HOW IMPORTANT ARE CHANGES IN PROFITS TAX TO HONG KONG' S "COMPETITIVENESS"?

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摘要

香港最近流傳快要增加利得稅的消息，令部份人士感到憂慮。商界尤其關注加利得稅對本地吸引海外投資所帶來潛在的衝擊。本文嘗試探討此課題的來龍去脈，利用最近的調查數據，研究國際投資者在作出揀選投資地區的決定時，利得稅所扮演的角色有多重要。調查結果指出，在作出這些投資決定時，利得稅雖然是一個重要的因素，但它只是眾多考慮因素之一，兼且通常不是最重要的一個．此外，結果亦顯示，在稅制的眾多特點之中，稅率只是投資者所要考慮的其中一項而已。

Introduction

During the lead-up to the Budget speech in Hong Kong earlier this year, it was rumoured that the rate of company profits tax was about to be increased by half a percentage point from the current 16 percent. At the time, this tax hike seemed to be a distinct possibility, as the government had previously been making well-publicised noises about the need to find extra sources of revenue to avoid structural budget deficits.

These rumours were seemingly confirmed the day before the Budget. First, Executive Councillor Tam Yiu-chung mentioned in a press conference after an Exco meeting that there was "scope" for a profits tax hike. Then, as if to confirm everyone's growing fears, fellow Exco member Henry Tang Ying-yen voiced his own opinion that the rate of profits tax would be increased.

In the event, as we all know, the Budget speech that Financial Secretary Donald Tsang finally presented contained no reference to an increase in profits tax. But this was not done before vociferous warnings of the potential effects of such a hike had been made. These warnings naturally came from business-friendly quarters; by contrast, those representing other interests, such as labour, were in general much more supportive of the move.

The majority of these warnings related to Hong Kong's international "competitiveness" and the threat that the proposed tax hike posed to it. It is true that, in general, higher taxes on profits can be seen as leaving companies based in Hong Kong with less profit available for reinvestment, potentially harming their future competitive position. But in general the warnings focused on a particular aspect of international competition: the ability to attract new investment from overseas. For example, one distinguished commentator voiced his concern about competition from countries such as Singapore, which had recently reduced its tax rate. His recommendation to the Hong Kong government was that, rather than to *increase* taxes on profits, it needed to *reduce* effective tax rates in the SAR to encourage multinational investors.

The Perceived Importance of Being "Tax Competitive"

There is no doubting the growing economic importance of overseas investment as "globalisation" has taken hold. In recent years, barriers to international investment, such as capital controls and foreign exchange restrictions, have been either dramatically reduced or entirely eliminated in many parts of the world. This has led to a huge rise in the level of international investment. In the last two decades, the global rate of growth of such investment has easily outstripped the rate of increase in world output, and has even exceeded the impressive growth in world trade. Of course, this development has been reflected in the growing importance of such capital flows to individual economies. The United Nations[1] recently reported that in the UK, foreign investment in 1998 represented over 25 percent of total investment, and for Hong Kong nearly 30 percent. The importance of foreign investment is apparent in many developing countries also; in China, the figure was nearly 13 percent.

The reductions in barriers to investment mentioned above have also meant that tax differentials between countries are now perceived as increasingly important in influencing the location of investment. In such a global environment, many countries around the world have reduced their taxes on corporate profits in an attempt to attract globally footloose capital. In one of the most dramatic examples, Ireland reduced its tax rate on profits from manufacturing from its traditionally high levels to just 10 percent. Governments around the world have taken note that many of these countries have subsequently achieved impressive inward investment and strong economic growth (Ireland is now the "Celtic Tiger"!). Although it may be naï ve to attribute such success stories

[1] Statistics and analysis from UNCTAD's World Investment Reports 1999 and 2000. New York: United Nations.

only to tax reductions, the impression remains that being "tax competitive" is now crucially important to a country's economic well being.

But How Important is Taxation in Influencing Investment?

In light of the above, it is perhaps not surprising that a proposed increase in the taxation of profits in Hong Kong, which appears to threaten foreign investment, is met with some alarm. But to what extent is this response justified? An answer to this question is important as it may affect the decision as to whether any increases in government revenues should come from profits tax or from other sources, such as a sales tax. This article attempts to shed some light on the matter by providing recent evidence as to how important a role the taxation of profits plays in the investment location decisions of international investors.

Intuitively, one would expect the taxation of profits to affect investment location decisions. Companies will, *everything else being equal*, wish to invest in the least cost environment, since this will provide them with the largest returns on their capital. As taxation is likely to be a significant component of the charges against profits of most companies, corporations will prefer to invest in countries which charge the lowest taxes on investment income. Not only does raising taxes deter new investment by multinational corporations, but it also encourages the withdrawal of existing investment, to be relocated elsewhere in a more tax-friendly environment. Conversely, reducing taxes encourages funds from overseas. Indeed, much quantitative research (primarily concerning capital flows into and out of the US) appears to support this.[2]

It seems therefore that on the face of it there are good reasons for Hong Kong to remain tax competitive by avoiding an increase in profits tax. However, there are two significant problems with the argument that such an increase will necessarily affect levels of inward investment.

The first of these relates to the fact that not only the country hosting the investment may wish to tax profits from that investment. The "home" country, that is, the country from where the investing company comes, may wish to do so too, although normally only when the overseas income is repatriated. This of course can lead to a situation where the same income may be taxed twice by different countries. To avoid this, many home countries allow taxes paid in the host country to be credited against taxes payable on the same income in the home country (although no "refunds" are ever given if host country taxation is greater than home country taxation). In such cases, what this means in practice is that the company's total tax bill (that is, home plus host country taxes) on income from overseas investment is set by the tax regime of either the home or the host country, whichever is the higher. In the case of low-tax Hong Kong, this normally means that the total tax bill of a foreign investing company is likely to be determined by the taxes of its home country.

Thus, changes in the size of the Hong Kong tax bill alone may not affect the company's total tax charge: the effect of raising or lowering profits tax in the SAR may simply be to alter the distribution of the tax revenue between the host and home governments. This is of particular relevance, since the countries that have exported the most capital to the SAR in recent years, China, the US, Japan and the UK, all practice this system of tax credit to some extent.

There is a second problem with the belief that, all other things being equal, an investor will invest in the lowest tax country: the fact that all other things are rarely equal. For a start, there are normally many considerations involved in these decisions other than costs, such as the size of the potential market or the political stability of the country. Even if one considers only costs, there are many costs other than taxation involved, such as those for transportation and labour.

The Views of International Investors

In order to obtain an understanding of the importance of taxation on investment location, it is therefore useful to compare its importance with that of the other factors involved in the decision. An appropriate way to do this is to survey decision-makers as to their experiences when choosing an investment location, and indeed several such surveys have been undertaken in recent years. In many cases, taxation was found to be high on the list of factors. However, in others, the greater importance of factors such as labour costs, exchange rate considerations, and, for emerging economies such as China, the size of the potential market was stressed.

A problem with previous surveys has been that the list of factors scrutinised has been less than comprehensive. An effort to improve upon this was undertaken by the author in February last year in a survey of executives from 600 of the world's largest multinational corporations.3 The executives were given a list of 23 factors, including the taxation of profits (and an open item in case any important factors had been missed). They were then asked to rate the importance of those factors on a scale of 1 to 10 (1 = not at all important, 10 = extremely important). The results were as follows (only the top 12 factors out of the 23 are shown):

[2] A useful review of the quantitative literature can be found in The Report of the Committee of Independent Experts on Company Taxation, chaired by O. Ruding, March 1992. Brussels: European Commission.

[3] See "Corporate Taxation and the Investment Location Decisions of Multinational Corporations" by the author in *The Asia-Pacific Journal of Taxation*, Spring 2000.

Importance of Various Factors in the Investment Location Decision

Ranking	Factor	Average Response
1	Political stability of the country	7.73
2	Size of local market	7.47
3	Proximity to markets	7.37
4	Environment in that country	7.34
5	Transparency/predictability of legal and regulatory framework	7.16
6	Quality of infrastructure, communication, etc.	7.11
7	Availability and quality of labour	7.05
8	**Taxation of profits**	**6.66**
9	Avoidance of obstacles to importing to that country (tariffs, quotas, other restrictions)	6.62
10	Other strategic aims	6.50
11	Incidence of corruption in that country	6.41
12	Availability and cost of other basic inputs	6.03

The overall impression from the survey results, consistent with prior studies, is that taxation is only one of many factors involved in investment location decisions, and that although important in those decisions, it is generally not the most important one. For investment into Hong Kong, the above survey results reinforce a common perception: that the inflows of capital are likely influenced much more by the market potential (the second and third placed factors), especially that of neighbouring China. The fact that political stability and macro-economic conditions are also significant factors has been borne out on several occasions in Hong Kong's recent history, with investment levels dropping sharply in times of political uncertainty and in the recent economic downturn.

Nevertheless, the above evidence implies that tax is important to investors, and at least partly justifies the pre-Budget warnings that an increase in Hong Kong profits tax would scare off overseas investment.

One more point, however, should be made here about the proposed tax hike: it concerned only a rise in the *rate* of tax. Even if tax is accepted as a significant factor in investment location decisions, the rate of tax is only one out of many attributes of the profits tax system which are relevant to foreign investors. Other attributes, such as the breadth of the tax base, or the transparency of the system, are likely to be relevant too.

In the survey mentioned above, the executives were also asked, on the same scale of 1 to 10, to evaluate the importance of the various corporate tax system attributes when evaluating the attractiveness of the system with regard to potential investment. The results were as follows (all 13 attributes surveyed are shown):

Importance of Corporate Tax System Attributes in the Investment Location Decision

Ranking	Factor	Average Response
1	Transparency of the tax system	7.64
2	Predictability of the tax system	7.61
3	**Statutory tax rate**	**7.50**
4	Availability and extent of relief for double taxation	7.33
5	Predictability and consistency of tax judgements and interpretations by the courts	7.30
6	Rate of withholding tax on repatriated profit	7.27
7	Other benefits from existence of relevant tax treaties	6.40
8	Availability and size of allowances, deductions, etc.	6.24
9	Special tax incentives for investment (e.g. tax holidays)	6.05
10	Ease and cost of complying with tax legislation	5.97
11	Availability and extent of loss relief	5.71
12	Effectiveness of tax collection	5.33
13	Comprehensiveness and effectiveness of anti-avoidance legislation	5.31

From the above table, it can be seen that the tax rate, in third place, is indeed considered one of the most important attributes. However, so too are certain general qualities of the tax system, that is, transparency, stability and consistency. It is noticeable that in the case of many of the attributes found here to be most important, the Hong Kong profits tax system compares favourably with other jurisdictions. For example, its system is stable and (with some major exceptions concerning the source of profits) transparent and predictable. It offers comparatively low rates of tax. In sum, the SAR would seem to have a very attractive tax regime for investors, with its low rate of tax being only one out of many investor-friendly characteristics.

Some Concluding Remarks

So, what can be concluded from the above about the recent warnings of the effect of the rise in the rate of profits tax on investment? It should be said from the outset that the threatened rise was a small one, and thus in itself unlikely to change investors' decisions. Also, it has been seen that, due to the nature of international double tax relief, such a rise may not effect the eventual total tax burden on foreign investors. When it is further considered that taxation is only one, and probably not the most important, of several potential influences on investment location, the tax rate hike which caused such consternation a few months ago may appear less threatening to the SAR's ability to attract capital.

However, it would be prudent not to underestimate the possible effects of such a hike on inward investment. Even though the rate of tax is only one attribute of the tax system potentially considered by investors, the survey results have shown that it is one of the most important. Its "headline" quality is likely to be important in forming investors' immediate perceptions of the severity of the tax system. The results of the survey also emphasize the importance of the predictability of the tax system. Business thrives on certainty, as such a quality is crucial in assuring foreign investors that their investment returns are not to be endangered by future adverse tax developments. Hong Kong's tax system has been remarkably stable over the years, and this stability is clearly one of its most attractive features. If investors view a rise in tax rates, no matter how small, as a portent of more serious developments to come, it will pose a threat to this important feature of the Hong Kong tax system. The danger warnings issued in the run-up to the Budget will then be seen to be justified.