Tax policy and budget proposals 2021-22

Preparing for the recovery

Hong Kong Institute of
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Introduction

For many people 2020 will be remembered as an annus horribilis, a year of few redeeming moments. The near-total disruption to lives due to the COVID-19 pandemic and the related restrictions on travel, had a significant impact on the economy. For tourist-focused sectors such as retail and hotels, the misery compounded that experienced in 2019 due to the social disruption.

The pandemic's effects followed those of the continuing trade war between China and the United States of America. The dispute came to Hong Kong during the year through the removal of its special trading status granted under the United States-Hong Kong Policy Act of 1992, and demands for goods made in Hong Kong to be labelled "Made in China".

Although the US elections saw change in the leadership of the country, its impact on Hong Kong is uncertain at this stage.

While many hold out hope for a vaccine to mitigate the virus, it is likely that 2021 will still face disruption due to the virus. The Hong Kong Special Administrative Region Government (the government) should therefore continue to support the economy and its preparations for the recovery.

Preparing for the recovery

To fight the pandemic and support the economy, the government has allocated almost $290 billion dollars – around 10% of gross domestic product (GDP) – through three rounds of Anti-epidemic Fund measures. This has been allocated to programmes including job support and creation, sector-specific programmes, and support for organizations' investment in technology and their future.

Unemployment, and underemployment, has increased. The unemployment rate reached 6.4% in the three months ending September 2020, the highest in nearly 16 years. Underemployment also reached 3.8% during the period, the highest in 17 years.

Even with the financial support, in mid-November the government was projecting a decline in real GDP of 6.1%, barring any sharp resurgence of local COVID-19 infections or abrupt relapse in global economic activity. While the International Monetary Fund forecasts that the economy will return to growth in 2021, the recovery will be modest at 3.7%. This is the biggest decrease in GDP recorded by Hong Kong, below the 5.9% decrease after the Asian Financial Crisis in 1997.

Hong Kong will therefore need help from the government in preparing for the recovery, supporting its population, and providing the training the working age population needs to benefit from the digital transformation taking place.

In our recommendations we propose five measures regarding preparing for recovery.

Adapting to the new normal through more extensive digital transformation

COVID-19 has shown the world the importance of investing in technology, and the infrastructure needed to support it. 2020 was meant to be the great year of the introduction of 5G, the new superfast, low latency telecommunications standard. Hong Kong's first 5G subscription plan launched in the year, but support is still needed to facilitate total coverage and increase usage of the technology. SMEs also require support in their digital transformations and cybersecurity.

We propose three measures for adapting to the new normal through more extensive digital transformation.

Public finance and taxation

The record government deficit predicted for 2020 is a consequence of its anti-epidemic fund spending. Yet it also demonstrates some of the problems Hong Kong faces due to its narrow tax base.

The year also saw progress, albeit slowed by the pandemic, towards agreement in international taxation that is likely to require adjustments to the Hong Kong tax system. The Organization for Economic Cooperation and Development's Base Erosion and Profit-Shifting 2.0 initiative, which may be agreed by the middle of 2021, proposes allocating taxing rights for cross-border activities based on revised nexus and profit allocation rules and introducing a global minimum taxation rate for multinational enterprises. As a low tax jurisdiction, Hong Kong must ensure that it collects the "top-up tax" levied under these rules on Hong Kong profits, or face tax leakage to other jurisdictions.

We make nine recommendations for how the government should review the public finance and taxation situation in Hong Kong.

Environmental measures

The pandemic demonstrates how fragile life can be. Sustainability and ecologically friendly policies should be a key consideration in preparing for the recovery.

More attention is focused on environmental concerns than ever before. Businesses are becoming increasingly aware that investors, particularly among the younger generations, are concerned about the impact of climate change and environmental damage, and choosing to invest in less damaging businesses. During the year, the environmental, social and governance reporting requirements of the Listing Rules of the Stock Exchange of Hong Kong were strengthened, with more required to be discussed on a comply-or-explain basis than previously.

Air quality is also an important consideration. A study by the Hong Kong University of Science and Technology found that in Mainland China, the lockdown measures may have delayed 24,000 to 36,000 early deaths[1]. Improving local air quality would improve the livelihoods of Hong Kong's citizens.

We make four recommendations of environmental measures to consider for Hong Kong's future.

[1] https://www.ust.hk/news/research-and-innovation/hkust-study-finds-city-lockdown-improves-air-quality-may-delay-24000?highlight=%E5%9C%8B%E4%BF%8A

I. ***Preparing for the recovery***

COVID-19 has badly hit the world economy. Hong Kong is no exception. The initial expectations that the pandemic would remain localized, and disappear after a few months, like the experience of Hong Kong with SARS in 2003, or MERS in South Korea in 2015, have been proven to be over-optimistic. With international travel almost at a complete halt since February 2020, businesses in specific sectors like airlines, hotels, guesthouses and exhibitions have been almost dormant.

Due to various social distancing requirements for prevention of the spread of COVID-19, the catering industry has not fared a lot better than many of the tourism-related industries mentioned above. Besides, many businesses have introduced work from home (WFH) arrangements in order to mitigate the impact that COVID-19 brings to normal business operations. Yet virtual business models do not work for all sectors, and for others – particularly smaller organizations – the costs of new hardware or technologies are prohibitive.

It is generally believed that economic recovery will be sustainable only when effective vaccines for COVID-19 become widely available. There are some positive signs now that vaccination has already started in some countries, and reports suggest that Hong Kong may receive a first batch in early 2021. At the same time, many jurisdictions, including Hong Kong, have also seen another upsurge in the number of infections towards the end of 2020, which has led to the re-imposition of stricter social distancing measures and more restrictions on the operation of some businesses.

With an economic outlook that continues to be uncertain for the time being, businesses have been delaying hiring and some have even been downsizing their operations for long-term survival.

Nevertheless, it is imperative for Hong Kong to remain competitive while awaiting a more sustainable economic recovery in the global market place. We propose the following measures to maintain economic momentum:

- **Measure 1: Continue to support job creation in both the public and private sectors**
- **Measure 2: Employment-related financial assistance**
- **Measure 3: Career transition assistance**
- **Measure 4: Targeted relief measures**
- **Measure 5: Maintaining Hong Kong as an international commercial centre**

Measure 1: Continue to support job creation in both the public and private sectors

The government should continue to support job creation to help the economic recovery from the pandemic.

The record high unemployment rate

The government allocated HK$81 billion[2] in two rounds of job retention subsidies under the Employment Support Scheme (ESS). However, the effect of the ESS does not appear to be

[2] Government to launch series of job retention and job creation measures to alleviate worsening unemployment: https://www.info.gov.hk/gia/general/202004/20/P2020042000538.htm

long lasting, and Hong Kong experienced a record high unemployment rate in Q3 2020.

The Census and Statistics Department indicated that the unemployment rate has reached 6.4% as at September 2020, which is the highest in nearly 16 years. The underemployment rate has also reached 3.8%,[3] the highest in 17 years, and 0.3% higher than the post-SARS period. Underemployment is concentrated in the catering, transport, insurance and education sectors. The announcement in October 2020 by Cathay Pacific of the axing of 8,500 posts, of which 5,300 staff were made redundant in Hong Kong,[4] also demonstrates that there is still far to go before a broad economic recovery begins. More companies may make a similar commercial decision to restructure in order to maintain their long-term competitiveness.

Creating jobs for fresh graduates

The rising unemployment rate in Q2 and Q3 2020 may be attributed in part to new university graduates entering the workforce in May/June. With the reduction in the appetite for hiring, the openings in the market are not sufficient to absorb the majority of the graduate population. Unemployment may further increase when the 2021 cohort of students graduates.

Since April 2020, the government has earmarked $6.6 billion to create around 30,000 short-term jobs in the public and private sectors in the coming two years for people of different skills and academic qualifications.[5&6]

The Home Affairs Bureau has been subsidising non-governmental organisations to organise internship activities in the Mainland for young people from Hong Kong. In particular, being one of the major cooperation initiatives between Hong Kong and Guangdong, the Guangdong-Hong Kong-Macau Greater Bay Area (GBA) Hong Kong Youth Internship Scheme has been expanded to cover all the Mainland cities in the GBA since 2019. Around 950 young people have taken up internship placements in GBA.[7]

In the 2020 Policy Address, the Chief Executive reiterated that the government would keep hiring replacements of civil servants due to attrition (mainly related to retirement) even though the government will freeze the overall headcount of the civil service establishment in 2021/22. The average attrition rate for the past few years has been about 7,000 to 8,000 civil servants per year.[8]

The introduction of short-term internships, in both Hong Kong and other Mainland cities in the GBA, may be an efficient way for 2020 graduates still seeking employment to gain work experience during the economic downturn.

The government should provide more support to universities launching career support programmes to help match graduates with employers.

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[3] https://www.censtatd.gov.hk/hkstat/sub/sp200_tc.jsp?productCode=D5250021
[4] Cathay axes record 5,300 Hong Kong jobs and closes regional airline in HK$2.2 billion survival plan, South China Morning Post, https://www.scmp.com/news/hong-kong/politics/article/3106365/cathay-pacific-eliminate-8500-job-posts-hk22-billion
[5] https://www.info.gov.hk/gia/general/202004/20/P2020042000538.htm
[6] https://www.info.gov.hk/gia/general/202011/26/P2020112600630.htm
[7] https://www.info.gov.hk/gia/general/202011/18/P2020111800294.htm
[8] https://www.info.gov.hk/gia/general/202011/26/P2020112600630.htm

Accelerating scheduled infrastructure/construction projects

Employment in the construction sector has also been badly affected by the pandemic, with the unemployment rate hovering at 10.9% and underemployment at 8.3% in the period July-September 2020. **The government should consider accelerating scheduled infrastructure/construction projects**, e.g. flood prevention and drainage improvement, highway/tunnel improvement, redevelopment of aged buildings, etc., to create jobs. This should have a neutral impact on government spending overall, as the money has already been allocated to these projects.

Further public discussion and consultation should still take place on proposed new mega-infrastructure projects to build consensus in the community on the way ahead.

Measure 2: Employment-related financial assistance

The government should extend the salary subsidy to employers hiring graduates in selected industries. Meanwhile employees' protection under the Protection of Wages on Insolvency Fund (PWIF) should also be enhanced.[9]

Extending the salary subsidy to employers hiring graduates in selected industries

In addition to new graduates, young professionals who have just completed professional training or are waiting to attend professional assessment examinations are also facing difficulties in finding jobs. The government has provided salary subsidies to employers who hire graduates and assistant professionals in the engineering, architectural, surveying, town planning and landscape sectors.[10] There are two types of subsidies:

1) Training Subsidy for Graduates (Architectural, Surveying, Town Planning and Landscape Sectors) - $5,610 per month per employed graduate
2) Training Subsidy for Assistant Professionals (Engineering, Architectural, Surveying, Town Planning and Landscape Sectors) - $10,000 per month per employed graduate

The government should consider extending the application deadline, which closed on 30 November 2020, and the scope of its existing support scheme to cover other business sectors, e.g., fintech.

Enhancing employees' protection under Protection of Wages on Insolvency Fund (PWIF)

The government should review certain claim ceilings under the PWIF.

The impact of COVID-19 is expected to result in many businesses failing and an associated increase in the numbers of unemployed. Businesses insolvent at the time of their closure would not be able to pay salaries in arrears and severance payments to former employees. In these circumstances, former employees may look to the PWIF for payment of their outstanding entitlements.

The PWIF was set up to provide timely relief in the form of ex-gratia payments, subject to certain ceilings, to employees in the event of business closures of their insolvent employers.

[9] https://www.labour.gov.hk/eng/erb/content4.htm
[10] https://www.devb.gov.hk/en/issues_in_focus/support_easpl/index.html

The claim ceilings for arrears of wages and wages in lieu of notice, in particular, have not been reviewed for over 20 years. The government should review these claim ceilings to ensure that they are in line with the current income levels of the workforce and cost of living in Hong Kong.

<u>Measure 3: Career transition assistance</u>

The government should provide online training programmes for selected industries to help the unemployed to develop their skill sets.

The provision of financial assistance is a way to provide relief to the unemployed. However, ensuring the skill sets of the unemployed are up-to-date and relevant to the demands of the market is equally important. Since Q4 2019, the Employees Retraining Board has launched two rounds of the ***"***Love Upgrading Special Scheme***"***[11] *(LU Special Scheme)*. The scheme provides free training courses and special monthly allowances to those between jobs. It supports the unemployed and underemployed with short-term transitional cash subsidies and helps them to upgrade their skill sets with the aim of helping them get back into the job market. **The training period of the scheme will end on 31 March 2021. The government should consider extending the training period.**

In addition, as businesses are becoming more reliant on technology, it is important for workers to be sufficiently trained in the use of these technologies. **The provision of free online training programmes for selected industries can help the unemployed to improve their skills in order to find new roles.**

<u>Measure 4: Targeted relief measures</u>

The government should ensure that any future economic relief measures are targeted as far as possible to maximize the benefits while minimizing the burden on public finances. We suggest measures across five areas.

<u>Providing domestic consumption subsidies</u>

Consumer spending typically has a multiplying effect on the economy. If people are not spending, it is difficult for the economy to recover. In the first two rounds of government support through the Anti-epidemic Fund, subsidies were mainly given to business owners. We suggest future rounds should target private consumers to support the recovery.

Different jurisdictions have used cash vouchers or consumer subsidy schemes instead of direct cash subsidies to business owners to incentivize consumers to spend. For example, the "Eat Out to Help Out Scheme"[12] in the UK is a targeted measure in which the UK government helped individuals to settle their dining bills instead of giving direct cash subsidies to the restaurants. A similar measure in Hong Kong may help the catering industries.

Taiwan's "Triple Stimulus Voucher Programme"[13] is another example. The programme allows citizens and their foreign spouses to purchase vouchers with a face value of

[11] https://www.erb.org/scheme/en/Introduction/
[12] https://www.gov.uk/government/publications/get-more-information-about-the-eat-out-to-help-out-scheme/get-more-information-about-the-eat-out-to-help-out-scheme
[13] https://3000.gov.tw/EN/#

NTD3,000 for the price of NTD1,000. The vouchers can be used generally for local spending, with a few exceptions.

Though the sums that the government can allocate to such measures are not unlimited, and businesses without sufficient reserves will eventually fail, the examples above illustrate how resources can be used to achieve a multiplying effect.

Supporting staycation, work from hotel and quarantine centres

Activity in the hotel and guesthouse sectors has been severely impacted due to the restrictions on international travel since February 2020. Many hotels and guesthouses are now providing different packages to local guests to generate demand. These include:

- Offers where property conversion or additional investment are required:

    - Long-term stay at affordable rates. The long-term stay packages offered by guesthouses appear popular among people living in the subdivided housing. Yet, guesthouses may need to undergo some conversions or upgrades to make the property fit for long-term stays.
    - Provision of co-working spaces and work from hotel offers. WFH is common these days. However, as the size of the flats in Hong Kong tends to be small, some homes may not be fit for work purposes, e.g., people who need to conduct a lot of virtual meetings in noisy homes. Some hotels have expanded their business centres to provide isolated hot desks for users, while others even allow for day-use of their guest rooms at discounted rates for work purposes. Hotels may need to improve their internet connection bandwidth and provide computer peripherals to guests taking advantage of these day-use offers.

- Offers where investment is not required:

    - Staycations. Many hotels are offering staycation packages to their guests. This helps boost the occupancy rate and catering income and supports employment.
    - Quarantine centres. Some hotels are offering quarantine packages to those who are required to undergo compulsory quarantine upon arrival in Hong Kong.

For those offers where conversion or investment is required, the government can consider offering a super tax deduction on the qualifying expenditure. Combining this with the tax loss carry-back proposal measure (discussed below), hotels or guesthouses may be eligible for tax refunds. This would help ease their cash flow pressures.

If the government were to introduce a consumer voucher scheme covering hotels and guesthouses, demand may increase. Of course it will be essential that hotels and guesthouses maintain the highest hygiene standards in order to minimize the chance of any cases of COVID-19 resulting in further temporary shutdowns.

Increasing the subsidies on residential electricity spending

The consumption of residential electricity for many has increased this year due to WFH arrangements and the government implementing rules on social distancing measures.

The government's current electricity charges subsidy scheme has paid a subsidy of $160 for each residential electricity account from January 2020 to November 2020, and $240 in December.[14] **Consideration should be given to extending the subsidies on electricity consumption for another six months.**

Offering additional allowances to social security recipients

The interests of social security recipients should not be forgotten. The government should consider making double payments to recipients, as in previous years.

Measure 5: Maintaining Hong Kong as an international commercial centre

Measures should be introduced to support Hong Kong's position as an international commercial centre by promoting Hong Kong's image and status as an international finance and trading hub.

In the Economic Freedom of the World 2020 Annual Report[15] issued by the Fraser Institute, Hong Kong was again ranked as the freest economy in the world. However, the report was based on 2018 data and the government should work to ensure Hong Kong maintains its position by reaffirming its commitment to the legal system underpinning this freedom.

In addition to the domestic issues facing Hong Kong, the trade war between China and the United States is having a negative impact on Hong Kong. While there have been benefits for the Hong Kong stock market due to some Mainland companies choosing to list on the Hong Kong Stock Exchange rather than in the US, or to apply for a secondary listing in Hong Kong, as mentioned above, other areas of the economy have suffered. These include shipping, where a reciprocal tax agreement between the US and Hong Kong has been cancelled, and the new requirement for Hong Kong manufactured goods to be labelled, "Made in China" rather than "Made in Hong Kong", as previously.

[14] Electricity relief details announced: https://www.news.gov.hk/eng/2020/04/20200421/20200421_141104_732.html
[15] https://www.fraserinstitute.org/sites/default/files/economic-freedom-of-the-world-2020.pdf

II. ***Adapting to the new normal through more extensive digital transformation***

Being able to work remotely has proven to be critical to the survival of many businesses in 2020. Big data, mobility, internet security and robotic process automation (RPA) are key areas of IT development and advancement. WFH is indeed a specific form of agility and an illustration on how important IT is for success in this internet era.

Hong Kong's existing Smart City initiative is a combination of said IT initiatives. Yet, good coverage of high speed internet connections is a critical success factor to the implementation of almost all IT initiatives mentioned above.

We propose the following measures to support Hong Kong's digital transformation:

- **Measure 6: Facilitating digital transformation**
- **Measure 7: Cybersecurity**
- **Measure 8: Subsidies to needy students**

Measure 6: Facilitating digital transformation

The government should support Hong Kong's digital transformation through improving internet connectivity, supporting the digitalization of SMEs, and improving its own e-service offering.

Pursuing seamless internet connectivity

(a) To improve internet and mobile coverage

Broadband internet access has become an integral part of life worldwide. 27 facility-based operators and 224 services-based operators are authorized to provide broadband internet access services in Hong Kong. With the continuous network roll-out of facility-based operators, Hong Kong enjoys near ubiquitous coverage by broadband networks through the deployment of various technologies, including around 80% of fixed broadband subscriptions for service plans having a speed of 100 Mbps or above.[16] In general, Hong Kong's internet coverage and connectivity are considered to be world class.

However, internet coverage in some rural and mountainous areas can be poor. Installing fixed line internet connections may not be cost effective due to low population densities. Extending the mobile network may be a workable alternative to eliminate blind spots. This would enable people living in the less accessible areas to WFH effectively. It may also incentivize others to move away from urban areas, reducing the pressure on public transportation and lowering roadside emissions.

(b) To continue supporting the development of 5G infrastructure

Development of Hong Kong's 5G infrastructure is critical to securing the benefits of this new technology. 5G will fully enable Internet of Things technologies and open new possibilities for artificial intelligence and machine learning, among many others.

[16] Community Authority 2018-19 Annual Report: https://www.legco.gov.hk/yr19-20/english/counmtg/papers/cm20191211-sp069-e.pdf

5G services launched in Hong Kong on 1 April 2020. The government's support for the deployment of 5G infrastructure is essential for the healthy development of the 5G ecosystem in Hong Kong. The Subsidy Scheme for Encouraging Early Deployment of 5G[17] (the 5G scheme) introduced under the second round of the Anti-epidemic Fund, subsidizes up to 100 approved projects for 50% of the cost directly relevant to the deployment of 5G technology, subject to a cap of $500,000. However, only 16 projects were approved from May to September 2020. **To encourage businesses to deploy 5G, the government should speed up the review and approval process for the 5G Scheme and extend the lifespan of the 5G Scheme until the 5G usage has become more popular in Hong Kong.**

(c) To improve internet connectivity in the free hotspots in government establishments

Free Wi-Fi services are provided at over 30,000 Wi-Fi hotspots spread across all 18 districts through "Wi-Fi.HK", which was established by the government and a number of public and private organizations in 2014.[18]

These Wi-Fi hotspots are located in various government premises, including public libraries, public enquiry service centres, sports centres, cultural and recreational centres, cooked food markets and centres, job centres, community halls, major parks and government buildings and offices. However, many people have experienced connectivity problems, i.e., low connection speed and service disconnection, when using the hotspots. **The government should consider improving the service to improve the user experience.**

Supporting SMEs' digital transformation

Due to the outbreak of COVID-19, many businesses have had to rely on virtual workplaces to minimize the impact on their operations. One positive consequence of this is that it has accelerated the digital transformation of businesses.

For small and medium-sized enterprises (SMEs), new technologies can help to optimize their operational processes and reduce operating costs. It is expected that SMEs will increasingly undergo digital transformation in the coming years.

While the benefits are clear, the costs of revamping IT and digital infrastructure can be high. SMEs lag behind large business groups on digitalization, due to the cost and their lack of resources for addressing cybersecurity risks. SMEs are among the worst hit by the pandemic as they tend to rely heavily on a small number of suppliers and customers, and may not have the cash reserves and funding support to weather the downturn. Although there are a number of subscription services providing "Infrastructure as a Service" and "Software as a Service", which include multiple digital solutions, SMEs may still find these solutions too costly.

In view of the above, **the Innovation and Technology Bureau (ITB) should take the lead in developing a public cloud infrastructure for SMEs to have affordable and secure virtual work environments.**

[17] https://www.ofca.gov.hk/en/industry_focus/telecommunications/5g_subsidy/index.html
[18] https://wi-fi.hk/en

To upgrade the existing e-government services

The government has emphasized in its Smart City Blueprint for Hong Kong[19], published in February 2020, its intention to use technology in the delivery of both information and services. Currently, over 200 e-government services are provided through GovHK.[20] However, **the experience during the pandemic has proven that the e-government services should be upgraded. For example by:**

- **Providing a much broader scope of user-friendly and responsive public services digitally**
- **Providing electronic payments and digital signature options for more government services**

Measure 7: Cybersecurity

WFH is part of the new normal. However, this creates a reliance on secured connections to servers in offices or the cloud to access confidential information. These connections are vulnerable to malicious cyberattacks. SMEs may have installed basic security software but the security level may be very low and easily penetrable.

Building a robust cyber security system could be too costly for SMEs and the fact that they are not widely aware of the risks that cyberattacks could bring is concerning. In view of this, **it is worthwhile for the government to consider the following measures**:

- **Strengthening education to the business community and SMEs in particular on good cybersecurity practices**
- **Promoting the usage of existing public resources currently available to SMEs, e.g. the Cyber Security Information Portal**[21]
- **Assisting SMEs in the implementation of cybersecurity solutions**

Measure 8: Subsidies for needy students

A decent internet connection and access to computer hardware are essential for online learning. When the city was partially locked down from February to September 2020, pupils and students were not required to attend schools and they relied heavily on online classes to continue learning. However, the cost of internet subscription and computer hardware may be prohibitive for underprivileged families.

To support needy families, the Student Finance Office of the Working Family and Student Financial Assistance Agency and the Social Welfare Department have been disbursing subsidies under the Subsidy Scheme for Internet Access Charges[22] (SIA) to eligible families since the 2010/11 school year.

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[19] https://www.smartcity.gov.hk/
[20] https://www.smartcity.gov.hk/develop_plans/government/
[21] https://www.gov.hk/en/business/ecommerce/infosec/index.htm
[22] https://www.wfsfaa.gov.hk/sfo/en/primarysecondary/yjd/other/sia.htm

The rate of the SIA is adjusted regularly with reference to prevailing market rates of internet access services. **The government should continue this scheme and ensure that the subsidy can cover the cost of basic internet plans**.

Even after students have returned to classes, access to computer hardware remains vital. It is increasingly common for primary and secondary schools to ask students to use computers or tablets in their ordinary classroom teaching. The cost of computers or tablets may be a significant financial burden for underprivileged families.

The Education Bureau launched a subsidy scheme for primary and secondary students, in the 2018/19 school year, to support their purchases of mobile computer devices to facilitate the practice of e-learning[23], which will run for three years.

In view of the increased reliance on online classes, the government should consider extending the scheme for one more year and expanding its coverage to university students and also including internet expenses.

To streamline the application process, the government should consider allowing qualifying students to apply directly to the Education Bureau (instead of applying through the schools) for the subsidies.

Further measures in relation to digital transformation will be outlined in the latter part of these proposals.

[23] https://www.edb.gov.hk/en/edu-system/primary-secondary/applicable-to-primary-secondary/it-in-edu/ite-ccf/ccf_index.html

III. Public finance and taxation

The government's spending on the Anti-epidemic Fund and other measures and the fact that less tax revenue is anticipated for the 2020/21 financial year due to the economic downturn have both contributed to an expected record high budget deficit of HK$300 billion for 2020/21. It is projected that the fiscal reserves will drop to HK$800 billion by 31 March 2021, which is equivalent to about 13 months of government expenditure.

The narrow revenue base of Hong Kong has contributed to the quick depletion of fiscal reserves. Currently, profits tax, salaries tax, stamp duty and land premium contributed most of the recurring income of the government. These income sources are highly sensitive to the economic cycle.

On the expense side of the budget, education, health services and social welfare account for most of the government's expenditure. An ageing population and increasing dependency ratio are problems facing Hong Kong and will likely lead to increases in the government's medical and social welfare expenses.

There is also a pressing need to review the Inland Revenue Ordinance (IRO) and tax system in light of significant changes in the international tax landscape. Currently, the government is facing the challenge of trying to align the local tax system with new and developing international tax rules.

We propose the following measures to ensure that Hong Kong's public finances and taxation system are prepared for the recovery:

- **Measure 9: Review the public finance revenue model**
- **Measure 10: Undertake a comprehensive review of the Hong Kong tax system**
- **Measure 11: Expedite treaty negotiations with major trading partners**
- **Measure 12: Introduce unilateral tax credit for foreign taxes paid in non-treaty jurisdictions**
- **Measure 13: Promote Hong Kong as an intellectual property hub**
- **Measure 14: Enhance tax certainty**
- **Measure 15: Rationalize personal allowances**
- **Measure 16: Tax measures to support remote learning & working**
- **Measure 17: Other tax-related support measures**

Measure 9: Review the public finance revenue model

The government should review the public finance revenue model with a view to overcoming the problems associated with the narrow tax base in Hong Kong, addressing the longer-term public finance challenges and avoiding an ongoing structural deficit.

This review is not only driven by domestic concerns. There is also an international aspect. The low tax rates of Hong Kong have made the territory very competitive in attracting investments in the past. However, many other developed countries have reduced their income tax rates and shifted their reliance from direct to indirect taxes. Since Hong Kong currently has limited revenue from indirect taxes, there is a limited room for further reduction of direct tax rates to remain competitive. In any case, Hong Kong has little room to reduce its profits tax rate further in the light of international developments. In particular, Pillar 2 of the Organization for Economic Cooperation and Development (OECD)'s Base Erosion and Profit Shifting (BEPS) 2.0 proposal will require a minimum tax rate to be imposed in each jurisdiction in which multinational enterprises operate.

As a reduction of effective tax rates is not possible, the government should consider introducing new types of broad-based taxes. There is never a good time to introduce new taxes, yet it takes time to conduct a feasibility study, draft legislation and build the related taxation infrastructure, as well as community support, before the formal introduction of new taxes. Therefore, if the government were to start with the feasibility study now, the new taxes could be introduced when the economy has recovered.

Measure 10: Undertake a comprehensive review of the Hong Kong tax system

In response to the changes in international tax rules initiated by the OECD and the European Union (EU), as well as the changes in business models, many jurisdictions have been undergoing tax reforms or updating their tax laws. US tax reform, the introduction of digital services taxes in the UK, France and other jurisdictions, and diverted profits tax in Australia and the UK, have been undertaken in order to make tax systems more competitive, efficient and equitable, and to align with the changing international business and tax environment.

The Hong Kong tax system is based on the IRO which was first written in 1947. The last major review was undertaken decades ago. In response to recent significant changes in the international tax landscape, the IRO has been amended in a piecemeal manner, for example introducing extensive provisions on exchange of information and transfer pricing. Therefore, a holistic review of the tax system is recommended to bring the system up to date and ensure it is fit for purpose. The review should cover:

- BEPS 2.0 readiness
- Exploring the possibilities of introducing re-domiciliation rules in the Companies Ordinance
- Hong Kong's preferential tax regimes

BEPS 2.0 readiness

Under the OECD's latest initiative, BEPS 2.0, new tax rules have been proposed in respect of two key aspects:

- Pillar One: Amending the rules for allocating taxing rights over the profits from multinational consumer-facing businesses and automated digital services, giving greater taxing rights to market jurisdictions. In addition, creating new nexus rules where these businesses have a significant economic presence in a jurisdiction.
- Pillar Two: Giving the parent and source jurisdictions a right to tax untaxed/undertaxed income where an entity's income is taxed at an effective rate below a certain minimum rate. Known as the Global Anti-Base Erosion rules (GloBE), they seek to ensure that multinational enterprises (MNEs) pay a minimum level of tax on a global basis and dissuade them form shifting profits to low tax jurisdictions.

International agreement on these proposals is expected to be reached by mid-2021.

The GloBE proposal will significantly impact large MNEs, and consequently the attractiveness of Hong Kong's tax system:

- A company's income that is not subject to tax at an effective tax rate (ETR) equal to or higher than a certain agreed minimum rate in a jurisdiction, may be subject to "top-up tax" in the jurisdiction of its ultimate parent entity.
- While the minimum rate under GloBE has yet to be determined, it is expected to be at least 10%.
- This could have a significant impact on attractiveness of Hong Kong's territorial tax regime, various existing concessionary tax regimes and the capital gains exemption.

In June 2020, the government set up its own advisory panel on the initiative, which will review the possible impact of BEPS 2.0 on the competitiveness of Hong Kong's business environment, and advise the Financial Secretary on strategies and measures to facilitate the sustainable development of Hong Kong as an international financial, trading and business centre. The government has also reached out to different stakeholders to collect views on how implementation of BEPS 2.0 would impact their business operations and structures going forward. The Institute welcomes these actions. The government's action plans in response to BEPS 2.0 should take into account the following:

- Minimizing the impact of the GloBE proposal on Hong Kong's businesses and preserving the current competitiveness of Hong Kong's tax system by proactively lobbying the OECD. The lobbying should be in defence of Hong Kong's tax regimes/treatments (e.g. offshore regime, capital gain exemption and various existing concessionary tax regimes) as being "non-harmful" and excluded from the application of the GloBE rules.
- Where possible, working in partnership with Asian jurisdictions sharing common interests, e.g. Macau and Malaysia, to develop coordinated responses to the OECD.
- Preventing the loss of taxing rights and tax leakage by implementing an "alternative minimum tax" under the domestic tax law that mirrors the tax base and rate of GloBE. Such a "domestic alternative minimum tax" has been advocated by stakeholders and tax professionals as a defensive measure. The aim would be to ensure that multinational enterprises' jurisdictional ETRs are at least equal to the agreed minimum rate, and to prevent the application of GloBE rules in such a way as to allow other jurisdictions to collect the tax differential on business conducted in or from Hong Kong, in this case. It appears that the OECD does not find such defensive measures problematic.

Exploring the possibilities of introducing re-domiciliation rules in the Companies Ordinance

MNEs are reviewing the impact that implementation of BEPS 2.0 may have on their operations. Though many MNEs are taking a "wait and see" approach, preparing to take actions only once the detailed rules of BEPS 2.0 are finalized, many are also considering cross-border group restructuring to lower their overall ETRs.

Hong Kong, being a relatively low tax jurisdiction, could be an attractive jurisdiction for MNEs in which to relocate their relatively mobile group activities, and “economic substance”. However, at present the Hong Kong Companies Ordinance does not make provision for foreign companies to re-domicile to Hong Kong. While there were discussions on the possible introduction of re-domiciliation rules into the Companies Ordinance in 2019, when certain offshore jurisdictions, e.g. BVI, Cayman Islands and Bermuda, introduced economic substance laws, in response to the OECD’s “substantial activities” requirements, this was not a policy priority of the government. As BEPS 2.0 will likely have a bigger impact on Hong Kong compared to the economic substance laws, the government should reconsider the proposal to introduce re-domiciliation rules into the Companies Ordinance as a policy priority.

Review of Hong Kong’s preferential tax regimes

The government has introduced a range of preferential tax regimes over the years to maintain Hong Kong’s competitiveness. The ring-fencing features of some of these preferential tax regimes in their original form had drawn the attention and concern of the OECD and EU.

To address the concerns, the government has reviewed some of the preferential regimes, e.g. the corporate treasury centre, professional reinsurance, captive insurance and offshore funds regimes, and legislated changes to remove the ring fencing features of these regimes. According to the OECD 2018 progress report on BEPS Action 5[24] and the 2019 harmful tax practices peer review,[25] the following preferential tax regimes were regarded as not harmful:

- Profits tax concession for corporate treasury centres
- Profits tax concessions for aircraft lessors and aircraft leasing managers
- Profits tax concession for professional reinsurers
- Profits tax concession for captive insurers
- Profits tax exemptions for ship operators

While the results of these reviews are important for Hong Kong, there has not been a review of the effectiveness of these tax incentives. It is questionable whether certain tax incentives, e.g. tax incentive offered to Islamic financing arrangements, serve their intended purposes effectively. Therefore, the government should conduct a review on the effectiveness of the preferential tax regimes taking into account the following points:

- Whether the extensive, specific anti-avoidance provisions accompanying new incentives are too aggressive and make it overly burdensome for taxpayers to use the preferential tax regimes.
- How attractive and user-friendly the preferential tax regimes are compared to competing jurisdictions where similar preferential tax regimes are also in place and may have been so for some time.

[24] http://www.oecd.org/ctp/harmful-tax-practices-2018-progress-report-on-preferential-regimes-9789264311480-en.htm
[25] https://www.oecd.org/tax/beps/harmful-tax-practices-peer-review-results-on-preferential-regimes.pdf

Measure 11: Expedite treaty negotiations with major trading partners

The government has been making efforts in expanding Hong Kong's tax treaty network in recent years. Currently, 45 comprehensive avoidance of double taxation agreements (CDTA) have been signed. However, the number of CDTAs in place is still far below that in other major jurisdictions (e.g. the number of CDTA concluded in Mainland China, United Kingdom, Japan and Singapore are all above 90).

The government should maintain the momentum on treaty negotiations to expand the treaty network, particularly with its major trading partners.

Measure 12: Introduce unilateral tax credit for foreign taxes paid in non-treaty jurisdictions

Under the existing Hong Kong tax practice, taxpayers in Hong Kong can claim tax credits on foreign tax paid in relation to passive and service income, e.g., interest and royalty in jurisdictions that have CDTAs with Hong Kong. However, this tax credit relief mechanism does not apply to those tax payments made to non-CDTA jurisdictions. More problematically, these tax payments are not acceptable tax deductible expenses for profits tax purposes.

Overseas investors that intend to set up their regional operational hubs in Hong Kong suffer from this narrow foreign tax relief mechanism. Without a unilateral tax credit mechanism, companies receiving substantial amounts of royalties or service fees from non-CDTA jurisdictions face double taxation and high tax costs. This discourages the development of Hong Kong as an intellectual property (IP) hub (see below). Therefore, the government should consider introducing a unilateral tax credit mechanism to ensure the competitiveness and fairness of the tax system.

Measure 13: Promote Hong Kong as an intellectual property hub

Tax measures have been introduced with the aim of making Hong Kong a research and development (R&D) and IP hub. For instance, the Inland Revenue (Amendment) (No. 7) Ordinance 2018 provides an enhanced tax deduction of 300% for the first HK$2 million and 200% for the remaining amount of qualifying R&D expenditure incurred. The Inland Revenue (Amendment) (No. 5) Ordinance 2018 was enacted to include three additional types of IP rights in the IP deduction regime. Yet, these rules remain complex with many restrictions. Some of the anti-avoidance rules also hinder genuine restructuring and mergers and acquisitions from taking place in a tax efficient manner.

Furthermore, the existing IP taxation regime (with only eight types of IP rights in scope) is insufficient to cover certain important "intangible assets" (required to be recognized as such based on prevailing accounting standards) of many businesses in the modern economy. For instance, certain "blackhole expenditure", such as upfront lump-sum franchise or licence fees, spectrum utilization fees (SUF) and payments for indefeasible rights of use (IRU), which the Inland Revenue Department (IRD) treats as capital in nature, cannot be claimed as deductible by taxpayers without any specific provisions in the IRO allowing such deduction. Notwithstanding the unavailability of a tax deduction, the revenue connected with such expenditures remains taxable, resulting in unreasonably high tax burden for certain taxpayers, as they are essentially taxed on a gross revenue basis.

Besides, certain types of cross-border revenue from the exploitation of IP (e.g. royalties) may attract overseas withholding tax, resulting in double taxation if no CDTA exists between Hong Kong and that jurisdiction.

To alleviate the hardships faced by such taxpayers and to help make Hong Kong a true IP hub, the government should consider reviewing and revising the tax rules to cater for the following:

- Modify the enhanced R&D tax deduction rules, based on an thorough understanding of the commercial constraints of businesses engaged in R&D activities, which are unable to enjoy the deduction (normal or enhanced), and consider the possibility of R&D tax credits for start-up businesses.
- Relax certain anti-avoidance provisions under the IP deduction rules to allow genuine commercial transactions to enjoy the benefits.
- Expand the scope of tax deduction on expenditure in relation to certain "intangible assets", e.g. upfront lump-sum payments made for acquiring a licence or franchise, SUF and IRU.
- Offer unilateral tax credits for overseas withholding tax paid on royalties by Hong Kong companies.

Measure 14: Enhance tax certainty

Taxpayers and potential investors want to see certainty in their tax positions and clarity in the tax system. Under the current Hong Kong tax legislation, the limitation period for tax cases is six years after the relevant year of assessment, which can be extended to 10 years in the case of fraud or wilful evasion of taxes.

It is not uncommon for it to take more than six years for taxpayers to settle field audit and tax investigation cases with the IRD. Taxpayers are therefore required to retain documents for many years to corroborate their cases. The inability to provide supporting evidence can also be due to change of employees or business owners. Taxpayers may therefore be disadvantaged. If the limitation period were to be reduced to three years after the end of the years of assessment, and the IRD's review process were accelerated, taxpayers and investors would have more certainty to support their plans for their future development and reduce their compliance costs. Shortening the limitation period would also help speed up collection of tax underpaid in field audit and tax investigation cases.

The government should also consider revising the tax law to give statements of loss the same status as notices of assessment. Currently, if warranted, the IRD has the right to deny the tax losses stated in the statements of loss when they issue notices of assessment in future years, which could be decades later. Therefore, strictly speaking, a statement of loss is not a confirmation of tax loss agreed by the IRD. The uncertainty about the availability of tax losses is detrimental to business planning.

Measure 15: Rationalize personal allowances

The basic salaries tax personal allowances should be increased at least in line with inflation. This can help put additional money in consumers' pockets.

The government should rationalize the allowance for dependants. Pending a review, we propose that these allowances should all be increased in line with inflation.

The allowances for children and other dependants have been revised at various times, with different levels of increases for each. For example, since 2018/19 while allowances and additional allowances for dependent parents and grandparents were increased by around 8.5%, child allowances were increased by 20%. The basis for these adjustments should be made more transparent. The level of the existing allowances for single and married persons, children, dependent parents or grandparents, dependent siblings, single parents and disabled dependants should be reviewed and rationalized.

Thereafter, any adjustments should be made on a more transparent and consistent basis, where appropriate. Where there are sound policy, or other, reasons for differential adjustments, these should also be made clear.

Measure 16: Tax measures to support remote learning & working

The government should consider allowing tax deductions for remote learning and working expenses (e.g. hardware and internet subscription costs) for a limited period of time.

This year, many taxpayers have had to spend more on buying mobile devices, computer hardware and peripherals to set up their home office and facilitate their children's online classes. Taxpayers may also need to upgrade their home internet connection so that family members can work or study effectively at the same time.

The existing deduction rules for personal expenses under salaries tax are very stringent and therefore, it is unlikely that taxpayers can successfully make deduction claims on these expenses against their employment income for salaries tax purposes. To this end, the government should consider allowing deductions for a limited period of time (in order to protect government revenue). We recommend for the years of assessment 2020/21 and 2021/22:

- Allowing tax deduction for expenses incurred for purchasing mobile or computer devices and peripherals and internet subscription for self-usage, subject to a ceiling of HK$10,000.
- Introducing a concessionary deduction on purchasing mobile or computer devices for full-time students supported by the taxpayers for online learning purposes where the taxpayers are claiming child or dependent allowances, subject to a claim ceiling of HK$5,000 per student.

Measure 17: Other tax-related support measures

The government should introduce other tax-related support for individuals and businesses.

Extending the tax payment deadlines

The government should consider extending the 2019/20 and 2020/21 tax payment deadlines for salaries tax, personal assessment and profits tax for three months, for both instalments.

Both business and individual taxpayers are facing a difficult time due to COVID-19 and may encounter difficulties in settling their tax bills on time. Businesses are struggling to stay afloat amidst the major economic downturn. Some individuals have been unemployed or underemployed for over six months, while others are required to take no pay leave. An extension of the payment deadline would provide more time for the economic recovery to take hold, and personal financial situations to improve.

If taxpayers still have difficulties in settling their tax payments by the extended due dates, they may apply for payment of tax by instalments. For qualifying cases, we recommend that no surcharge should be imposed for a maximum period of one year from the due dates.

Middle class households

Due to the long-lasting effect of COVID-19, some in the middle class may face layoffs or pay cuts.

To help relieve the heavy financial burden on the middle class, the government should consider the following measures:

- Maintaining the tax rebate policy in 2020/21 and increasing the rebate ceiling from HK$20,000 to HK$30,000.
- Introducing home rental deduction for rental payments made by taxpayers on their primary residence, with a ceiling of HK$100,000/year.

Businesses

- ***To introduce a 200% super deduction for landlords on rent waived***

  The government should share the burden with landlords who offer rental concessions by giving 200% special deduction on rent forgiven during 2020/21 and 2021/22. This super deduction would in effect result in the government sharing 33% of the cost of rent waived (i.e., 16.5% X 2 = 33%).

  In Hong Kong, rent represents a major expense item for retailers, a sector hit hard by COVID-19. Many retailers have closed down physical stores and moved their front lines to online sales. The store vacancy rate in shopping malls will increase if this trend continues. Some landlords, including the government, which provided 75% rental concessions for tenants and hirers of government premises from April 2020 to September 2020[26], have already offered reductions to tenants.

[26] Gov't tenants get larger rent cut: https://www.news.gov.hk/eng/2020/04/20200408/20200408_194318_191.html

- ***To introduce tax loss carryback in the profits tax regime***

  The government should allow tax loss to be carried backward for the year of assessment (YA) 2020/21 as an effective mean of helping businesses handle cash flow problems.

  Temporary tax loss carried backward has been offered in other jurisdictions such as Singapore, which introduced the Loss Carry-back Relief in 2006[27]. The relief allows taxpayers to carry back the current year unutilized capital allowances (CAs) and trading losses for one year. The scheme was subsequently enhanced and businesses may elect to carry-back unutilized CAs and trading losses from YA 2020 up to three YAs immediately preceding YA 2020 (i.e. YA 2017, YA 2018 and YA 2019).

  Similarly, in view of COVID-19, the US government is allowing businesses to carry back net operating losses arising in 2018, 2019 and 2020 for 5 years and provides cash refunds to taxpayers[28].

[27] https://www.iras.gov.sg/irashome/Businesses/Companies/Working-out-Corporate-Income-Taxes/Claiming-Reliefs/Loss-Carry-Back-Relief/

[28] https://home.kpmg/cn/en/home/insights/2020/04/tax-alert-4-hk-us-income-tax-relief-in-response-to-coronavirus.html

IV. *Environmental measures*

Hong Kong's recovery from the pandemic represents an opportunity to improve the local environment. With increasing worldwide concern about environmental degradation and climate change, sustainability and eco-friendly activities are increasingly important considerations for society. Furthermore, following the recent publication of the Council for Sustainable Development in Hong Kong's Report on the Public Engagement on Long-term Decarbonisation Strategy, we note the Chief Executive's announcement in the Policy Address that Hong Kong will strive to achieve carbon neutrality before 2050.

We propose that the government consider the following measures to improve the local environment and the citizens' well-being:

- **Measure 18: Facilitate the distribution of second hand computers to needy students**
- **Measure 19: Green taxes**
- **Measure 20: Incentives for replacing aged commercial vehicles**
- **Measure 21: Electric vehicles**

Measure 18: Facilitate the distribution of second hand computers to needy students

The government should make use of the Computer and Communication Products Recycling Programme[29] (CCRP) and distribute refurbished second hand computer devices to needy students.

The Environmental Protection Department, originally introduced the CCRP in 2008, which was extended in 2015. The CCRP is funded by industry to provide a means for the public to dispose of used computer equipment and communication products in an environmentally sound manner. The programme raises public awareness of the need to reduce, re-use and recycle computer and communication products. Products are collected and refurbished by a charitable organization, and the refurbished equipment is donated to the needy. Finally, a commercial recycler dismantles broken devices to recover useful parts and materials.

Measure 19: Green taxes

The government should consider introducing some tax and non-tax measures based on the "polluter pays" principle.

Tax can be used as an integral part of the government's anti-pollution and decarbonisation strategy, and to promote sustainability and conservation of resources, and encourage greener behaviour by companies and individuals.

- Suggested tax measures to consider:
  - Emission taxes
  - Tax levies based on polluting inputs
  - Credits for emission reductions
- Suggested non-tax measures to consider:
  - Public sector procurement policies

[29] https://www.wastereduction.gov.hk/en/workplace/crp_intro.htm

- A refund scheme to encourage recycling of beverage containers (plastic bottles, non-refillable glass bottles, aluminum cans, etc.)

<u>Measure 20: Incentives for replacing aged commercial vehicles</u>

The government should consider providing incentives to accelerate the replacement of aged commercial vehicles, to reduce roadside emissions and upgrade the transport fleets.

Roadside emissions from commercial vehicles are among the major contributors to air pollution. The government's approach to phasing out 82,000 pre-Euro IV diesel commercial vehicles (DCVs) including goods vehicles, light buses and non-franchised buses is a combination of incentives and regulation. Over 29,000 applications under the programme (including minibuses) received ex-gratia payment from the government, accounting for over 95% of the total Euro III-eligible DCVs[30]. However, liquefied petroleum gas (LPG) taxis and public minibuses are not within the scope of this programme.

The government limits the service life of DCVs registered on or after 1 February 2014 to 15 years. However, there is no service life limit for LPG taxis and minibuses. Other locations have mandated replacement lifespans e.g. Japan (5 years), Sydney (6.5 years), and Singapore (8 years)[31]. The government should consider doing so.

Taxis

In Hong Kong, there are over 18,000 licensed taxis[32] on the road, all of which are using LPG. However, only around 1,000 are new vehicles, and over 7,000 taxis are over 10 years old. Taxis are heavily used vehicles because they are on the road all the time, contributing 20% of the total road mileage in Hong Kong. To reduce the level of pollution, emissions-reduction catalytic converters must be installed in taxis. However, these converters wear out and need to be replaced every 12 to 18 months. If the converters are not replaced quickly, up to 10 times more pollutants, including NO_x, CO and volatile organic compounds are released.

A one-off subsidy scheme, amounting to $80 million, was launched in 2013 to assist and educate the vehicle owners about the importance of replacing the catalytic converters. However, it seems that relying on owners to replace the catalytic converters may not be an effective way to reduce roadside emissions.

If Hong Kong were to replace these 7,000 aged taxies, roadside emissions would be reduced immediately and significantly, by a quantum of 18 tonnes of hydrocarbons, 21 tonnes of NO_x, 328 tonnes of CO and 131,800 tonnes of CO_2 annually.

Public minibuses

Public minibuses are the third most popular mode of public transport in Hong Kong[33] carrying 1.8 million passengers daily. Of 4,350 licensed minibuses, 2,760 are aged 10

[30] https://www.epd.gov.hk/epd/english/environmentinhk/air/prob_solutions/Phasing_out_diesel_comm_veh.html#statistics
[31] https://www.legco.gov.hk/yr16-17/english/panels/tp/papers/tp20170317cb4-666-5-e.pdf
[32] https://www.td.gov.hk/en/transport_in_hong_kong/public_transport/taxi/index.html
[33] https://www.td.gov.hk/en/transport_in_hong_kong/public_transport/minibuses/index.html

years or above, and the pace of replacement is slow. As of February 2020, only around 400 Euro III public light buses have been replaced. The government should consider providing further subsidies or interest free loans to minibus owners to accelerate replacement of commercial vehicles.

Measure 21: Electric vehicles

The government should consider broadening the definition of electric vehicles (EVs) to include a mix of technologies, under the upcoming EV roadmap; encouraging early adoption of greener cell vehicles as a transition to 100% EVs, which will take time, and providing incentives for the replacement of pure fossil-fuel cars, particularly aged vehicles, with battery EVs (BEV), hybrids, and plug-in hybrid cars to reduce emissions.

Broadening the definition of EVs that qualify for the preferential treatments

The government has introduced various measures to promote the use of EVs, and is working on its first roadmap for popularizing EVs, which is likely to be announced in Q1 2021. Yet, the EVs only make up around 1.6% of registered private vehicles[34]. The current preferential treatment on first registration fee applies only to cars or other vehicles with motors powered purely by electricity.

In some jurisdictions, EVs also cover vehicles powered by a combination of fuel and electricity with rechargeable batteries (i.e. plug-in hybrid EVs) and those powered by fuel cells instead of batteries (i.e. fuel cell vehicles (FCVs)). For instance, Singapore and UK consider FCVs, hybrid EVs and plug-in hybrid EVs to be important types of EVs.

Commercial vehicles account for the largest share of roadside emissions. From a practical point of view, it is unlikely that commercial vehicles would switch to EVs due to the battery capacity and long-charging period. Hybrids or FCVs are more sensible and pragmatic alternatives for commercial vehicles. Replacing LPG taxis with hybrid LPG taxis would reduce fuel consumption by 50%, and emissions of CO_2 by 65% and NO_x by 89%.

Expanding the charging network

The charging station network in Hong Kong is still underdeveloped. As at the end of September 2020, there are 16,759 charging stations for EVs[35]. To expedite expansion of the EV charging station network, the government should consider:

- Specifying clearly the required provision of EV chargers and their specifications in upcoming land tender documents.
- Outlining a clear roadmap for the development of the charging station network, reflecting the distribution of each type of charging station.
- Incentivizing EV owners to invest in their own charging points near homes/offices by revising the first registration fee concessions for private EVs on a “charge first, refund later” mechanism, i.e., the first registration fee will be fully refunded upon self-installation of charging points.

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[34] Legislative Council Secretariat, Research Office’s Fact Sheet - Policies and measures on promoting the use of electric vehicles in selected places: https://www.legco.gov.hk/research-publications/english/1920fs01-policies-and-measures-on-promoting-the-use-of-electric-vehicles-in-selected-places-20200610-e.pdf
[35] https://www.epd.gov.hk/epd/english/environmentinhk/air/prob_solutions/promotion_ev.html

Appendix 1: Proposed changes for salaries tax allowances and deductions

Allowances and deductions	Existing (HK$)	Proposed (HK$)
Allowances[1]:		
- Basic	132,000	134,640
- Married person	264,000	269,280
- Child (annual, each dependant, the 1st to 9th child)	120,000	122,400
- Child (initial, each dependant, the 1st to 9th child)	120,000	122,400
- Dependent brother or sister (each dependant)	37,500	38,250
- Dependent parent/ grandparent (each dependant)		
- aged 60 or above or is eligible to claim an allowance under the government's disability allowance scheme	50,000	51,000
- aged 55 or above but below 60	25,000	25,500
- Additional dependent parent/ grandparent (each dependant)		
- aged 60 or above or is eligible to claim an allowance under the government's disability allowance scheme	50,000	51,000
- aged 55 or above but below 60	25,000	25,500
- Single parent	132,000	134,640
- Personal disability	75,000	76,500
- Disabled dependant (each dependant)	75,000	76,500
Deductions, maximum limit:		
- Self-education expenses	100,000 limited to claims by taxpayer	100,000 limited to claims by taxpayer
- Private healthcare insurance premiums	8,000	8,000
- Rental payment for taxpayer's primary residence	-	100,000

[1] For illustration purposes, the proposed allowances are increased on the assumption that the benchmark is set at current levels and the inflation rate is 2%.

Appendix 2: Proposed changes in salaries tax allowances and deductions - impact on a typical individual

Example: Single person

This example illustrates the impact of[2]:

- an increase of basic allowance to HK$134,640
- a deduction of rental payment with annual limit of HK$100,000

	Existing (HK$)		Proposed (HK$)		Savings (HK$)	Savings (%)
Income		300,000		300,000		
Allowances/ deductions:						
Basic allowance	132,000		134,640			
Mandatory MPF contribution	18,000		18,000			
Private healthcare insurance	8,000		8,000			
Rental payment	-		100,000			
Total allowances/ deductions		158,000		260,640		
Net chargeable income		142,000		39,360		
Tax payable		8,200		787	7,413	90%

[2] Assumptions are as for Appendix 1.

Appendix 3: Proposed changes in salaries tax allowances and deductions - impact on a typical family

Example: Married person with spouse separately assessed, two children who are not newborns, and living with two dependent parents over 60 years of age throughout the whole year

This example illustrates the impact of[3]:

- an increase of basic allowance to HK$134,650
- an increase in child allowance to HK$122,400
- an increase in dependent parents allowance and additional allowance to HK$51,000

	Existing (HK$)			Proposed (HK$)			Savings (HK$)	Savings (%)
Income			750,000			750,000		
Allowances/ deductions:								
Basic allowance		132,000			134,640			
Child allowance	2 children 120,000 each	240,000		2 children 122,400 each	244,800			
Dependent parent allowance and additional allowance	2 parents 100,000 each	200,000		2 parents 102,000 each	204,000			
Mandatory MPF contribution		18,000			18,000			
Private healthcare insurance	1 taxpayer and 2 children 8,000 each	24,000		1 taxpayer and 2 children 8,000 each	24,000			
Total allowances/ deductions			614,000			625,440		
Net chargeable income			136,000			124,560		
Tax payable			7,600			6,456	1,144	15%

[3] Assumptions are as for Appendix 1.