

HKIoD's Submission on the 2009-2010 Government Budget Executive Summary

- 1 Manufacturing SMEs are important to Hong Kong's GDP and employment. A more accommodative tax policy is needed for their survival and development, especially in the areas of the source rule on profits and the tax treatment of import processing. Tax treatment for R&D spending should be steered towards enabling the development and application of technology, and improving the competitiveness of our industries.
- 2 Closer cooperation between the Government and Mainland authorities is necessary to help Hong Kong companies gain access to the domestic Mainland market and to secure banking facilities on the Mainland to service their business.
- 3 A concerted effort is called for to develop Hong Kong into a regional hub for professional education and training. This would create a new impetus to growth while helping to improve corporate governance and reinforce our position as a provider of business services to the region.
- 4 Economic recession brings serious unemployment concerns, and underscores the need for government policy that is supportive of small business which is a key source of employment.
- 5 The financial tsunami has highlighted Hong Kong's unique advantages in serving as China's international financial center. Government should act on this opportunity and develop the government bond market and Hong Kong's role as a RMB settlement center for trade in the region.
- 6 Fiscal policy in Hong Kong needs a fundamental change away from a tax and expenditure pattern that feeds rather than counters the economic cycle. Land policy should also be adjusted so that it is not viewed primarily as a revenue source but as a resource for territory-wide development.

HKIoD's Submission on the 2009-2010 Government Budget

A More Accommodating Tax Policy for Manufacturing SMEs

The financial tsunami has hit the world economy hard and Hong Kong being a very open economy has borne its full brunt. Much recent attention has focused on the plight of the manufacturing sector, especially for Hong Kong-owned factories operating in the Pearl River Delta (PRD), and for good reasons. According to a 2006 study by the TDC, the manufacturing and trading sector is the largest contributor to our economy, accounting for fully a quarter of the GDP.¹ Another government study shows that import-export trade alone accounted for over 20% of GDP and 16% of total employment in 2006.² Therefore any sharp downturn in the manufacturing and trade sector is bound to have serious repercussion on the entire economy.

Recently the Government has done much to help manufacturers weather this crisis and these initiatives should be applauded. However, given the extreme severity and long-term nature of the problem the government must not let up on its effort.

In particular, the Government has yet to change its unfavorable tax policy towards manufacturing despite repeated pleas from manufacturers and their accountants in recent years. A nagging concern for manufacturers is the source rule on profits, particularly where it applies to the taxation of cross-border manufacturing profits and trading profits under the totality of facts approach. This area needs greater clarity and more accommodating tax treatment.

Another area that needs urgent attention is that many Hong Kong manufacturers in the Mainland have long operated under a contract processing mode. But policy change in the Mainland in recent years has forced many manufacturers to switch to import processing instead. However, the Hong Kong tax treatment towards import processing is much less favorable than for contract processing. This disparity needs to be rectified for it throws up a serious obstacle to manufacturers that are trying to restructure their operating mode to cater to changing Mainland policy.

¹ "Development and Contribution of Hong Kong's Manufacturing and Trading Sector", Hong Kong Trade Development Council, November, 2006

² "The Situation of the Four Key Industries in the Hong Kong Economy in 2006", Feature Article, Hong Kong Monthly Digest of Statistics, March 2008.

In order to help our industries upgrade their technology, favorable tax treatment for R&D is needed including more generous write-offs and depreciation allowances. As well, increased funding for R&D schemes targeted on SMEs is called for.

Finally, there have been industry complaints that the tax authorities have tightened their tax grip on cross-border manufacturers in recent years and there have been no signs of this abating despite the current crisis situation. Notwithstanding the recent pledge by the Government not to raise taxes, the Government must also resist all temptation to step up its tax collection effort to mend its own budget deficit during tough economic times.

Cooperation with Mainland in Helping Manufacturing SMEs

The global credit crunch has led to a severe curtailment in access to credit for Hong Kong businesses, including manufacturers operating across the border. The Government should liaise with governments at the central and local levels to help our manufacturers secure bank loans on the Mainland. To this end the recent visit paid by the Hong Kong Monetary Authority to Guangdong authorities should be commended. Also, the Government could help our manufacturers in negotiating better market access in the Mainland to make up for lost export orders caused by the severe recession in our traditional overseas markets.

Corporate Governance and Professional Education

For their longer-term survival, our businesses including manufacturers must upgrade their operations. This includes not just branding and moving up the product value chain, but also improving corporate governance as well. This case is illustrated by the rather disappointing outcome of the SME Loan Guarantee Scheme, where despite government effort to expand the Scheme few new loans have been granted to manufacturers. There are myriad reasons for this unsatisfactory outcome, but one factor is that many SMEs do not have sound corporate governance including proper internal and financial control, and thus are ill prepared to submit sound loan proposals. This illustrates that corporate governance education remains an important aspect of the upgrading of SMEs that must not be overlooked.

Related to this issue is that Hong Kong being a regional hub in the provision of business services already possesses many of the ingredients for it to also become a hub for professional education. Becoming a professional education hub would not only help maintain the competitive edge of our professional services, but would itself serve as an impetus to economic growth. However, for Hong Kong to become a regional hub for professional and higher

education requires a concerted effort led by the government, and includes initiatives to promote the outreach of our educational institutions and the expansion of conference and hotel facilities that are cost-effective.

English and Putonghua skills of our labor force remain inadequate and more resources have to be deployed in this area for Hong Kong to serve its role as China's world city effectively.

SMEs are Key to Entrepreneurship and Employment

With the deepening recession, unemployment has emerged as a major concern. Small business has always been an important employer although this fact is often not given due recognition. In times of recession and economic dislocation, it is all the more imperative for the Government to foster a business environment that is friendly to small business, including small proprietors that run shops and provide services in the neighborhoods. Hence, it is troubling to see that while malls in public estates are being refurbished and rents raised, it has the effect of driving out mom-and-pop operations and replacing them with larger shops and chain stores. The Government should recognize the special contribution of small neighborhood businesses to our economy and society as well as the formidable challenge they face against large, established competitors, and actively pursue policies that are truly conducive to their formation and survival. In this connection, the cost of doing business is important, and the Government should keep an active tab on the pricing of utilities and other necessities that is determined by the few, such as the price of petrol.

The Competition Law now in the works is welcome but only if it could actually help rather than hinder small business at the end of the day, and this depends on how the Law emerges in its final form and how it is applied in practice.

Identifying Opportunities in Times of Crisis

Although it seems hard to find a silver lining amid all the bad economic news, one has reasons to believe that Hong Kong could yet emerge from the financial tsunami with its status as an international financial center reinforced rather than weakened. The crisis has underscored the pitfalls of a closely integrated global financial system, where economies with highly open capital markets have few means of shielding themselves from global financial contagion. Yet it is through this painful lesson that the value of Hong Kong to China has become ever more apparent, in that we offer a financial system, fully transparent to Beijing, through which China could readily tap into the global capital markets, at the same time that it provides a natural firewall that could

help buffer the Mainland economy from global financial contagion. In sum, the financial tsunami has underscored Hong Kong's unique advantages under One Country Two Systems in serving as China's natural, off-shore international financial center.

The valuable role played by Hong Kong in China's financial development has recently been reaffirmed by Beijing's 30-point directive that called for Hong Kong to expand its role in issuing RMB bonds and serving as the RMB settlement center for trade in the region. Hong Kong should seize this opportunity to further develop its financial services sector, especially the bond market.

In fact, the recent international banking panic shows that there could be a substantial unmet demand for government bonds as a safe investment vehicle and a store of value. With the government's role as the ultimate backer of the financial system being reaffirmed in the current crisis, it follows quite naturally that there would be a demand for direct "sovereign" obligations backed by the government. Indeed, government bonds could have a place in the MPFs and pension plans for employees, as well as the nest eggs of retirees who are living longer than ever and spending more years living off their retirement savings. We urge the Government to look into the possibility of issuing government bonds to meet a potential market need. Government bonds could also serve as a tool for better and more flexible fiscal policy management, and the development of a vibrant bond market would also bolster Hong Kong's role as a financial center. Finally, the retail bond market in general could be made more active if securities houses are given greater participation in the distribution network along with commercial banks.

Outside of the financial sector, Hong Kong has other industries with untapped potential that could be developed given greater government support. Hong Kong boasts excellent health services and rising international recognition of its biomedical research. At the same time Hong Kong has a strong foundation in the development of Chinese medicine. The Government should step up efforts for science and evidence-based development of clinical practices of Chinese medicine and integrative Chinese and western medicine.

Fiscal Policy

The latest financial crisis also carries with it important lessons for Hong Kong in terms of the management of our fiscal policy. First of all, the crisis of confidence suffered by the international financial system in recent months should dispel for good the erroneous notion

that the Government has in recent years maintained a higher level of fiscal reserves than necessary. The fact of the matter is that Hong Kong has now been hit by international financial contagion for the second time in a decade, which shows that external financial shocks are more a fixture than a contingency in our financial landscape. Fiscal reserves are an indispensable tool during economic turmoil. Furthermore, the IMF has suggested that Hong Kong should maintain fiscal reserves at a level equal to around 30 to 50% of our GDP, and by that standard our fiscal reserves were only barely adequate even as we emerged from over four years of economic boom that ended in early 2008.

The latest crisis also underscores the need for the Government to completely rethink the way it manages the fiscal budget over the business cycle. Fiscal policy is supposed to play a stabilizing role in the business cycle, by being accommodating when the economy is in a downturn and contractionary when the economy is in a boom, with fiscal reserves serving as the buffer and actively managed to serve this macroeconomic objective. But Hong Kong has always followed a tradition that has stood this fundamental principle on its head, with the Government being busy granting tax concessions when the economy is booming and the government budget shows a surplus, and scrambling for revenue when the economy is in recession and the government budget goes into deficit. But such a fiscal policy has the effect of exacerbating rather than countering the business cycle, by adding spending during times of boom and undercutting the economy during downturns. In fact, the kind of problem where the tax authorities are under pressure to increase tax collection during recession discussed above is exactly the kind of practice that the Government must avoid in the future.

Unlocking Land Supply for Development

Land policy deserves special mention in this discussion of fiscal policy because it has long been a sore point in Hong Kong's overall economic development strategy. There have long been complaints that much needed construction for diverse purposes is left unbuilt for a lack of land, such as private hospitals, international and special schools, and university dormitories and other expansions. Perhaps the reason for this impasse is that land is extremely valuable in Hong Kong and its use on concessionary terms could only be granted after due deliberation. But the point is that the Government has generally been too restrictive with land policy and as a result much of the building critical to our overall economic development is left permanently on the drawing board. We urge that a more proactive approach be adopted in the granting of land on concessionary terms for purposes that are beneficial for the overall economy and where they do not compete with the interests of developers.

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The Hong Kong Institute of Directors

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