Public Policies in the Hong Kong Economy :
With Emphasis on Manufacturing

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Hong Kong is generally regarded as the freest economy in the world and the Hong Kong government is known for its laissez faire economic policy. This is by and large a correct portrayal of what has been taking place in Hong Kong in the post-war years. In this paper I shall consider several issues relating to the manufacturing sector. First, what are the essential features of Hong Kong's laissez faire economic policy? Second, why did the Hong Kong government chose to implement such a policy, when for most of that period Britain adopted a socialist oriented policy. Third, what implications did a laissez faire policy have for the development of the economy and society? Fourth, what is the future of the laissez faire policy in the future, especially in light of the restoration of sovereignty over Hong Kong from Britain to China? My discussion will be partly analytical and partly historical. I shall develop some of my key: points through an analysis of a few important events that had a major impact on Hong Kong's development and policy environment.

It is important to appreciate that although in the area of economic affairs, Hong Kong had adopted a largely laissez faire approach to policy matters, however, in the area of social policy Hong Kong has been quite statist. As a consequence, this too has important implications for Hong Kong development and policy environment. However, I will not be looking at issues outside the economic area, even though they may have an effect on economic policies.

The Political Economy of Economic Policy

In 1945, Hong Kong's population was about 600,000. Today it is 6.5 million. At the end of the war Hong Kong's per capita income was about one fourth of that in Britain. Today it exceeds that of the United States by a small amount. This rapid rate of economic growth is not uncommon in our part of Asia. However, Hong Kong's economic miracle is largely attributed to the adoption of a laissez faire economy policy.

The key features of this policy is minimal government intervention in the market, the rule of law, free and unfettered trade, open and competitive markets, a simple and predictable tax regime, low tax rates, balanced budgets, limited public expenditures, a stable currency and price stability.

Hong Kong in the post war year has been characterized by an unusual degree of economic and civic freedoms. On the other hand, Hong Kong is largely an administered state. It does not have a large measure of political freedom by Western standards. The relationship among economic, civil and political freedoms is complex and perhaps still inadequately understood. It is generally believed that India has a large measure of civil and political freedoms, but little economic freedom. It is sometimes alleged that political freedoms in many Western economies have retarded economic freedoms.

To some extent the absence of political freedoms have made it possible for the colonial administration to implement its laissez faire policy. Two factors are important. First, an administration that is legally and politically not accountable to the public makes it possible for the personal convictions of senior administrators to prevail in a colonial administration. It is to some extent a historical accident that the chief architect of Hong Kong's economic policy was the result of a Financial Secretary who held office throughout the 1960s. Sir John Cowperthwaite was a believer in laissez faire and put his convictions into action. The tax regime and fiscal system has survived to the present and is to a large extent enshrined in the Basic Law. His successors have by and large continued that policy to this day. The fact that every budget proposed by the administration was never challenged in an appointed legislature made it possible for a laissez faire policy to be sustained. Eventually the benefits of the policy was able to command a sufficient intellectual and popular following to become somewhat entrenched in the community to be able to survive legislative challenge from an increasingly elected legislature that began to emerge in the 1980s.

Second, a foreign colonial administration governing an alien population in the post colonial era naturally felt sufficiently constrained in its political behavior to wish to minimize its obtrusiveness in a city half way round the globe. The British government at the end of war was more concerned with its own economic recovery than with the affairs in a far off city. Its main concern, which it took great pains to communicate to the colonial administration, was that Hong Kong must not become a fiscal burden of the British government. Successive generations of colonial administrators in Hong Kong were far more interested in being a minimalist government. Diplomatically the rise of China probably contributed to the short-term approach of the colonial administration. Civil servants on the whole was keen to minimize mistakes by doing as little as they can get away with so that they can retire after a stable and colorless career comfortably back to Britain.

Third, in order not to alienate themselves from the community, the administration would selectively incorporate public opinion in its policy making process through a consultation process through some 400 advisory committees whose members were appointed. To some extent the administration saw itself as balancing the various vested interest groups and holding them in abeyance, but at the same time taking into account some of their legitimate concerns.

It is no doubt true that as a small economy without natural resources beyond its geographic location and an excellent harbor, Hong Kong had little choice but to pursue a free trade policy in order to improve its standard of living. This was a lesson that the more interventionist Singaporean government soon learned after its independence. Nevertheless the colonial setting in a post-colonial era and accidents of history had an important effect.

The Rise of Labor Intensive Manufacturing

Before the war Hong Kong was primarily an entrepot. Manufacturing was largely absent. The population in Hong Kong was predominantly made up of sojourners who did not consider the territory to be their home. Export oriented labor intensive manufacturing emerged only after the war. Three factors contributed to its rise. First, the arrival of numerous Shanghai industrialists. Second, the arrival of workers and peasants with their families from Guangdong. These immigrants chose to stay in Hong Kong permanently. The population of Hong Kong between 1945 and 1951 rose from 600,000 to 2.1 million. Third, the United Nations embargo against China during the Korean War effectively ended Hong Kong's vibrant entrepot trade.

Viewed in its historical context the rise of manufacturing in Hong Kong occurred because of a dramatic shift in Hong Kong's comparative advantage in the post war years. These changes were largely the result of external events that had little to do with Hong Kong's own development. Export driven industrialization was neither the result of a trade promotion policy nor an industrial policy of the government. In this sense the industrialization of Hong Kong had little to do with government policy. It simply emerged. The government did not promote it or stood in its way. If the government wished to take any credit for the policy it was to provide a legal, economic and business environment that allowed the entrepreneurs and workers to flourish. Hong Kong's manufacturing sector was well supported by other entrepreneurs and professionals who had arrived from Shanghai in the areas of shipping, banking, retail business, movies and professional services. The British and Chinese bankers and traders indigenous to Hong Kong also provided valuable financial support and overseas networks.

One of the most significant events in the development of manufacturing in Hong Kong was the imposition of voluntary export restraints on textiles and garments export by the United States government through the Multi-Fiber Agreement (MFA). The Hong Kong government's response was unique in that it decided to allocate the quotas to the manufacturers according to their previous export performance. It also allowed the manufacturers to trade these quotas on the market freelyand top collect the quota rent for themselves. As a result it created a uniquely efficient system for the utilization of these scarce and valuable quotas that is unrivalled anywhere else. The quota allocation system also avoided the problem of public corruption associated with government administration of quotas. This episode is particularly revealing of the government's laissez faire economic philosophy and approach to economic policy.

The industry was able to reap scarce economic rents and to expand into high value added products. It became by far the most important industry in Hong Kong during the 1960s and the 1970s. Nevertheless the annual exercise of trade negotiations with the United States government brought Hong Kong trade officials into close collaboration with the textile and garment manufacturers. The Textile Advisory Board became one of the most powerful advisory committees. Influential manufacturers took turns in sitting on the Board and many were appointed to the Legislative and Executive Councils. The success of the group in persuading government to fund the development of the technical institutes and colleges, the polytechnics, the Vocational Training Council, the Productivity Council; to exempt trucks from expensive licensing requirements; to buy power at preferential rates; and to provide industrial land at a cheaper price are evidence of the groups enormous influence. In the past many joke that the Trade Department's most important job was to administer the textile and garment quotas. Indeed the influence of this powerful lobby continues to be felt even today in the many levels of government.

Although there were other manufacturing industries but none of them had the influence and sophistication of the textile and garment lobby. However, these other industrialists also benefited from the successful lobbying of the textile and garment manufacturers. In one sense the policies they obtained and which the government was willing to concede did not necessarily favored one set of industries over another, although they were clearly pro-industry.

The Changing Fortunes of Manufacturing

The first golden era of the textile and garment manufacturers was the 1960s when the enormous growth of young female labor force provided these labor-intensive industries with its most important support. These workers were the baby boom generation of the immigrants that had arrived in the immediate post war years. By the 1970s these young women workers had reached their marriage and maternity years and were withdrawing from the labor force. The problem of labor shortage was compounded by the first oil shock of 1973. A huge industrial lobbying effort emerged. The then Financial Secretary, Sir Philip Haddon-Cave, finally succumbed to the political pressure and established a Committee on Industrial Diversification to study the matter. The Report was issued in 1977 and included recommendations on enhancing productivity and the development of new products and markets, however, it was soon overtaken by events.

China began to open its economy in 1979. In the span of 18 months between 1980 and 1981 some 400,000 people crossed the border from China into Hong Kong. The tide was stemmed after the Hong Kong government abandoned its reach base policy and started to repatriate illegal entrants from China back across the border. The sudden influx solved Hong

Kong's labor shortage problem literally overnight. As real wages fell, industrial output rebounded. Labor intensive manufacturing acquired a new leash of life.

In the 1980s, the manufacturing both expanded and migrated across the border into south China. The abundance of low wage labor there provided the labor intensive manufacturing sector with its second golden era. Many firms were able to expand their production almost ten times. Huge fortunes were made within a very short span of time. Unfortunately to the dismay of many married mothers, who have completed their child bearing and child rearing years, and were to return to the labor force in the 1980s were finding that many manufacturing job opportunities were gone and they were competing against younger female workers in China. China's opening occurred at a very opportune time for Hong Kong. It took place at a time when Hong Kong's comparative advantage in labor intensive manufacturing was ending, but the existing knowledge and skills in operating labor intensive manufacturing had not yet depreciated or become obsolete.

The predicament of the quota driven textile and garment industry is particularly interesting. Although Hong Kong was no longer competitive in manufacturing many low value added textile and garment products, however, the quotas themselves were valuable. To utilize them profitably it was necessary to import workers. A new lobbying effort emerged to bring in workers from China was widely supported by business but bitterly opposed by workers. The government finding itself caught between two camps and tried to strike a middle ground by allowing a limited number of imported workers. The employers were also required to pay imported workers the same wages as those provided to local workers. It is interesting to note that business sector support for imported workers was not limited to the manufacturing sector alone and certainly not the-quota driven textile and garment industry. A proposal to allow businesses to bid for the quotas was not accepted by government because of the successful lobbying of the textile and garment industries. The proposal, which would result in an efficient allocation of the labor import quotas, did not favor the low valued added textile and garment industries.

In October 1997, Mr. Tung Chee Hwa the Chief Executive of the Hong Kong Special Administrative Region announced the establishment of a committee for the textile and garments industry to support their development. No details are available at this point, but one would not be surprised if the committee would recommend policies to favor that sector some time in the future.

The Re-emergence of Industry and Technology Policy

Although the expansion of labor intensive industries into China provided a golden opportunity for the growth of Hong Kong manufacturers, however, the future of manufacturing was not assured. First, the future prospects of Hong Kong's old manufacturers in low value added production operating across the border was not assured. Increasingly Hong Kong was adding value through servicing manufacturing production in China rather than engaging in production per se.

Second, the attempt to upgrade productivity into high value added production in China was having some major difficulties. The lack of protection for intellectual property rights and the arbitrariness of government behavior in China were deterring investments in R and D and the adoption of high value added production processes. The problems encountered in managing and retaining key management technical, and skilled staff and the uncertainties inherent in controlling the production process made it risky to develop knowledge intensive production in China.

Some new manufacturers were retracing their steps and hoping to return to Hong Kong. Unfortunately the cost structure in Hong Kong was becoming prohibitive. The opening of China had fundamentally transformed the Hong Kong economic structure. Today less than 10% of GDP and employment is still classified as manufacturing. It is believed that some of it is not really manufacturing, but simply a statistical artifact of the classification system. Labor costs are expensive and although an unusually large proportion of the students continue to study science and engineering subjects in the schools and universities because of the presence of a rigid system of student places, few of them aspire to work in manufacturing. Furthermore housing costs are extremely expensive that hardly any foreign companies have an interest in investing in manufacturing in Hong Kong.

Nevertheless manufacturers with an interest in high value added processes have continued to press the government to develop industrial estates, science parks, and funding to support applied research. Their efforts are also supported by the universities who probably would benefit from additional applied research and development grants. The Industry and Technology Development Council is now distributing more funding for such purposes, although the amounts are still quite modest by the standards of most industrialized countries and those in the East Asia region. It is interesting to note that the funding actually is provided to very specific projects with a well defined problem or application. As a consequence some amount of picking winners is inevitable, but the effect will be limited by the funding that is available. The government has also announced the establishment of a new Information Technology Bureau for the purpose of promoting and coordinating the use and development of information technology in the territory.

The Industry Department is now believed to be willing to accommodate the proposal to establish a government credit guarantee fund to support small and medium enterprises to be administered by the banks. This idea would not have been entertained in the past but is finding favor with the current administration perhaps as a concession to business to demonstrate that the government is supporting industry. It is believed that the amount of funds to be made available will be limited.

The Future of Industrial Policy

Our discussion of Hong Kong's past reveals that government has on the whole been reluctant to take an active role in formulating an industrial and technology policy. In particular there is no policy that is explicitly discriminatory in developing selective or strategic industries.

This is not to say that it has not adopted policies that have favored industries as a whole over other non-industrial sectors. But these are primarily focussed on providing human capital formation, land resources, information dissemination and to a lesser extent selective funding for research and development. At no time were credit policies and fiscal measures used to support industries either generally or selectively.

It is worth noting that these industry support policies were put in place largely as a result of intense and effective lobbying from industry interests rather than the product of government pro-active initiatives. They are best described as the reluctant but politically necessary concessions that the administration had to undertake to accommodate the clamor of vocal and powerful vested interests.

The future of industry and technology policy depends on a number of factors. The new Special Administrative Region government that came into office on 1 July 1997 is likely to be by inclination more explicitly pro-business than previous administrations. The legislature is likely to be more representative of organized business interests, but the difference today is that instead of being appointed members the organized business interests will be elected through functional constituencies and by an electoral college. They are therefore likely to be more entrenched than under the British administration. The government may therefore be more sympathetic to business lobbying interests, including both old and new manufacturing interests.

The restoration of sovereignty over Hong Kong from Britain to China is unlikely to have a major impact on industrial policy. It may, however, speed up the coordination of cross border movements of goods and people and the development of large infrastructure projects that were neglected in the previous years due to political quarrels between the British and Chinese governments. While these issues are not directly industrial policy as traditionally understood, it could have a significant effect on further integration of the Chinese hinterland as a manufacturing base of Hong Kong. If this occurs it would be another significant boost for Hong Kong's manufacturing sector.

Fears that China will interfere in Hong Kong's economic affairs have not materialized. The fact that many old industrialists from Hong Kong have cultivated successfully the Chinese leadership probably reflects the political savvy of these industrialists in hedging their bets rather than a sign of the Chinese leadership's inclination to interfere in Hong Kong's industrial policy.

Despite Hong Kong's growing penchant to flirt with industrial and technology policy the main thrust of that policy is likely to be sector neutral. Measures that are likely to be non-neutral and selective are unlikely to be extensively adopted with any major commitment of resources. The Hong Kong government is poorly equipped to intervene with the market process on a large scale simply because it does not command the resources necessary to do so. A low tax rate makes it difficult to finance large recurrent spending for industrial policy in an era where there are powerful competing social demands for scarce budgetary resources. The huge reserves accumulated by the government are largely derived from land related revenue which had increased enormously as a result of asset price inflation in the past decade. It is unlikely that future recurrent spending will be financed by such one off revenue increases. Furthermore the currency crises in a number of countries in Asia this year and the recent speculative attacks against the Hong Kong Dollar will give government a compelling reason to keep its reserves out of reach.

As Hong Kong's economy is already dominated by the service sector the competing demands for government attention will inevitably neutralize the lobbying efforts of the industrialists. The Industry Support Fund is now no longer the only fund the government has supported. A separate and new Services Support Fund had already been established and is functioning. The importance of technology is not perceived primarily as an industrial concern but effects all sectors. For this reason, it is quite likely that although the commitment to a laissez faire economic policy will be weakened it is unlikely to be abandoned entirely by government. It will still be the last line of defense of a government that must hold the interest groups in abeyance, is limited in its ability to intervene because of fiscal restraints, and has to demonstrate its ability to maintain prosperity and stability to a highly mobile population and investors that could leave at will if taxes rise and regulations become prohibitively expensive for businesses to grow.