

2005 Policy Address

Challenges and Threats to Hong Kong's Economic Development in the Longer Term

1. Hong Kong losing its status as the region's logistics hub

Over the past two decades, with the expanded production activities of Hong Kong manufacturers in the adjacent Pearl River Delta region, there has been a sharp rise in the volume of goods shipped overseas via Hong Kong's air and sea ports. The strong demand for transport and logistics services arising from the rapid growth in container throughput has propelled the fast development of this sector.

However, Hong Kong's status as the logistics hub in the region is now facing intensifying competition from Shenzhen. For instance, in this year's first seven months, Hong Kong's container throughput has only increased 1% year-on-year to 12.6 million TEU, whereas the corresponding figures for Shenzhen were 22.5% and 8.8 million respectively. If the present growth trends of Hong Kong's and Shenzhen's ports are to continue, Hong Kong will before long lose out to its rival in the race for the region's leading logistics hub.

In stark contrast to Shenzhen's continued improvement in vessel frequency and handling efficiency, the competitiveness of the Hong Kong port has been significantly eroded in recent years by expensive terminal handling charges and high inland transportation costs. Given the importance of the transport and logistics sector to the economy, we see an urgent need for the Government to tackle the problems faced by this sector and to take active steps to help the operators regain their competitiveness. In this regard, the Government should adopt the following measures:

- Expedite the construction of the Hong Kong-Macao-Zhuhai Bridge to reduce the costs and time for transporting goods from the west bank of the Pearl River to Hong Kong;
- Reposition Hong Kong as a feeder port of South China and engage the Guangxi Government in forming a strategic partnership to facilitate the feeding of goods produced in the province to Hong Kong's terminals;
- Maintain a close dialogue with the container terminals, liner companies and other interested parties to progressively reduce the terminal handling charges and other surcharges;
- Strengthen co-operation with the Mainland authorities and remove bottlenecks to speed up cross-boundary cargo clearance;
- Expand the capacity of the river trade terminal and related facilities to accommodate the increased volume of cargoes transported to Hong Kong by river vessels; and
- Make building container terminal number ten a priority in the Government's policy agenda.

Further, the aging and dwindling pool of local container-truck drivers is a concern to the transport and logistics sector. The problem is worsening with the Mainland authority prohibiting people aged 60 years or above from driving container-trucks. The Government should find ways to increase the supply of younger drivers to meet the demand of local operators; otherwise, the sector's competitiveness will be compromised.

2. Lack of growth engines to drive economic development in the longer term

In the aftermath of the Asian financial crisis, there was energetic debate in the community about the direction of Hong Kong's economic development. While it was unanimously agreed that Hong Kong needs to transform into a high value-added and knowledge-based economy, we have yet to see the emergence of new industries as growth engines to drive and sustain our economic development in the longer term.

In identifying new growth engines for Hong Kong, the following factors should be given serious consideration.

- Hong Kong should promote its unique geographical advantages to attract multinational and Mainland companies to set up regional headquarters in the territory.
- Hong Kong's business environment including its taxation regime needs to further improve to encourage new investment and to build up its reputation as a premier asset management centre in the region.
- The Government should foster stronger collaboration between industry and local universities/research institutes, and take a more proactive approach to nurture new industries with good development potential.
- Hong Kong should model on the success of other small-scale and open economies (e.g. Switzerland, Denmark and Finland) where the governments play a strong leading and supporting role in the focused development of their niche industries.

(a) Industrial Development

Government policy and support is instrumental in identifying and developing new growth engines. Take Singapore as an example, under the keen support of the Singaporean government (including the provision of tax incentives, R&D funds and facilities, and seed capital), the contribution of the pharmaceutical industry to its economy has grown substantially of late. Following several large international drug companies setting up production plants in Singapore in recent years, pharmaceutical products now rank third in the country's exports after petroleum and electronics.

The SAR Government should learn from the successful experience of countries like Singapore and formulate a blueprint for advancing Hong Kong's industrial

development. In our previous submissions to the Government, we have pointed out the potential of developing Hong Kong's automobile components and environmental industries and how Hong Kong may benefit from their vibrant development. We hope the Government will find our recommendations useful in mapping out a concrete plan to support and assist these two industries.

In addition, with the implementation of Ceps and the recent re-imposition of quotas on Chinese textile products by the EU, an increasing number of Hong Kong manufacturers are interested in setting up new production lines in the territory. The Government should offer incentives and the necessary support to encourage them to do so. Since many of these manufacturers are worried that Hong Kong does not have enough labour with the right skills for their prospective operations, the Government should ensure that the Vocational Training Council (VTC) and other training institutions would train more local workers with skills essential for today's manufacturing operations. If the supply of skilled workers under such circumstances remains insufficient, importation of Mainland workers should be considered.

(b) Innovation and technology development

Innovation and technology is a crucial element in driving the advancement of Hong Kong's industries. Last year, the Government revised its innovation and technology strategy and proposed using the Innovation and Technology Fund (ITF) to establish R&D centres for four technology fields.

While agreeing with the direction of the new strategy, we believe that the existing support provided by the Government through ITF is inadequate to upgrade Hong Kong's R&D capabilities to a level comparable to its overseas competitors. It needs to introduce other complementary measures to attract major foreign technology companies to set up R&D centres in the territory, thereby cultivating a more vigorous innovation and technology culture in the local business community.

In our view, tax incentives in the form of triple tax deduction on companies' R&D expenditures are by far the most effective means to encourage them to expand investment in such strategic activities. The Government may also need to consider changing the funding methods of the universities to foster closer collaboration between industry and academia in developing innovative products. One possibility is for the Government to offer a special one-to-one matching grant to the institution on its profit share derived from new products successfully developed and commercialised in partnership with the private sector. Moreover, the Government should encourage the Hong Kong Productivity Council and the VTC to extend or strengthen their services in the PRD, thereby helping Hong Kong companies operating in the delta upgrade their technical and manpower capabilities.

Innovative design helps improve the value-added contents of products made by

Hong Kong companies. It should be incorporated in the Government's innovation and technology strategy. The DesignSmart Initiative and the establishment of the Inno Centre are important steps in the right direction to promote Hong Kong's design development. We hope the Government will expand the scope and scale of these programmes to strengthen its support to this sector, so that Hong Kong will turn itself in a focal point of design excellence in the region.

(c) Helping Hong Kong's service industries expand business in the Mainland

While Hong Kong is predominantly a service economy, the Mainland's service industries are relatively underdeveloped with immense expansion potential. Hong Kong's service companies should tap the vast business opportunities available in the Mainland.

Although Ceps has provided a framework for Hong Kong's service providers to enter the Mainland market, the existence of various administrative and policy hurdles, including excessively high investment thresholds, complicated licensing procedures and the absence of a mechanism for mutual recognition of professional qualifications, have deterred many interested companies from setting up business operations there.

To address this issue, the SAR Government should join hands with Mainland authorities to closely monitor Ceps's implementation. For this purpose, it would be desirable to compile a database on Hong Kong service companies which have successfully developed business in the Mainland under Ceps, as well as the location, nature and scale of such operations. The SAR Government should proactively approach local companies in those sectors with a low participation rate in the Mainland to understand their problems, and work with its Mainland counterpart to look for a solution.

(d) Attracting multinational and Mainland enterprises to establish regional headquarters in Hong Kong

Hong Kong's unique advantages, including a simple and predictable tax system, low tax rates, free flow of information, world class infrastructure and the absence of foreign exchange control, are the envy of many economies. Hong Kong should widely promote these advantages to multinational and Mainland enterprises to attract them to set up regional headquarters here.

Last year, the State Council and Ministry of Commerce jointly announced "Provisions for Approving Mainland Enterprises to Establish Companies in Hong Kong and Macao". This document, which provides for simplified approval procedures for mainland enterprises to invest in Hong Kong, embodies the Central Government's policy to encourage Mainland enterprises to maximise the use of Hong Kong as a facilitator for business expansion overseas.

According to a recent survey conducted by the Hong Kong Trade Development Council, the top three problems confronted by Mainland enterprises in establishing a presence in Hong Kong are: Hong Kong's operating costs being too high, lack of information about setting up and doing business in Hong Kong, and strict immigration control on Mainland residents working and staying in Hong Kong.

Active steps should be taken by the Government to address these problems. For instance, the Government needs to mount large-scale publicity campaigns in major Mainland cities to promote Hong Kong's advantages and organise regular seminars to disseminate information on Hong Kong's business environment and the procedure for setting up business. The Government should also loosen the existing strict immigration requirements on Mainland businessmen.

Whether a taxation regime is friendly to business is an important consideration for companies in deciding the location of its headquarters. The abolition of estate duty will give Hong Kong an extra advantage as a premier asset management centre. The related bill has already been introduced into the Legislative Council and is expected to be passed in the next few months. Upon enactment of the abolition, the Government should widely promote this in the international business community through its overseas networks to ensure that both foreign and Mainland enterprises are aware of its positive implications for investors.

Last week, the FHKI together with two other local trade associations submitted a joint letter to the Secretary for Financial Services and Treasury expressing our concerns over the Government's current practice on offshore profits claims. In particular, we are worried that applying the "totality of facts" approach in determining the source of trading profits will undermine the simplicity and certainty of Hong Kong's tax regime, thus counteracting the Government's effort to attract companies to locate in Hong Kong. We hope the Government will look into this issue with timely deliberation and caution.

3. Aging Population and Manpower Mismatch

The aging population and manpower mismatch are also major threats to Hong Kong's economic development in the longer term. The Government should draw up a comprehensive population policy to tackle these issues and ensure Hong Kong has the right mix of talents to meet its future development needs.

The rise in the number of elderly in the population is likely to deplete the Government's coffers as public expenditure on healthcare and social welfare may need to expand correspondingly to cater for this group of citizens. As a first step to solve this problem, the Government should consider providing tax allowances to encourage younger people to purchase medical insurance, thus reducing their reliance on public healthcare provision when they age.

As from 1 October, Hong Kong people working in the Mainland will be required to contribute to its social security insurance system. Many of these workers will choose to reside in Hong Kong after retirement and they will not be covered by Hong Kong's MPF Scheme. This is a matter of concern to us due to its implications for Hong Kong's social security system. The SAR Government should look into the issue and work out a feasible arrangement to cope with the situation.

According to the Government's latest manpower projection, in 2007 there will be undersupply of manpower with university and associate degrees, while there will be substantial oversupply of workers with senior secondary education or below. This projection is related to the expansion of high value-added economic activities in Hong Kong and the relocation of low skill jobs across the border.

If manpower mismatch is not addressed promptly, the competitiveness of Hong Kong will be adversely affected and its ability to develop into a knowledge-based economy significantly curtailed. We recommend the adoption of the following policies to reverse the trend:

- Encourage young people and the unemployed to look for employment opportunities in the Mainland and offer them support in case of emergency;
- Introduce a point system to bring in the right kinds of talents needed for Hong Kong's development; and
- Offer permanent resident status and other incentives to attract young Mainland/overseas professionals and university graduates who can secure employment in Hong Kong.