GST: An irritant, or a body blow to Hong Kong's colossal logistics sector?

Report for

Hongkong Association of Freight Forwarding And Logistics Ltd.

Strategic Access Limited
November 2006

Strategic Access Limited,
Room 1004, F/10 Wilson House, 19 Wyndham Street, Central, Hong Kong
Tel.: (852)2866-9579 Fax: (852)2866-9895

Table of Contents

GST: An irritant, or a body blow to Hong Kong's colossal logistics sector?

1. Preamble

Following expressions of concern from members of the Hong Kong Association of Freight Forwarding and Logistics (Haffa) about the potential impact on their business of the introduction of a Goods and Services Tax (GST) in Hong Kong, Haffa has commissioned a broad based investigation into the introduction of GST.

This investigation has tried to stay above the simple "knee jerk" view that any change is bad, but instead has tried to explore in empirical terms the impact a GST would have on Haffa members in particular and on the logistics sector in general. The investigation has involved significant numbers of in-depth interviews with logistics practitioners to discover in practical terms the impact of such a change to Hong Kong's tax system.

The investigation has been conducted with the full knowledge that insights might be critical to the future practicability of a GST in Hong Kong. The trading and logistics sector employs over 800,000 people in Hong Kong, and is acknowledged by the Hong Kong Government as a pillar of our economy. In short, powerfully deleterious consequences for the logistics sector would be likely to undermine the prospect of GST being introduced.

2. Summary of findings

- Haffa members generally acknowledge the Government's in-good-faith concern over the need to broaden the tax base.

- They also acknowledge the Government's in-good-faith efforts, taking account of the importance of the logistics sector to the overall wellbeing of the economy, to minimise damaging impacts for the sector by proposing that the logistics sector in general terms be "zero rated" for tax purposes, and be exempted from onerous documentary requirements through introduction of a "Qualifying Exporter Scheme" (QES).

- They expressed concern that the high level of generality of the Government's consultation materials makes detailed analysis of the impact of GST virtually impossible – in particular critical details linked to the nature and substance of the Qualifying Exporter Scheme (QES).

- Taking these factors into account, Haffa members believe that a GST, by requiring the establishment of an "in-bond" infrastructure to manage the import and export of all goods, whether for use inside Hong Kong, or for re-export or transhipment, would destroy the primary foundation stone of Hong Kong's competitiveness – our "free port" status.

- Even if a QES could be crafted to allow indefinite suspension of GST, the result would be a complex set of new bureaucratic arrangements where much would rest on practical interpretations by Government officials, in particular those in the Customs & Excise.

- Even if a scheme could be crafted that allowed simpler documentation than that required on the Mainland, the simple narrowing of the bureaucratic gap between Hong Kong and the Mainland would take the industry one step closer to moving operations into the Mainland, where costs are lower, end users are closer to hand, and new and more efficient airports are emerging.

- **In short, they appear unanimously to believe that introduction of GST would fatally compromise the cornerstone advantage underpinning Hong Kong's logistics economy – our "free port" status.**

3. Why relinquish our free port status?

The Government has tried to alleviate concerns from the logistics industry over GST by proposing that exports would be exempt. What the Government has overlooked is the crucial importance of Hong Kong's free port status. "Free port" does not only mean "duty free" or the absence of import duties. "Free port" means that Hong Kong allows a free flow of goods, without bureaucratic regulations, paperwork, or long or uncertain clearance times.

As a "free port", Hong Kong has allowed ample flexibility for the mixing of imports, exports and transshipment goods within the territory for consolidation and re-consolidation purposes. If a GST is implemented, the Hong Kong Government would be relinquishing the most important competitive advantage of the logistics sector. Any mitigating measure that could be introduced would only decrease the transparency of Hong Kong's import/export regulations, and increase the bureaucratic burden for the trading and logistics sector.

GST – The Straw that Breaks the Camel's Back

Hong Kong's logistics industry, facing increasing competition against competing cities in the Mainland, has long recognised that it cannot afford to be complacent. As the Mainland's seaports and airports continue to advance, many of Hong Kong's more forward-looking logistics firms have already tested using these hubs. The bureaucracy involved in dealing with customs on the Mainland has always been a powerful deterrent against these freight forwarder operations moving their operations to the Mainland where they could otherwise capture lower land and cargo handling costs. Hong Kong's ease of customs has always been a pull factor keeping the logistics industry within Hong Kong, especially the high value-added just-in-time air freight business.

However, the Mainland is making a determined and focused effort to modernise its customs procedures. Already, many of the larger Hong Kong and multinational freight forwarders and logistics providers have set up small operations at Yantian port, and Baiyun and Baoan airports. These could be representative offices for now, but in five to 10 years' time – the time frame of implementing GST in Hong Kong – these operations will likely grow significantly.

Given the competitive environment for Hong Kong and thin margins in the logistics sector, the larger logistics operators and freight forwarders are likely to shift their operations gradually to the Mainland. The gap between Mainland customs efficiency and Hong Kong's is still substantial, but it would be a tragic irony if the Hong Kong Government were to take a step backward in the ease and simplicity of customs procedures, destroy its critical and distinctive operation as a free port, and erode Hong Kong's clearest source of competitive advantage.

4. Government measures to insulate and protect the Logistics sector, and why they wouldn't work

Haffa acknowledges that the Government has made a deliberate effort to propose mitigating measures to reduce the bureaucratic hassle a GST would bring to the trade and logistics industry. (For the benefit of Haffa members and others in the logistics industry, those measures are summarised in the Appendix on p.14.)

Whether or not those measures would be neutral in their impact on the competitiveness of the logistics industry will largely depend on their detailed design and implementation. The various schemes, in particular the QES, if not designed properly, could open a Pandora's Box and create more bureaucratic hassle than it is intended to resolve. In the case of Singapore, the simple fact that four to six different schemes are available to firms in the logistics and freight forwarding business continues, even today, to cause adaptation problems to small to medium sized market players, 12 years after GST was first implemented.

If in spite of Haffa members' fundamental opposition to introduction of GST-related changes to Hong Kong's import-export environment it is still decided that GST should be introduced, then minimisation of negative impacts would be critical, and would need to be based on close and detailed consultation with stakeholders.

Pivotal importance of the Qualifying Exporter Scheme

In the spirit of defending Hong Kong's competitiveness as an efficient trading centre, the Government has proposed a Qualifying Exporter Scheme (QES), which would allow the suspension of GST for traders whose export sales account for more than 51% of turnover. The aim is that the scheme would relieve cash flow problems for traders primarily involved in re-export and transshipment.

In the preliminary proposals published so far, the Government has suggested that the QES will be modeled after the Major Exporter Scheme (MES) in Singapore, with no further details provided. Several exchanges with three Government bureaus (FSTB, C&ED and IRD) and their tax accounting consultants revealed that the Approved Third Party Logistics Company Scheme (Approved 3PL Scheme), commenced in January 2004 by the Singaporean Customs, would also be incorporated into Hong Kong's QES. MES status is granted to shippers, who can in turn register a maximum of 20 freight forwarders as "authorised declaring agents" to handle the goods on behalf of the shipper. The shipper, however, is liable for GST payment. The shipper is also responsible for notifying Customs of the appointment of the authorised agents, as well as any subsequent changes to the list.

An Approved 3PL Company is one that provides value-added services on behalf of an MES trader. These include freight forwarders, transportation and warehousing firms that perform activities such as inventory control, packing and re-packing, consolidation and de-consolidation, and "pick & pack". Again, these Approved 3PL Companies can also appoint a maximum of 20 "authorised declaring agents" to handle the import/export process on their behalves.

The Approved 3PL Company Scheme, started in 2004, in part reflects where the MES scheme and other GST mitigation measures employed by the Singaporean government have fallen short. According to logistics operators in Singapore, when GST was first introduced in Singapore in the mid-1990s, regional distribution centre (RDC) activities had to cease or move away because of the administrative costs and the lack of flexibility. Ongoing efforts to tweak regulations to address shortcomings have been a source of persistent change and uncertainty, and have yet fully to resolve problems created by the introduction of GST.

The exact design of Hong Kong's QES is therefore critically important, but analysis is badly handicapped by the lack of detail in this area, and by Government insistence that the design will be subject to future discussion with the industry. Shortcomings of Singapore's MES scheme as a template is a clear and unresolved source of concern. Drawing upon the mixed results from Singapore's implementation of an MES, the following bureaucratic tensions and risks associated with the QES should be carefully considered:

1) In most cases, freight forwarders would be appointed by the shippers' overseas customers, not the shippers themselves. This means shippers with QES status would from time to time have to work with freight forwarders they are not familiar with or have not done due diligence on. It would also mean the overseas customers may be appointing a freight forwarder that is not already on the list of the appointed agents of a QES shipper. The Government would need to ensure that the paperwork involved in appointing a new agent or changing from one agent to another take minimal processing time. In the long run, if signing up a new agent or switching agents required a long wait or a substantial amount of paperwork, we could expect shippers to have the tendency to favour using the larger freight forwarders as their agents, and persuading their overseas clients to do so, thereby compromising the interests of smaller freight forwarders and logistics companies in Hong Kong.

2) Because the criterion for attaining and renewing QES status would be that a shipper's turnover consists of more than 51% export sales, it would be important for shippers to present adequate and complete

export documentation to the Inland Revenue Department to prove the export transactions had indeed taken place, and that the value of export sales had been accurately computed. This would mean the responsibility rested on shippers to ensure that the forwarders, with whom they may or may not have a close working relationship, retained appropriate documentary proof, such as airway bills, bills of lading or export permits. Otherwise, the QES shippers could risk having to pay the 5% GST on some of their imports (which they could not prove had been exported). This would increase the record keeping costs borne by shippers and freight forwarders.

3) Different types of exported goods would present different export scenarios, and the QES would have to be designed so that as many as possible of these scenarios were taken into consideration. Many Hong Kong shippers import raw materials and export them to China for processing and manufacturing (technically a transshipment), import the products for value-added activities such as assembly or packaging, and then export these again. In order to minimise compliance cost for the logistics industry, it would be important for Government to set clear rules or guidelines regarding the estimation of values of imported and exported goods at each stage. For instance, should the cost of value-added activities be counted into the value of these imports and exports? In the experience of Singapore, MES traders suddenly found themselves subject to close scrutiny from the tax authorities, who needed to ensure the shippers were not abusing their MES status and under-declaring their import sales. The values of imports declared on the shippers' GST returns are rigorously compared with values declared on the import permits issued by the Singapore Customs. Setting very clear guidelines on how to estimate, calculate and declare the values would therefore be crucial to reducing administrative costs associated with such a scheme in Hong Kong.

From the above, we can see that even though cash flow issues could be mitigated by the QES, the scheme itself is likely to be costly to administer – both for the Government to regulate and for the industry to comply. Resolving cash flow problems should not be the only mitigation facilitated by this elaborate scheme.

The Hong Kong Government appears to draw heavily upon Singapore's GST implementation experience as a prototype for designing measures for Hong Kong's logistics sector. The Government believes that Singapore is similar to Hong Kong as a city economy with a limited domestic market, whose trade and logistics sectors are involved mainly in re-exports and transshipment. However, there are significant differences between Hong Kong and Singapore. In contrast to the thousands of tiny entrepreneurial firms that account for 98% of Hong Kong's economy, including a majority of the trade and logistics sector, the economic structure of Singapore consists of many large and multinational enterprises. The ability of SMEs to tolerate and cope with administrative costs is naturally more limited than larger firms.

Secondly, while Hong Kong logistics firms could easily shift their operations to Mainland China, where many of them have already set up shop, it makes little commercial sense for Singapore's freight forwarders to move to Malaysia. In short, Singaporean firms have nowhere to go.

The Hong Kong Government has also hailed Singapore as a city where GST has not impeded growth in its strong trade and logistics sector, or its economic growth. What is not noted is that Hong Kong has outpaced it consistently, in spite of considerable and very focused Government support for logistics in Singapore, and that Hong Kong's outperformance is due in significant measure to our "free port" status, and the simplicity and efficiency this allows.

5. Practical impacts on day-to-day operations

Implementing GST and building a bonded infrastructure to accommodate the change appears to be extremely costly and unnecessarily burdensome to the trade and logistics industries. Even as GST is in public consultation, the Government's current proposals have introduced uncertainty in the business environment for the logistics sector. The trade and logistics sector has thrived in the past because Hong Kong is a free port, a unique and unparalleled status in the world. Free port status has also allowed Hong Kong's logistics sector to maintain its competitive edge against emerging, fierce competition from the Mainland.

In promoting GST as a solution to Hong Kong's broader tax reform needs, the Government appears to have profoundly underestimated the cost of relinquishing the free port status and the benefits this liberal environment has brought Hong Kong over the years. It appears to lack insight into how GST implementation, together with all the schemes and special arrangements designed to mitigate its effects, would impact the day-to-day operation in the logistics sector. This section warns of the "devil in the details" by pointing out some of the bureaucratic uncertainties, legal grey areas and administrative costs that could arise from current proposals:

Additional clearance time and paperwork burden: It has been often argued by Government that the time required for paperwork would not increase because declarations would be made electronically by means of an electronic declaration system connecting to the Customs & Excise Department (C&ED). Just because declarations are made in an electronic system, it doesn't mean there is no paperwork involved.

For the electronic system to work properly, the Government would need to ensure that the cost of the proprietary electronic system is not unduly borne by freight forwarders. In the past two years, Haffa had worked closely with the Airport Authority to minimise truck waiting times and cut-off times at the air cargo handling terminals. For the Government to introduce a GST and thereby increasing clearance times and truck waiting times at the border would run counter to the efforts made by Haffa, the Airport Authority and others in the air cargo industry to reduce those times.

The Government would in addition need to clarify the responsibilities of each party. In the US and in Singapore, the shipper is directly responsible for settling the GST payment, and the payment of other import duties, with the customs authorities. If the shipper chooses to have a freight forwarder pay on his behalf, he pays a fee and/or interest for the forwarder to do so. Whether or how Hong Kong's GST arrangements emulated such a pattern is wholly unclear, and is fraught with issues of legal and practical liability.

Calculation of import value: The Shippers' Council in Hong Kong has made continuous efforts to promote the shipping terms of FOB (free on board) Hong Kong, in order to encourage overseas customers to use the Hong Kong seaport or airport instead of Mainland competitors. In Government proposals, GST would be calculated on a percentage of the CIF (cost, insurance and freight) value of the goods. The Government would need to devise formulae to translate CIF into the more popular FOB, as well as other payment terms such as Delivered Duty Unpaid (DDU) and Delivered Duty Paid (DDP).

Definition of liabilities: The variety of payment terms could also become a problem for the practical implementation of GST. For instance, goods on DDU and DDP terms belong to the consignee, and not to the shipper until the sales transaction is completed. Deciding who is liable to pay the GST on various payment terms would create confusion within the freight forwarding industry and among the shippers.

Deferred GST Payment Scheme (DGPS): It is proposed that importers could defer paying GST for three to seven weeks if they join the DGPS. The Government's intention appears to be to set up the DGPS for those importers who are not eligible to join the QES. From exchanges with C&ED, the DGPS is intended for those who are not ready for advanced declaration of imports, and therefore the three to seven week period of deferred GST payment takes into account the time needed to obtain necessary documentation to complete the declaration process. However, the Government does not seem to have adequately measured or taken account of the bureaucracy and uncertainty created by such arrangements. In addition, the three to seven week deferment period is widely perceived as wholly insufficient for even the most basic regional distribution centre functions.

Approved Temporary Storage Areas (ATSAs): Both the ATSAs and the Bonded Warehouses will be entirely new entities created, part of a bonded infrastructure that has never before existed in Hong Kong. The simple disruption involved in the creation of this new infrastructure is clearly unwelcome and is likely to be a distraction to hard-pressed executives for a significant transitional period. The expertise involved in creating a bonded facility in a free port and the day-to-day operation of such a facility simply does not exist in Hong Kong. Insurance costs would inevitably rise for traders placing goods in ATSAs. According to Government proposals, ATSA operators would need to furnish a financial security to the Government to cover any revenue loss as a result of mishandling or loss of goods, and to insure against such a loss. Liability for the goods would need to be clearly defined both in legal terms and practical terms.

Bonded Warehouses (BWs): The Government expects only a very small portion of Hong Kong's imports and exports would be stored in bonded warehouses. (In exchanges with various Government bureaus including FSTB and seconded consultants, C&ED and IRD, the Government described the BW concept as the counterpart of Singapore's Free Trade Zone. Again, it is difficult to believe that having Bonded Warehouses could be a positive development for the Hong Kong logistics sector. The Government has not provided details in its published proposals regarding the licensing process and operational requirements. It is understood that freight forwarders and logistics providers may license their rented or owned facilities as Bonded Warehouses. It is unclear, however, what kind of logistics operations are permitted within the BWs. Would some value-added activities be allowed to take place? If so, which ones? In the Mainland, the bonded facilities require the segregation of import and export operations, in some cases requiring imports and exports to be stored in different buildings. If the segregation of imports and exports were to be needed, it would be detrimental to the livelihood of the logistics sector, since a large variety of logistics services would no longer be possible. The absence of clarity on such key issues, and the significant disruption that must be connected with them, remains a source of grave concern to the industry.

The execution of GST and various schemes intended to mitigate the GST's effects would therefore involve an extensive exercise with shippers, freight forwarders, other logistics providers, and their lawyers, insurers, accountants and auditors, as well as the Government to fundamentally re-organise the sector under a bonded infrastructure. A GST and the mitigation arrangements necessitated by them must inevitably become an institutional impediment to the competitiveness of the Hong Kong import/export and logistics sectors.

If it were market forces that had compromised the industry's competitiveness, then the logistics sector would have no one to blame. But for Hong Kong to relinquish its role as one of the freest ports in the world and voluntarily subject itself to a bureaucratic quagmire is seen as both unreasonable and unnecessary. Haffa hopes that the Government can re-consider its plans concerning GST, and the bonded infrastructure it would need to create.

6. Conclusion

The introduction of a GST, and the bonded trading infrastructure it would require, would at a stroke eliminate the single most important source of competitive advantage for Hong Kong's massive logistics and import-export sectors.

While the Government's in-good-faith efforts to mitigate negative impacts are recognised and appreciated, the conclusion must inescapably be that the arrangements needed to create and operate a bonded infrastructure would add cost, bureaucracy, and long-lasting uncertainty to an industry that is already under severe competitive challenge from neighbouring Mainland air and sea cargo hubs.

At the very least these changes would create inefficiencies, raise costs, and erode competitiveness. At worst, they would persuade many operators to move operations into the Pearl River Delta, where operating costs are lower, and clients are closer at hand. Hong Kong's simple and flexible free port environment has up to today been the single strongest reason for resisting China's centripetal pull. The narrowing of the bureaucratic difference between operation within Hong Kong, and operation inside the Chinese Mainland, would without question erode the logic of maintaining operations within Hong Kong. Exactly how many companies would move, and how soon, cannot accurately be predicted, but there would be no doubt about the outcome of introducing GST.

As a result, Haffa members, and others in the logistics sector ask Government seriously to reconsider plans to introduce GST.

Appendix:

A Summary of Government-proposed mitigating measures

The following description of government proposals combine the measures as published in government brochures, and insights from meetings with FSTB, C&ED and government consultants:

1) Exports and transshipments will be zero-rated.

2) Although imports are taxable at 5% of their CIF value, most shippers and freight forwarders would be eligible to join the Deferred GST Payment Scheme (DGPS) or the Qualifying Exporter Scheme (QES), thus relieving cash flow pressures of having to pay the 5% GST up-front.

3) The DGPS would allow a 3 to 7 weeks delay in GST payment.

4) The QES – modeled after the Major Exporter Scheme and the Approved Third Party Logistics Company Scheme in Singapore – will allow an indefinite suspension of GST for importers whose export sales by value are at least 51% of their turnover. With QES status, shippers and freight forwarders will be able to store their goods or perform value-added activities anywhere in Hong Kong.

5) An electronic system, similar to the existing Tradelink, would be set up to connect shippers, freight forwarders and the Customs & Excise Department. Upon electronic payment, the shipper or freight forwarder would be given a code similar to the Customs Validation Number (CVN), as proof that payment has been made. While the Government does not expect significant time and paperwork required for using this electronic system, compliance cost may be incurred, because the electronic system is likely to be a proprietary IT solution.

6) Since most of Hong Kong's shippers and freight forwarders deal with exports and transshipment, only a small portion of the logistics industry will need to use Approved Temporary Storage Areas (ATSAs) and Bonded Warehouses (BW), according to Government proposals. Therefore, the Government has proposed licensing existing storage areas as ATSAs, including the cargo terminals at the Airport, Kwai Chung Container Terminals, River Trade Terminal, Public Cargo Working Areas and private wharves. The Customs & Excise Department has informed us that they expect this space to be sufficient, because only a small portion of the logistics industry would fall outside of the QES. Meanwhile, shippers and forwarders will be able to apply for their existing warehouse facilities to become Bonded Warehouses.