

**Small-Medium Enterprises in Hong Kong:  
Recent Developments and Policy Issues**

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We review the recent developments of small and medium enterprises (SMEs) in Hong Kong and consider some relevant policy issues. The rapid economic development of Hong Kong in the past can in large part be attributed to the dynamic role of its SMEs. Small and medium enterprises account for a high proportion of Hong Kong's output and employment and they will continue to form the foundation of the Hong Kong economy. It is vital that appropriate policies are adopted that will ensure that they are able to continue to develop as Hong Kong's economy changes.

**Recent Trends of SMEs**

The definition of SMEs we have adopted is the number of persons engaged and varies from industry to industry (see Table 1 below):<sup>1</sup>

**Table 1: Definition of SMEs**

<b>Industry</b>	<b>Number of persons engaged</b>		
	<b>Small</b>	<b>Medium</b>	<b>Large</b>
Manufacturing	1-19	20-499	>500
Wholesale	<5	5-49	>50
Retail	<5	5-49	>50
Imports and exports	<5	5-49	>50
Restaurants	1-9	10-99	>100
Hotels and boarding houses	1-9	10-99	>100
Financing	1-9	10-49	>50
Business services	1-9	10-49	>50
Transport	<5	5-49	>50

The vast majority of companies in Hong Kong are SMEs. In 1997, there were 275,056 enterprises in the nine industries of manufacturing, import and export,

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<sup>1</sup> Further explanations of the definition we use is found in Ho Sau Lan, Liu Pak-wai, and Y.C. Richard Wong (1999), *The Recent Trend, Problems and Resolutions of Small Medium-sized Enterprises in Hong Kong* (Chinese version), The Hong Kong Chinese Importers' & Exporters' Association.

wholesale, retail, hotels and boarding houses, restaurants, financing, business services and transport and SMEs accounted for 98.9% of the total.<sup>2</sup>

The contribution of SMEs to the economy can be best described by their shares in employment and value added. In 1996, SMEs accounted for 70.2% of the total employment of 1,796,635 persons in the above nine industries. Further, SMEs accounted for ~~61.958.2~~% out of the total value added of HK\$523,025 million.

Average labour productivity of SMEs was HK\$~~56,59241,018~~ which was ~~88.19.0~~% of the average productivity of HK\$~~291,11470,770~~ for all enterprises. The average annual wage of employees of SMEs was HK\$~~152,31349,212~~, which was ~~87.190.0~~% of the average for all enterprises (HK\$~~174,79765,867~~). Average firm size of the nine industries was 6.2 persons while that of SMEs was 4.4 persons (see Table 2).

**Table 2: Development of SMEs 1989-96**

	Number of SMEs	Persons Engaged	Average Firm Size	Value-added per annum (HK\$mn)	Average Labour Productivity per annum (HK\$)	Average Wage per annum (HK\$)
1989	234,323	1,432,577	6.1	164,588	114,889	69,918
1990	251,362	1,457,073	5.8	186,687	128,125	78,697
1991	268,402	1,461,639	5.4	210,780	144,208	89,100
1992	283,053	1,441,854	5.1	235,758	163,510	92,840
1993	287,562	1,450,789	5.0	265,128	182,747	110,501
1994	291,694	1,385,198	4.7	288,514	208,284	126,935
1995	287,604	1,329,014	4.6	305,313	229,729	143,046
1996	285,204	1,261,207	4.4	323,616	256,592	152,313
1997*	152,772	755,493	4.9	158,376	209,632	155,720

Note: \* Figures for 1997 exclude wholesale industry and import & export industry<sup>3</sup> since complete data for SMEs in that year is not available

The past eight years have brought many changes for SMEs in the manufacturing, wholesale, retail, import and export, restaurant, hotel and boarding house, finance, business services, and transport sectors. Basically, the changes in these sectors mirrored the performance of the Hong Kong economy in this period.

<sup>2</sup> This is an approximate figure estimated from 1996 figures. Figures for 1997 have not been released.

<sup>3</sup> Deflator for each sector is difficult to obtain. Here for reference, we used composite price index of each year to deflate the figures in the year concerned to obtain real growth.

In the period from 1989-96, there was an increase in the number of SMEs from 234,323 to 285,204. However, there was a decline in total persons engaged 1,432,577 to 1,261,207. This reduction in employment was mainly due to the rapid decline of manufacturing industry. Despite this, total value added increased steadily from HK\$164,588 mn in 1989 to HK\$23,61603,974 mn in 1996, representing 21.2% and 27.125.5% respectively of GDP. Average labour productivity increased tremendously from HK\$114,889 to HK\$256,59241,018 while the average wage also increased from HK\$69,918 to HK\$152,31349,212. Average firm size of SMEs decreased from 6.1 to 4.4 (see Table 2).

In terms of growth, there were significant slowdown in number, person engaged, value-added, average labour productivity and average wage (see Table 3). And in more recent years, negative growth was recorded for most of these items. Persons engaged started to mark a negative growth at the earliest stage. There were also negative growth for enterprise number, value-added, average labour productivity, and average wage for SMEs starting from either 1995 or 1996. These reflect to a large extent the macroeconomic environment of the economy has little room for SMEs to expand and further improve efficiency of labour.

**Table 3: Annual Real Growth Rate 1989-96 (in %)**

	Number of SMEs	Persons Engaged	Value-added	Average Labour Productivity	Average Wage
1990	7.3	1.7	3.2	1.3	2.4
1991	6.8	0.3	1.3	1.0	1.6
1992	5.5	-1.4	2.3	3.8	-5.4
1993	1.6	0.6	3.7	3.0	10.2
1994	1.4	-4.5	0	5.2	6.1
1995	-1.4	-4.1	-3.3	1.2	3.6
1996	-0.8	-5.1	<u>-0.36.7</u>	<u>-51.4</u>	<u>0.2-2.0</u>
1990-6 average	2.8	-1.8	<u>0.904</u>	<u>2.81.9</u>	<u>2.42.1</u>
1997**	-4.4	1.9	4.4	6.2	5.4

—Note: \*\* figures of 1997 are for SMEs excluding those in wholesale industry and

— import & export industry.

At the industry level, we find in general that in most industries the growth in the number of SMEs mirrored the growth in the overall number of SME. There were two exceptions, however.

First, manufacturing, unlike the general trend, recorded a decrease in number, employment and total value added of SMEs. This was generally the result of the relocation of production from Hong Kong to the mainland. On the other hand, manufacturing still had a marked a growth increase in in average labour productivity and in average wages in real term (see Table 4), similar to the overall trend for SMEs. These reflect that manufacturing had not performed reasonably well. In fact, those parts of manufacturing remained in Hong Kong were mostly related to designed, packaging and marketing. These sectors still had some degree of efficiency improvement.

Table 4: Growth Rate of Different Aspects of SMEs of Manufacturing 1990-97

	<u>1990</u>	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>
<u>no. of SMEs</u>	<u>-1.2</u>	<u>-15.3</u>	<u>-5.0</u>	<u>-17.6</u>	<u>-7.0</u>	<u>-13.7</u>	<u>-6.3</u>	<u>-3.6</u>
<u>Persons engaged</u>	<u>-7.1</u>	<u>-13.2</u>	<u>-8.6</u>	<u>-16.3</u>	<u>-16.4</u>	<u>-15.9</u>	<u>-10.0</u>	<u>-12.5</u>
<u>Total value added</u>	<u>-7.5</u>	<u>-8.5</u>	<u>-4.3</u>	<u>-17.6</u>	<u>-20.1</u>	<u>-10.4</u>	<u>-7.5</u>	<u>-10.3</u>
<u>(real growth)</u>								
<u>Average labour productivity</u>	<u>0.4</u>	<u>7.2</u>	<u>5.6</u>	<u>0.2</u>	<u>-2.8</u>	<u>8.3</u>	<u>3.5</u>	<u>3.4</u>
<u>(real growth)</u>								
<u>Average wage</u>	<u>0.7</u>	<u>2.8</u>	<u>2.2</u>	<u>2.9</u>	<u>1.1</u>	<u>4.6</u>	<u>0.4</u>	<u>3.3</u>
<u>(real growth)</u>								

Second, the number of SMEs in the hotel and boarding house sector recorded a decrease from 1,485 to 1,155. Persons engaged and total value added in tandem dropped. This is understandable given the increasing dominance of large enterprises in the industry. Despite this, Similar to manufacturing, average labour productivity and average wage marked growth steadily (see Table 5). This is understandable given the increasing dominance of large enterprises in the industry.

Table 5: Growth Rate of Different Aspects of SMEs of Hotels 1990-97

	<u>1990</u>	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>
<u>no. of SMEs</u>	<u>-1.2</u>	<u>-15.3</u>	<u>-5.0</u>	<u>-17.6</u>	<u>-7.0</u>	<u>-13.7</u>	<u>-6.3</u>	<u>-3.6</u>
<u>Persons engaged</u>	<u>-7.1</u>	<u>-13.2</u>	<u>-8.6</u>	<u>-16.3</u>	<u>-16.4</u>	<u>-15.9</u>	<u>-10.0</u>	<u>-12.5</u>
<u>Total value added (real growth)</u>	<u>-7.5</u>	<u>-8.5</u>	<u>-4.3</u>	<u>-17.6</u>	<u>-20.1</u>	<u>-10.4</u>	<u>-7.5</u>	<u>-10.3</u>
<u>Average labour productivity (real growth)</u>	<u>0.4</u>	<u>7.2</u>	<u>5.6</u>	<u>0.2</u>	<u>-2.8</u>	<u>8.3</u>	<u>3.5</u>	<u>3.4</u>
<u>Average wage (real growth)</u>	<u>0.7</u>	<u>2.8</u>	<u>2.2</u>	<u>2.9</u>	<u>1.1</u>	<u>4.6</u>	<u>0.4</u>	<u>3.3</u>

On top of the above, it is interesting to note about the firm size at industry level. Table 6 reported average firm size (in terms of average persons engaged in that industry) of the nine industries over time. We found that firm size tends to decrease for manufacturing, wholesale, import & export, restaurants, and business services. Retail, hotels & boarding houses, and transport showed consistently decline in firm size. The case for financing is not so clear since firm size fluctuated over time, which tended to coincide with the fluctuation of the economy. The phenoneon on firm size will be discussed in next section.

Table 6: Average Persons Engaged by Industry

	<u>1982</u>	<u>1985</u>	<u>1988</u>	<u>1991</u>	<u>1994</u>	<u>1997</u>
<u>Manufacturing</u>	<u>19.8</u>	<u>18.5</u>	<u>17.2</u>	<u>14.8</u>	<u>13.6</u>	<u>11.6</u>
<u>Wholesale</u>	<u>5.3</u>	<u>4.6</u>	<u>4.6</u>	<u>4.0</u>	<u>4.0</u>	<u>3.3</u>
<u>Retail</u>	<u>3.7</u>	<u>3.5</u>	<u>3.7</u>	<u>3.9</u>	<u>4.1</u>	<u>4.6</u>
<u>Import &amp; Export</u>	<u>6.5</u>	<u>6.1</u>	<u>5.9</u>	<u>5.3</u>	<u>5.1</u>	<u>5.3</u>
<u>Restaurants</u>	<u>23.1</u>	<u>23.8</u>	<u>22.0</u>	<u>20.4</u>	<u>18.9</u>	<u>20.0</u>
<u>Hotels &amp; Boarding Houses</u>	<u>28.6</u>	<u>25.9</u>	<u>22.7</u>	<u>24.0</u>	<u>31.5</u>	<u>32.2</u>
<u>Financing</u>	<u>8.2</u>	<u>9.9</u>	<u>10.8</u>	<u>10.2</u>	<u>9.6</u>	<u>11.5</u>
<u>Business Services</u>	<u>11.4</u>	<u>10.2</u>	<u>9.1</u>	<u>7.4</u>	<u>5.8</u>	<u>6.4</u>

<u>Transport</u>	<u>3.8</u>	<u>4.0</u>	<u>4.3</u>	<u>4.6</u>	<u>4.9</u>	<u>5.4</u>
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### **Firm Size and Economies of Scale**

The data from 1979 to 1997 reveals that the proportion of small enterprises in the manufacturing, wholesale, import and export, restaurant, financing and business services sectors grew steadily and was matched by a downward trend in scale of operation (as measured by average size of firm). This is contrary to the common belief that the advantages of economies of scale in a market will lead to the emergence of large firms and decline in the proportion of small firms.

This empirical observation can be attributed to the effects of specialization and increasing market and transaction efficiency on firm size. The extent of the market for services in Hong Kong has expanded rapidly following the opening up of China. This has led to greater specialization in labour tasks, and in outputs and inputs, which have impact on firm size.

**—Table 4: Average Persons Engaged by Industry**

	1982	1985	1988	1991	1994	1997
Manufacturing	19.8	18.5	17.2	14.8	13.6	11.6
Wholesale	5.3	4.6	4.6	4.0	4.0	3.3
Retail	3.7	3.5	3.7	3.9	4.1	4.6
Import & Export	6.5	6.1	5.9	5.3	5.1	5.3
Restaurants	23.1	23.8	22.0	20.4	18.9	20.0
Hotels & Boarding Houses	28.6	25.9	22.7	24.0	31.5	32.2
Financing	8.2	9.9	10.8	10.2	9.6	11.5
Business Services	11.4	10.2	9.1	7.4	5.8	6.4
Transport	3.8	4.0	4.3	4.6	4.9	5.4

————Specialization of input refers to firms specializing in one or more of the intermediate services. In producing a product a firm undertakes a complicated process of design, marketing, sourcing raw materials, producing intermediate products, production management, storage and delivery to customers. A firm may have different degrees of comparative advantage in these functions. If the size of the market increases, firms specializing in one or more of these services will emerge in the market. A firm

may give up some of the functions and purchase the required inputs and services in the market instead. For instance, a firm may choose to hire an advertising agency for undertaking the firm's promotion affairs instead of running a promotion department itself. As a result, a lot of new small size firms will emerge to dominate the market for intermediate services.

And yet for some industries, the effect of economies of scale dominates. For hotel industry and retail industry, the brand name effect lead to a significant advantage for large firms. This is because their clients are dominated by final customers who make infrequent purchases. Therefore, these customers do not possess a great deal of information about the products and services they wish to purchase. Brand names help them to minimize on information costs. Investments in creating a brand name provides considerable advantage for firms to take advantage of economies of scale. As a consequence, the average firm size in the final customer oriented sectors has actually been growing.

The impact of these three types of specialization on firm size may differ. The ultimate effect depends on production technology, transaction efficiency and the degree of specialization brought about by an increasing market. If the advantage brought by economies of scale is offset by specialization in output and in input firm size will decrease. This is the case for the above industries.

### **Policy Recommendations**

Given their small size and limited resources, SMEs have little influence on the policy and macroeconomic environment. They often operate in isolation from each other and are not well managed. They are less able to lobby government for special privileges and treatment. Their greatest competitive power is in being flexible and adaptable. SMEs rely on the government to provide a level playing field so that they can find a niche in the market and compete with others effectively. Government policies that are aimed at picking winners create a policy environment that is on the whole unfavourable to the development of SMEs because they are unlikely to benefit from selective discriminatory policy measures.

An open business environment is therefore essential for SMEs to operate successfully. The government can help maintain this by keeping taxes simple and low,

providing land and infrastructure and an adequate supply of human skills, maintaining an open and competitive market environment, and upholding the rule of law to protect private property rights. These can help reduce the business costs for SMEs and help them to find better opportunities and develop their businesses.

In the past, when manufacturers were an important part of the local economy the discipline of the global market place provided a highly competitive environment for our export oriented manufacturers to compete and innovate. Today when the largest segment of our economy is in services, an important role for the government is to take a pro-active stance to deregulate and liberalize the service sectors, to reduce regulations that hinder business efficiency, to remove red tape and bureaucracy so as to help reduce business costs especially for SMEs. The government could open up the market for many services so as to enhance competition and allow new firms to enter markets that have been dominated by existing enterprises.

An important element of competitiveness in the service economy is the quality of human capital. Since SMEs are usually less able to offer in-house training to their employees than larger enterprises, they rely on the market to provide training and education opportunities. Government can help to improve education and training opportunities by introducing a voucher system as a means of subsidizing such activities. Such an approach can be targeted at special sectors of the population or at specific skills in a more market relevant way. This approach would enhance enormously the efficiency of the education and training sectors and would benefit many SMEs.

The importation of highly needed special skills is beneficial to the economy as a whole in generating new business opportunities and can also help SMEs indirectly.

### **Financing Problems of SMEs**

Financing has long been one of the major problems that SMEs face in their operations. One of the reasons for this is that many SMEs do not produce in Hong Kong and their capital assets such as machinery and equipment are located in the mainland. For such SMEs, financing from the mainland banks using these capital assets is difficult because of the restrictions on mainland banks. On the other hand, banks in Hong Kong seldom accept capital assets in the mainland as collateral when they consider loan applications from SMEs. The most common form of loans that SMEs obtain from banks is collateral based loans on property in Hong Kong.

Property loans are a viable and reliable source of funding for some SMEs.



However, it is vulnerable to price fluctuations and market sentiments in the property market, as happened during the recent financial crisis.

In view of this, it is imperative for the banks to develop new ways of assessing credit risk in making loans to SMEs. Enhancing market competition in the financial sector through further liberalization would encourage banks to the government should encourage the market to develop a credit register system so that banks can approve loans based on complete credit information on firms. Such information is important for banks when they want to assess whether loans to enterprises should be approved. The credit register could be structured with two tiers. The first tier of the credit register could contain information on the overall indebtedness of each commercial enterprise. The second tier of the credit register will record the credit performance of enterprises, such as whether they repay loans on schedule.

### **Encouragement of technology use**

Some of the common difficulties faced by SMEs are:

- (1) lack of funds for marketing their products and sufficient information on the market;
- (2) inability to explore overseas markets, making sales expansion difficult;
- (3) low levels of labour skills and knowledge which lower operating efficiency; and
- (4) inadequate funds for investment and know-how to apply technology in operations.

These problems can be alleviated if SMEs can apply technology in their operations. Because of positive information externalities (third party effect ), the government should encourage and assist SMEs to use technology. The government may:

- provide adequate and effective educational courses on information technology to SMEs.
- assist SMEs to establish a company information website, which will facilitate overseas buyers in contacting local SMEs. All the information on an SMEs may be placed in a well designed, easily accessed website.

### **Improving Management and Marketing Skills of SMEs**

Small and medium enterprises often operate on a family basis and lack management and marketing skills. In order to help raise their management skills, the government may consider providing support by:

- employing retired business experts as consultants to advise SMEs on improving their

operating skills.

- encouraging business case studies and conducting workshops to share experience and

good practices.

(Again, some of these things are already being done. Are the authors suggesting something more or different?)

### **Looking Ahead**

The mainland has for long provided Hong Kong with many business opportunities. As the hinterland of Hong Kong, it has helped nurture the large number of SMEs in Hong Kong. The mainland provided us with many immigrants with capital and skills in 1950s, which led Hong Kong to become a manufacturing centre. During the 1960s and 1970s, Hong Kong became an important re-export centre for the mainland. The opening-up of the mainland in 1978, on the other hand, brought about swift changes for Hong Kong's manufacturing. The mainland has become a production base for Hong Kong enterprises while Hong Kong has gradually developed into a service-based financial centre and intermediary service provider for the huge market of the mainland.

However, there is a fear that Hong Kong's role as an intermediary service provider will be replaced by mainland cities as the mainland economy develops. This fear is probably exaggerated. We should not overlook Hong Kong's strong position supported by the advantages of its critical mass of companies and business sectors and its well-established institutions. Cities in the mainland will try to catch up with us, but this will undoubtedly take time. Meanwhile, there are still many opportunities for collaboration between the mainland and Hong Kong as the mainland develops. Hong Kong will be able to capitalize on these opportunities and maintain its own economic development.

### **China's Accession to the WTO**

The accession of China to the WTO is now in sight given the recent bilateral agreement between the mainland and the US. This should be encouraging to both the mainland and Hong Kong. In the near term, there may be drawbacks for both Hong Kong and mainland firms facing potential competition from overseas. Yet, in the long term, both the mainland and Hong Kong will be able to capture the huge market potential arising from more open trade.

It has been estimated that the one-off induced increase in world exports of goods

and services resulting from China's accession to the WTO may be as large as US\$21.3 billion. In the long term the benefits may be greater as both economies grow as a result of the increased trade and investment. The immediate increase to the US has been estimated at \$3.1 billion.<sup>4</sup> China should gain from both exporting more to, and importing more from the world market, particularly the US. China will be more able to capture US markets previously held by other East Asian economies. China has estimated that imports and exports will grow 26.9% and 25.8% respectively, and GDP increase by 1.5% in 2005 if all entry procedures were successfully completed.<sup>5</sup>

At the industry level, in the mainland those industries such as vehicles, cotton and wheat with greater government protection and higher capital-intensity will suffer more from outside competition following China's accession to the WTO. But labour-intensive industries such as textiles and apparel should gain.

For Hong Kong, there are two areas of concern. First, on the trade side, it is feared that following China's accession to the WTO, the role of Hong Kong as China's entrepot will decline. It is true that Hong Kong's relative importance as an entrepot may decline as other Chinese cities develop and foreign companies increasingly trade directly with the mainland, but given the potential increase in overall trade with the mainland, Hong Kong will still benefit even if it is only able to share a proportionately smaller slice of the larger pie.

A second area of concern is Hong Kong's role as a services intermediary. A negative effect may be that large overseas enterprises may penetrate the mainland market directly without help from Hong Kong. But on the positive side, more and more small overseas companies may try to enter the mainland market as a result of the improved business environment. They may need the services of Hong Kong as they do not have enough knowledge and contacts to do it themselves. It is expected that demand for accounting, finance, legal, communications, and information technology services will grow tremendously. As a result, there will be many business opportunities for SMEs in Hong Kong.

For Hong Kong to capture the opportunities arising from the mainland's accession to the WTO, it must take action to prepare itself. We need to improve our transport

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<sup>4</sup> Daniel H. Rosen (1999), "China and the World Trade Organization: An Economic Balance Sheet", *International Economics Policy Briefs*, No.99-6, June, p.2.

<sup>5</sup> *Hong Kong Economic Times* (1999), 18 November.

system and customs procedures to create closer links with the mainland. We must promote Hong Kong enterprises in overseas market, and also to aid local enterprises in communicating with mainland authorities on business opportunities. More importantly, the government should explore with the mainland the possibility of early opening of some markets to Hong Kong enterprises. If this can be realized, Hong Kong enterprises will be in a better position to compete with overseas firms.

### **Conclusion**

The rapid rise of Hong Kong economy in the past has owed much to the enterprise of SMEs. Despite their small size, SMEs are noted for their flexibility and dynamism under changing economic circumstances. The fact that the recent Asian financial crisis hit SMEs badly does not negate the key advantages that these companies have. They will continue to be a major contributor to Hong Kong's economy as the economic outlook improves. To ensure that this happens, the best policy the government can follow is to provide a sound business environment, and an adequate supply of high quality human capital. Further, it should also encourage the use of information technology to raise the efficiency and quality of service provided by SMEs and initiate improvements to the banking system, such as establishment of a credit register, to ease financing problems faced by SMEs. Such measures will ensure that there is a level playing field on which SMEs can raise their efficiency and compete effectively to the ultimate benefit of the whole economy.