While direct tax is the most-mentioned revenue system, we do have a system of indirect tax mainly in the form of excise tax on goods such as car, gasoline, tobacco and alcohol etc. In addition, we have rates and other user-based fees and charges. It is therefore fair to say that the contribution to government revenue is widely spread among the different sectors of the society. Those who are not paying significant direct and indirect taxes still have to bear in some way a share of the cost for the running of our society. Obvious examples are rates and other government fees; less obvious examples are costs transferable through the operation of the markets such as rent and price for housing units.

Accordingly, the issue of widening the direct tax base has to be carefully considered from a redistribution point of view. In a highly interdependent society, it does not matter who pays the tax but who actually bear the consequence of a tax through interactive economic activities. This is a subject that requires careful analysis. In addition, we also suggest looking at the questions of how the distributive impact of the taxes and other transferable costs affects the standard of living of individual households and whether it corresponds with their ability to pay.

On transferable costs, a large portion of government revenue has been from the sale of land or other related sources. It accounts for roughly about 20% of the revenue over the years. The problem of this revenue source lies in its transferability: the more powerful market participants can pass it onto the weaker ones due to the limited supply of land and due to the highly inefficient structure of the property market. The cost has actually become the burden of homeowners. This is an important policy area; however, there is scarce public information about the distributive impact of such transferable costs.

The government's shift to user-based fees and charges, and mandatory savings under the Mandatory Provident Fund Schemes as another source of revenue in the economic sense already have the effect of re-distributing the economic burden for the welfare of our society. Again, there is little information on the re-distributive effect of imposing these fees and charges. In saying so, we are not opposing the user-based approach to sharing our social costs. Our point is: there should be a study to inform the public how the overall public cost is shared and based on such information how redistribution should and could be planned.

We would suggest the government to conduct a detailed study to assess the impact of taxes, user fees, charges and transferable costs on the disposable income of households, which is a better reflection of the standard of living of the different sectors of the society.

While we applaud the government's decision to undertake detailed study to monitor the correlation between government recurrent income and economic growth, to critically examine the viability of our existing tax regime and investigate the suitability of introducing new types of broad-based taxes, we take the view that this moment may not be the right time for the introduction of any new taxes as it could reverse the recovery process and activate the chain effects of economic contraction. We would also like to point out that the introduction of mandatory savings such as Mandatory Provident Fund contributions will reduce the financial burden of the government and, in economic sense, is already one of the means to expand the government's revenue base.

Further moves to expand the revenue base at present by introducing new taxes or fees in the middle of our recovery could reverse the process and activate the chain effects of contraction instead. Our view, as explained above, is that the government should give the economy another push and energize the economy in a bid to increase activities. On the assumption that we have a relatively buoyant revenue system, government revenue should also increase.

If we do have to restructure our revenue base, we would like to have more information from the government whether or not we have a structural deficit problem and how the impact of such restructuring will be distributed among the various sectors and our households.

5. Tax Competition and Employment

5.1 Our tax system

For a long time, we believe that our tax system is the most attractive to businesses. The system is simple, the tax burden is light and the administration is professional and proficient. More importantly, we have one of the best environments for doing business. All these are true.

However, other cities in the region can also produce a long list of attractions suggesting why businesses should go there. Tax has always been one of the most attention-getting items on the planning list and does play a significant role in deciding to where businesses and hence employment opportunities go.

Tax incentives do alter the flow of capital. However, we are not in favour of an active pursuit of tax competition. We believe our tax system is already competitive. Although we do not have explicit tax incentives, our system do have a lot to offer such as the exclusion of offshore profits, absence of capital gains tax, generous capital allowances and low tax rates. They are the inherent incentives already in the system. Such tax advantages need to be fully utilized as attractions to induce more investments to come and to retain businesses already here.

We as tax professionals are often involved in the process of making important investment decisions. We offer choices that provide better returns; we also provide clarifications to remove uncertainties. Where possible, we of course would like to highlight the attraction of doing business in Hong Kong from a tax point of view. There are two areas which can be improved to help us do our job more effectively.

5.1.1 Advance rulings

Since 1998, the scope of Advance Rulings has been expanded to basically cover all provisions under the Inland Revenue Ordinance. This procedure provides certainty and therefore enhances the quality of business decisions where there are interpretation difficulties. It offers comfort to decision-makers and would encourage them to make decisions in favour of using Hong Kong.

Rulings are now given, based on the technical merits of particular cases without paying any consideration to the policy of attracting or retaining business investments. This technical and inflexible approach has its advantage; nevertheless, it would screen off those borderline cases which if given due consideration from a policy perspective should be enticed to come and invest in Hong Kong. We therefore suggest more liberal interpretation from a policy perspective of the existing tax law to attract investments that will benefit Hong Kong be considered when advance rulings are given.

Rulings given on the basis of policy considerations may require the relevant officials to exercise discretion beyond their usual technical arena. Unrestrained discretion may also undermine the integrity of the tax system. However, if the policy considerations can be embodied in a clear set of rules, the danger of unrestrained discretion can be largely removed and the rule of law principle can be still adhered to. This should be done by means of formalizing desirable policy considerations under the Inland Revenue Rules which are the practical guidelines for the application of the provisions in the Inland Revenue Ordinance.

5.1.2 Transfer pricing provisions

Transfer pricing refers to the practice of pricing transactions among related parties. It is inevitable whenever a commercial organization operates in a decentralized manner or in an international setting. Tax considerations set in when the pricing practice results in profits attributed to different jurisdictions. It is the responsibility of taxpayers to ensure that the allocation of profits is reasonable and to provide justifications when necessary.

This is an area where tax disputes often arise and such disputes may involve more than one tax jurisdictions. Accordingly, there are internationally recognized principles such as those contained in the OECD Transfer Pricing Guidelines. Mainland China has adopted a similar theoretical framework. However, the Inland Revenue Ordinance does not have clear provisions in this respect and the Inland Revenue has been taking a broad-brush approach in dealing with this issue. Although no cross-border operations are the same, the Revenue invariably requires that a 50:50 apportionment should apply in practice. This treatment is technically incorrect and unfair in many circumstances. This issue was not pressing when another jurisdiction where a business has operations is prepared to forego its right to tax for reasons mainly to attract investments. Recently, however, there are increasing concerns as double taxation may occur when other jurisdictions are also asserting their right to tax.

We therefore submit that the transfer pricing provisions should now be enriched to provide better guidance to taxpayers.

In the absence of clear rules and fair practices, some businesses may choose to eliminate the risks of double taxation by moving the entire operations to another jurisdiction. Although many companies have moved their manufacturing to the Mainland, most still prefer to have their front office and back office operations located in Hong Kong. We have seen however more and more such operations being re-located. There are many reasons that may account for this phenomenon, but let us remove tax as one of these reasons.

5.2 Employment

The unemployment rate has dropped from its height of 6.3% in 1999 to 4.8% in the 3rd quarter of year 2000. However, this level still means pain to the unemployed who cannot match new needs of the changing labour market.

Apart from costs, tax consideration does affect the migration of capital and jobs; we would urge the government to remove undesirable tax implications for the front office and back office operations of those companies in the manufacturing industry whose factories are already in China. If these companies decide to move their non-manufacturing functions across the border, more non-professional and supporting jobs will be eliminated and many of those displaced will find it hard to find new jobs that match their old skill sets.

6. Incentives for Service Industries

You mentioned last year that providing a level playing field has always been one of the government's "maximum support and minimum intervention" policy. Our capital allowance scheme, one of the inherent tax incentives, is actually tilted towards manufacturing industry which was once the backbone of our economy. Our service industry by nature cannot obtain too much relief from such allowances, as their most important asset is human resources rather than plant and machinery.

As suggested above, the government should undertake careful study on the long-term strategy for developing some suitable high value-added industries in Hong Kong.

In the meantime, the government should support the further development of the service industry by providing incentives for building up talents and for upgrading the productivity skills of their human resources.

Our submission in this regard is to allow a tax deduction for qualifying training costs at 150% of the expenses incurred in this relation.

In addition, we would also suggest the government to remove "disincentives" in our tax system to attract and retain investors using Hong Kong as their regional service centres. In this regard, the government should consider allowing the deduction of interest expenses paid to overseas companies for borrowings used to fund their regional service centres in Hong Kong in genuine business circumstances. The current deduction rules were designed with heavy anti-avoidance considerations and could deny genuine business expenses incurred in this relation.

7. Personal allowances & Income Tax Rates

Despite the strong economic recovery, wages and salaries are expected to have meagre increases only (estimated to be 2-3% this year). Coupled with the fact that we have a slight deflation, we recommend no changes to be made to personal allowances and the income tax rate structure.

We trust our submission will receive your careful considerations. If we can be of further assistance, please feel free to let us know.

Yours faithfully,
For and on behalf of
Taxation Institute of Hong Kong

Thomas Lee
President