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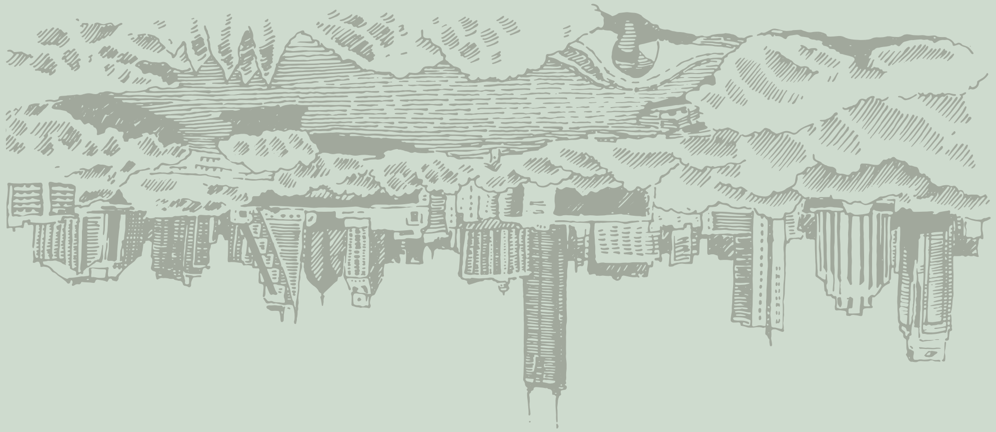
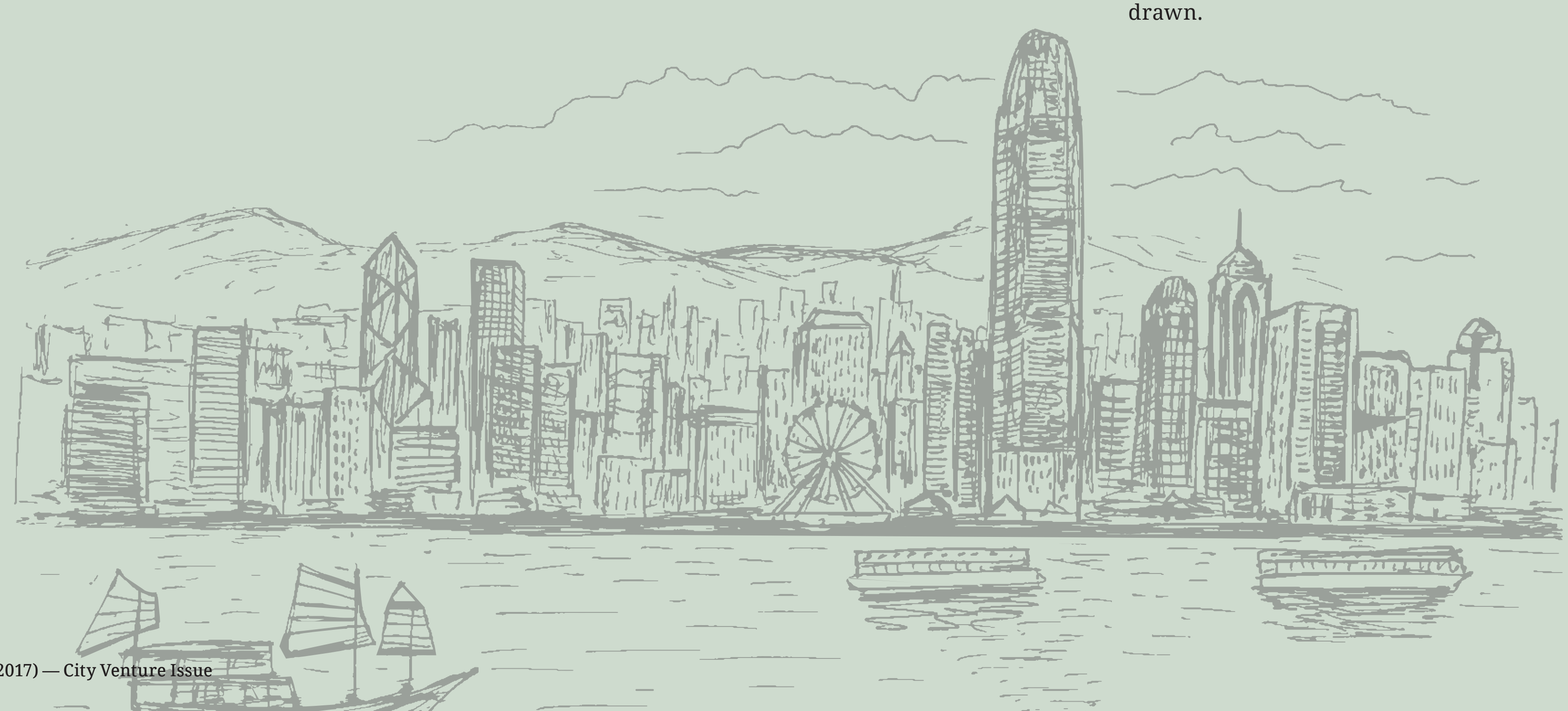


THE “TECH” OF TWO CITIES

WHY HONG KONG FAILED WHERE SHENZHEN SUCCEEDED



Shenzhen Special Economic Zone is an experiment...we want it to succeed, but if it fails, it is still a valuable experience

— Deng Xiaoping, June 29, 1985

Hong Kong’s prosperity and stability is closely associated with China’s development strategy

— Deng Xiaoping, June 3, 1988

Introduction

Shenzhen used to be a tiny town of around 30,000 people, north of the then prosperous British colony, Hong Kong, in southern China. The story is certainly entirely different now that Shenzhen is comparable to, if it has not already outshone its once proud neighbor.

Shenzhen’s Nanshan district, home to a huge hi-tech industrial park, is now China’s richest, with a higher per capita GDP than even capitalist Hong Kong. This article will compare the two cities through the use of CIV city cases. It will discuss whether the institutional differences can help to explain the respective growth stories of the cities. Afterwards, the article will consider the prospects of the Qianhai Shenzhen-Hong Kong Modern Service Industry Cooperation Zone, a national-level initiative to combine the core strengths of the two cities in an attempt to boost the existing technology center to a new level before a conclusion is drawn.

1. Institutional Differences Between Shenzhen and Hong Kong

Institutions are important for economic growth. The development of Hong Kong’s institutions has a close connection with its historical status as a colony of the British Empire, even after the handover. Having a legal system inherited from England is widely regarded as one of Hong Kong’s advantages.

The development of company law, which can facilitate the conduct of business, is a good example. Company law is important in two ways. First, it governs the corporate form which provides attractive features such as limited liability to shield the personal liability of investors, as well as the transferability of shares to give investors an exit right. Second, the law provides a clear allocation of rights and control to shareholders so that they are able to protect themselves by, for example, using their decision rights.

SHENZHEN IS COMPARABLE TO, IF IT HAS NOT ALREADY OUTSHONE ITS ONCE PROUD NEIGHBOR

Hong Kong is a clear winner in this regard. The genesis of the current framework was the Hong Kong Companies Ordinance of 1865 which mirrored the English Companies Act of 1862. It has closely followed the English model since then. In sharp contrast, China did not have a proper set of company laws until 1993. Unfortunately, the first company law was primarily aimed at state-owned enterprises but not private economic activities.

The law was generally highly restrictive; for example, it required all share transfers to take place through a securities exchange, which meant that a private non-market transfer between parties was not possible. Also, the law prohibited the directors of a company from transferring their own shares during their term of office, which effectively discouraged senior management of a company from having a financial interest in the company. The law was then amended several times to foster a more functional and friendly regime; for example, in 2013, the law was revamped to streamline the registration formalities and relax the threshold for setting up a company.

In light of the recent legal reforms, it might be useful to refer to the World Bank's Doing Business Report 2016, which provides measures of business regulations for local companies in 189 economies, to see how China has fared against Hong Kong (see table below). It can be seen that Hong Kong's regime remains better than that of China in all but ~~one~~ important ~~aspect~~ of doing business.

Despite the fact that Hong Kong is still leading in a number of aspects, it is unfair to write off China's efforts in improving its institutional environment through various legal reforms. Poor investor protection may put off potential funders from investing in a venture. In this regard, positive changes in the regulatory framework were witnessed in the revisions to the Chinese Company Law in 2005; for example, companies are allowed to use cumulative voting, thereby empowering minority shareholders to appoint their representatives to the corporate boards.

Table 1: How Hong Kong and China Have Fared Respectively in Different Key Aspects of Doing Business.

Source: World Bank (2016), Doing Business Report

World Bank's Doing Business Ranking of 189 Economies

TOPICS	CHINA'S RANKING	HONG KONG'S RANKING
Starting a Business	136	4
Dealing with Construction Permits	176	7
Getting Electricity	92	9
Registering Property	43	59
Obtaining Credit	79	19
Protecting Minority Investors	134	1
Paying Taxes	132	4
Trading across Borders	96	47
Enforcing Contracts	7	22
Resolving Insolvency	55	26

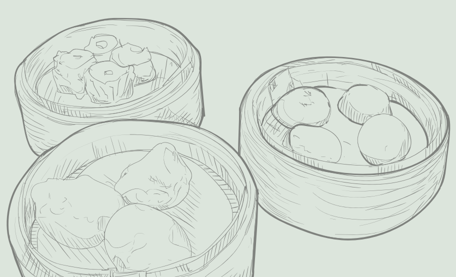
Also, a stricter duty of care is imposed on directors, supervisors, and senior management.

In the case of a dispute, shareholders have express rights to bring a legal action against corporate officers. Academic study has confirmed the significant upward movement in the level of shareholder protection made by China between 1995 and 2005. It is worth noting that law reforms may not necessarily lead to a better outcome (at least in the context of this article). One notable example will be the introduction of Labor Contract Law in 2008.

Following legal moves to enhance labor rights, the rising cost of China's famously cheap labor, the very factor that the country's economic boom was built on, appears to be irreversible. Such a change, which should have been welcomed by workers, means soaring business costs. The effect was immediate. In the first 10 months of 2008, 15,661 enterprises in Guangdong, the province where Shenzhen is located, closed their doors. Foxconn, Apple's supplier, which operates a mega-sized production base with 500,000 employees in Shenzhen, is now in the process of moving some production to India.

Indeed, spiraling business and living costs are the common problem facing the two cities. Hong Kong has been ranked globally as the least affordable city in which to buy a home, with average apartment prices at 19 times gross annual median income, the highest ever measured in the U.S.-based Demographia's survey in the past 11 years.

Likewise, in April 2016 homes in Shenzhen were sold at an average of RMB 49,259 per square meter (or US$690 a square foot), as much as the Rockridge neighborhood in Oakland in the U.S., a pricey part of the San Francisco Bay Area, where home prices average US$704 a square foot. The lack of affordable housing is causing talent and companies to leave or consider leaving for more affordable cities. Ren Zhenfei, founder of Huawei, warned that Shenzhen's housing prices could destroy the city's competitiveness.



2. Rise of the Once Humble Neighbor

In spite of a seemingly inferior institutional environment, it has not inhibited the rise of tech giants such as Huawei and Tencent, whose headquarters are in Shenzhen.

Founded by Ren Zhengfei in 1987, Huawei has grown from a small company with a turnover of just US$5,680 to a global company with a turnover of more than US$39 billion with a business presence in more than 170 countries and a staff of 170,000 in 2014. Huawei is a private business, wholly owned by its employees, with 82,471 employees owning shares in the company. According to the International Data Corporation, Huawei was the third-largest mobile phone manufacturer in the world in 2016, with 9.3 percent of market share, just behind Samsung (22.8%) and Apple (11.7%).

In the case of Tencent, it was founded in 1998 by Ma Huateng and others with the backing of Naspers, a South Africa-based multinational Internet and media group. In 2004, Tencent went public on the Hong Kong Stock Exchange. The company is a leading provider of Internet value-added services in China, and its headquarters is in the Nanshan District of Shenzhen. According to Barron's, in September 2016 Tencent became Asia's largest company by market capitalization.

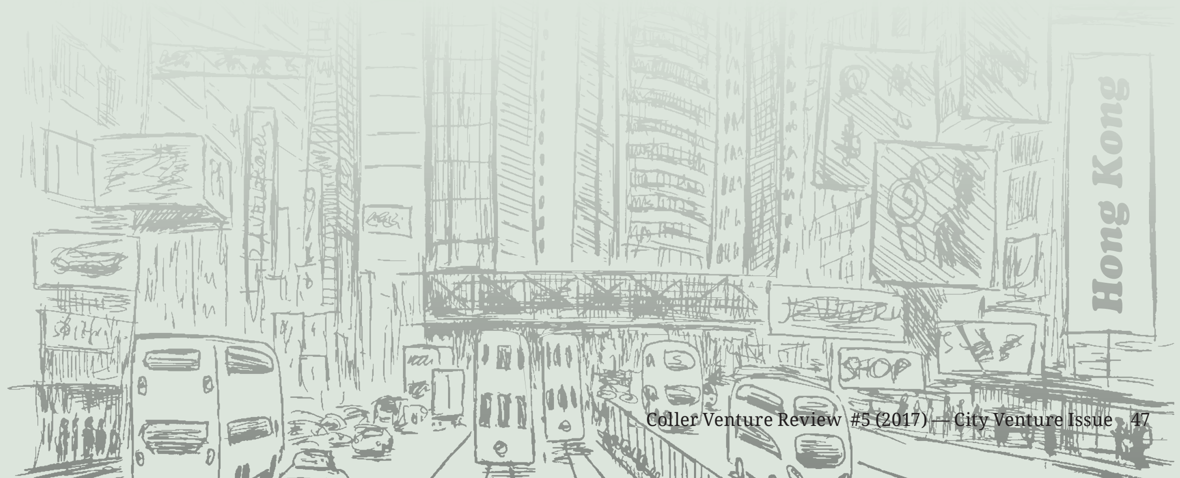
Despite its success in attracting Tencent to list on its stock exchange, Hong Kong has still had a number of missed opportunities. The Hong Kong Stock Exchange introduced the Growth Enterprise Market (GEM) in November 1999 to provide fund-raising opportunities for growth companies. Companies' abilities to obtain credit are a fundamental factor as to whether they can continue to grow.

Accessing credit has been a significant obstacle for Chinese companies. For example, at the end of 2006, according to the World Bank (2008), smaller businesses which contributed some 60% of China's GDP, accounted for only 15% of outstanding credit, most of which came from banks. This demonstrates the urgent need to diversify the fund-raising channels for these companies. Hong Kong's GEM should have been well placed to capture Chinese businesses. China finally launched its own Growth Enterprise Board (GEB) in October 2009, almost 10 years later than Hong Kong, and quickly outshone its Hong Kong counterpart.

As of now, Shenzhen's GEB has 555 companies, with a total market capitalization of RMB 5,636 billion (US$818 billion), compared to Hong Kong's GEM which has 248 companies, with a combined market capitalization of HKD 289 billion (US$37 billion).

A further missed opportunity is DJI, a market leader in unmanned aerial systems. The founder of the company is Frank Wang, who developed an unmanned miniature helicopter during his studies at the Hong Kong University of Science and Technology. This academic project paved the way for his highly successful business. DJI was estimated to account for 70% of the drone market in 2015. It is fair to say that DJI indeed has roots in Hong Kong despite the fact that the company was founded in 2006 in Shenzhen and then succeeded there.

In the face of some early successes for tech start-ups in Shenzhen, the Hong Kong government started to introduce various policy initiatives to promote technology and innovation. This was in sharp contrast to the non-interventionist philosophy shown by the colonial government, as discussed in the city's case box in this article.



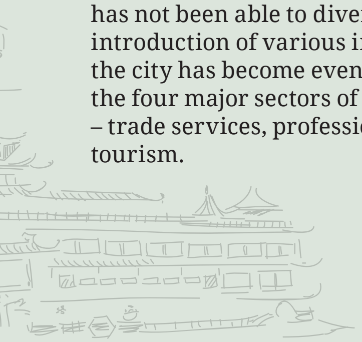
A major step was taken in 1999 when the government decided to proceed with the development of a Cyberport on the western side of Hong Kong Island. It was envisaged that upon full development, the Cyberport would accommodate about 130 companies of different sizes specializing in the application of advanced information technology. Simultaneously, a science park was established in Tai Po in the New Territories, with a view to further enhancing Hong Kong's technological infrastructure.

THE CENTRAL GOVERNMENT CLEARLY WANTS TO TAKE THE CITY TO THE NEXT LEVEL

In a 1999 policy address, then chief executive, Tung Chee-hwa, also foreshadowed other initiatives such as the establishment of a HKD 5 billion innovation and technology fund, the Applied Science and Technology Research Institute, and a growth enterprise market on the Hong Kong Stock Exchange.

After more than a decade of operation, former legislator Sin Chung-kai, who had represented the IT sector, reviewed the contribution of the Cyberport and the science park, remarking that "Both projects weren't failures, but I wouldn't say they were huge successes".

On the one hand, the Cyberport was able to nurture home-grown start-ups including GoGoVan, which links freelance truck drivers with people who need goods delivered, Coachbase, a developer of digital tools for sports teams, and AfterShip, which operates a global package tracking system for online retailers. On the other hand, it is worth noting that Hong Kong's economy has not been able to diversify with the introduction of various initiatives. Indeed, the city has become even more reliant on the four major sectors of financial services – trade services, professional services, and tourism.



3. Potential Synergy of the Two Cities

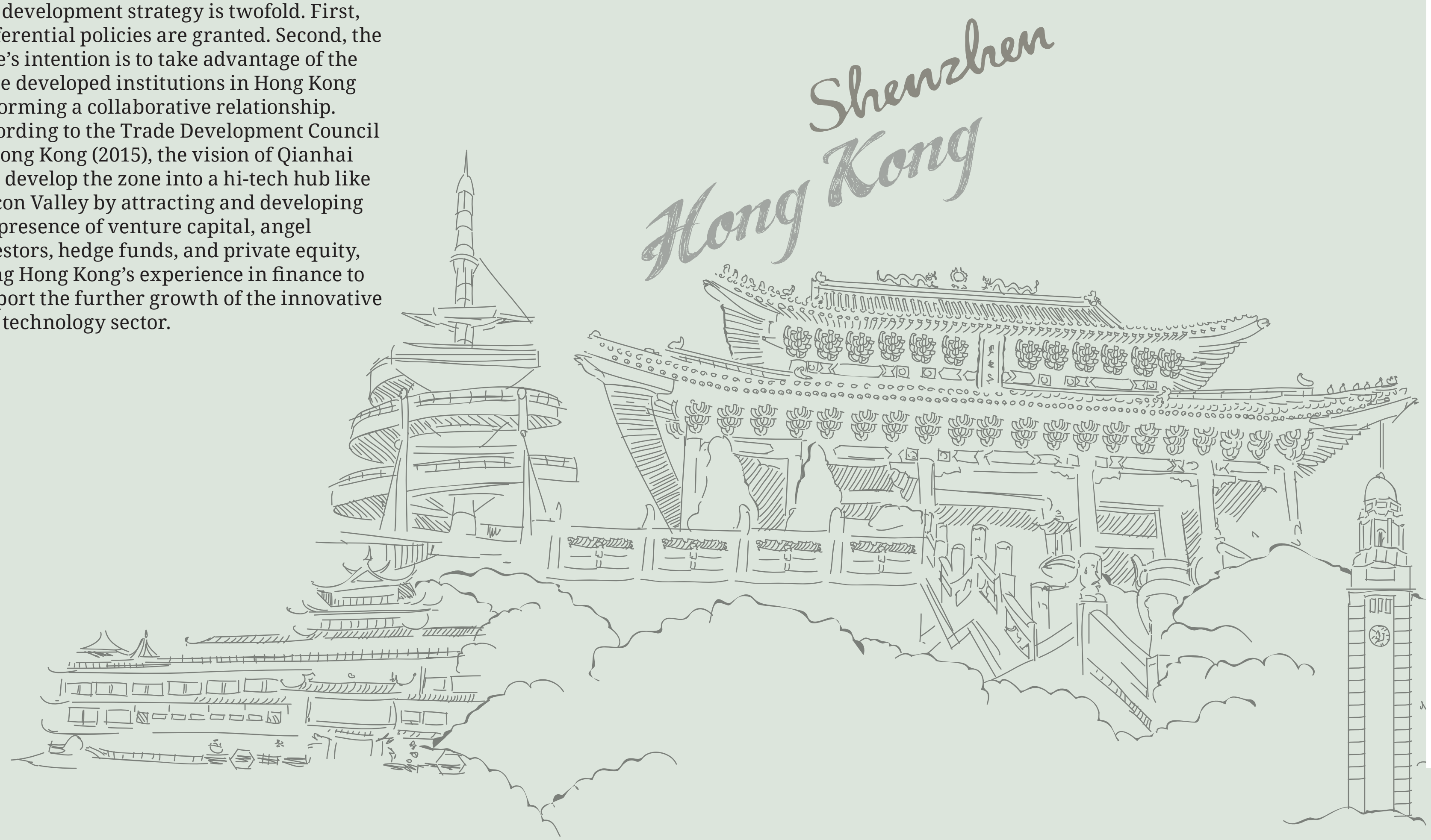
As discussed in Shenzhen's city case box in this issue, nowadays the city largely owes its success to its Special Economic Zone status and as a symbol of the pioneer in the country's economic reform. The central government clearly wants to take the city to the next level by drawing on the institutional advantages of nearby Hong Kong.

The Qianhai Shenzhen–Hong Kong Modern Service Industry Cooperation Zone (hereafter "Qianhai"), covering an area of 15 square kilometers, is located in the western part of Shenzhen. The concept was first initiated in August 2010 when the Overall Development Plan for Qianhai was released. The State Council affirmed the plan by announcing 22 measures which cover seven main aspects, including finance, tax, law, talents, education, medical care, and telecommunications, for the development and opening up of Qianhai.

The development strategy is twofold. First, preferential policies are granted. Second, the state's intention is to take advantage of the more developed institutions in Hong Kong by forming a collaborative relationship. According to the Trade Development Council of Hong Kong (2015), the vision of Qianhai is to develop the zone into a hi-tech hub like Silicon Valley by attracting and developing the presence of venture capital, angel investors, hedge funds, and private equity, using Hong Kong's experience in finance to support the further growth of the innovative and technology sector.

Conclusion

Institutions alone apparently cannot account for Shenzhen's rise. Hong Kong is superior to Shenzhen in terms of the ease to do business. Yet, the technology sector has thrived in Shenzhen but not in Hong Kong. One possible explanation is that talents are not mobile between Shenzhen and Hong Kong owing to border control. Shenzhen can easily draw on talent in a country of 1.3 billion people, but Hong Kong cannot. Shenzhen has arguably been one of the best destinations for budding entrepreneurs in China because Shenzhen is the most "special" among the Special Economic Zones, and Qianhai will be "more special than a Special Economic Zone". Qianhai seems to be a test of the mutually beneficial idea that one city has the innovation while another city has the capability to take it further.



FURTHER RESOURCES

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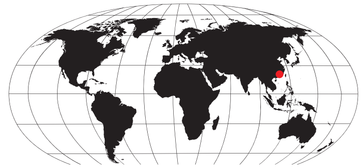
HONG KONG, 1997–2016
A LACKLUSTER PEARL OF THE ORIENT



CIV CITY CASE

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Inhabitants: 5 million (1979); 6.5 million (1997); 7.3 million (2015)

The Geographical Context

Hong Kong is located at the mouth of the Pearl River Delta on the coast of southern China, immediately south of Shenzhen. The boundary of Hong Kong has been largely unchanged since it was annexed by the British Empire during the Imperial China era. Addition of land has been achieved through reclamation.

Relationship with Government

On July 1, 1997, Hong Kong became a Special Administrative Region of China. Under the Basic Law of Hong Kong, the city enjoys a high degree of autonomy in accordance with the principle of “One Country Two Systems.” It possesses independent executive, legislative and judicial powers, but matters such as foreign affairs and national defense remain the responsibility of the Chinese central government.

Hong Kong’s legal system remains based on English common law. According to the Basic Law of Hong Kong, the socialist system and policies in China are not practiced in Hong Kong, and the city’s capitalist system and way of life are to remain unchanged until 2047. The Law also stipulates that the laws previously in force in Hong Kong, including common law, rules of equity, ordinances, subordinate legislation, and customary law are maintained.

Anchor Institutions

- **Financial markets with a long history.** Trading in company shares can be traced back to about 1860. One of the largest banks in the world, HSBC, first opened its door for business in Hong Kong in 1865.
- **Reliable government system.** The World Bank’s World Governance Indicators 2015 placed Hong Kong in the top 10 percent in terms of rule of law amongst 215 countries. Transparency International’s Corruption Perception Index 2015 placed Hong Kong 18th out of 168 countries.
- **A free port.** No tariff is charged on import or export of goods. Further, Hong Kong’s capital account is fully convertible, and there are no restrictions on foreign exchange dealings.

Venture Statistics

- GDP per capita in the city rose from HKD 22,860 in 1979 to HKD 211,592 in 1997 and HKD 328,117 in 2015 (The HKD has been pegged at a rate of around 7.8 per 1 USD since 1983).
- There were 474,517 companies in 1997; in 2015, the number rose to 1,288,666.
- Hong Kong is predominantly a service economy. This sector generated 92.7% of GDP in 2014, rising from 67.5% in 1980 and 84.4% in 1996.
- The number of patents granted rose from 2,619 in 1999 to 6,458 in 2015.

Strengths

- **Role as regional center.** Hong Kong is regarded as a premier commercial and financial center in the region; it is ranked first in the World Competitiveness Ranking 2016 and third in the Global Financial Centers Index of 2015.
- **The legal system.** Maintaining a legal system inherited from England is widely regarded as one of Hong Kong’s advantages.
- **Capitalist focus.** Another possible explanation for Hong Kong’s success was its determination to promote capitalism under colonial rule. Milton Friedman once referred to Hong Kong as the example of capitalism in action, as symbolized by its laissez-faire economic policy. Hong Kong has always tried to foster a flexible and competitive private sector, and to retain a small government posture.
- **The China factor.** Owing to the city’s geo-political proximity with China, the city’s economy has taken advantage of the rise of the Chinese economy by performing roles such as financier, trading partner, middleman, and facilitator.

Weaknesses

- **China’s interventionist policy.** It is believed that Hong Kong’s competitive advantages have been slowly eroded under Chinese rule, which has elicited the following media commentaries: “The Death of Hong Kong”; “Is Hong Kong Dying?”; and “An Era in Hong Kong is Ending, Thanks to China’s Tight Embrace.” One observation is that the government has been becoming more interventionist since the handover, as opposed to its previous positive non-interventionist approach. For example, during the Asian financial crisis in 1998, Donald Tsang, then chief executive, led an unusual plan to buy 11% of the shares on the Hang Seng Index, paying for the move by drawing on foreign exchange reserves.
- **Political tensions.** The tension between pro-Beijing and pro-democracy groups in the city has increased, as exemplified by the Umbrella Revolution and a related Occupy Central movement in 2014.
- **Uncertainty in the future.** Political stability is obviously a concern to investors. Confidence in the city has not been helped by the uncertainty left behind by the fact that Hong Kong’s special status will only last until 2047.

Ecosystem Players

As mentioned, the “positive non-interventionism” philosophy of the Hong Kong government means that it has not tried very hard to develop the technological sector. However, with the formation of the Innovation and Technology Bureau in November 2015 this is changing. The bureau is responsible for policy matters with a view to transforming Hong Kong into an innovation hub for technology.

Strategies Employed

Milton Friedman regarded Hong Kong as the best example of a free market economy and famously said, “If you want to see capitalism in action, go to Hong Kong. ”

Furthermore, family-controlled companies, which are common in Hong Kong, can make efficient decisions owing to a more personalized method of control, with less paperwork and fewer formalities. There is often family dominance in management largely based on personal trust. Frequent family contact limits discussions and negotiations in the organizational setting. This contact facilitates the tacit use of processes through the introduction of norms created by the family.

Results

Hong Kong remains an important center for trade, finance, and business in Asia, strategically located at the doorstep of China’s huge and vibrant economy. However, its importance has been overshadowed by the rise of other Chinese cities, most notably Shenzhen and Shanghai in terms of the technology and financial sectors respectively.

Lessons and Conclusions

- Hong Kong has always had a versatile economy. Before the growth and dominance of its financial services sector, international trade had long been a defining characteristic of the Hong Kong economy. Beginning in the 1950s, exports of domestically produced light industrial products served as the engine of growth for nearly three decades. Nonetheless, since the late 1970s, the migration of factories to Mainland China has forced Hong Kong to transform into a service-oriented economy.
- The “One Country, Two Systems” principle, as laid down in the Hong Kong Basic Law, has enabled the city to maintain its institutional advantages after the handover. However, the city’s future will largely hinge on how credible the Chinese state is in keeping its promises. The increasing discontent amongst citizens about the local political environment and the resulting civil unrest undoubtedly cast doubt over the city’s future.

SHENZHEN, 1979–2016
FROM LOW-TECH TO HI-TECH

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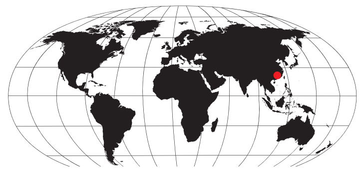

CIV CITY CASE

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Inhabitants 30,000 (1979); 10 million (2016)

The Geographical Context

Shenzhen is a major city in Guangdong Province of southern China, located immediately north of Hong Kong. Its proximity to Hong Kong can explain the city's early rise which was highly successfully in attracting investments from Hong Kong.

Relationship with Government

The city was designated as one of the first four Special Economic Zones in the late 1970s and early 1980s. These zones were established to encourage foreign citizens and overseas Chinese and their companies – especially those from Hong Kong and Macau – to open factories and set up enterprises and other establishments there. Preferential treatment was given to these investors.

Anchor Institutions

Shenzhen's Hi-Tech Park located in the Nanshan District has been home to tech giants such as Tencent (established in 1998), ZTE (established in 1985), and DJI (established in 2006).

Venture Statistics

- GDP per capita in the city rose from RMB 606 (around US$260) in 1979 to RMB 160,000 (around US$25,500) in 2015.
- There were only 501 enterprises in 1979; by 2014, the number had risen to 843,977.
- Secondary industries contributed only 20.5 percent of GDP in 1979, but rose to 50% in the 2000s, while tertiary industries contributed to another half of GDP. Here secondary industries refer to mining, manufacturing, production and supply of electric power, water and gas, and construction. Tertiary industries refer to all other industries not included in primary (mostly agricultural) or secondary industries.
- Number of patents granted rose from 160 in 1991 to 53,687 in 2014.

Strengths

- **Excellent support from the central government.** As part of China's national economic reform in 1978, Shenzhen's Special Economic Zone status had enabled it to gain a first mover advantage over other cities which were opened to overseas investment at a later time. In addition to being granted Special Economic Zone status, Shenzhen has enjoyed symbolic status as the pioneer in the country's economic reform and was famously visited by the legendary Chinese leader, Deng Xiaoping, as part of his Southern Excursion in 1992.
- **Foreign investment incentives.** The Special Economic Zone status provides foreigners with actual incentives to set up a business there. These include, for example, the preferential rate of income tax of 15%, notably lower than the rate of 20–40% outside the zone. Furthermore, raw and semi-processed materials, machinery and equipment, and other capital goods necessary for production that are imported by enterprises in the zone are exempt from import duties. Also, the lawful profit that an investor receives can be remitted abroad, despite the existence of currency control in China.

Weaknesses

- **Inherent weaknesses of the Chinese economy.** The city's development may have been hampered by some of China's weaknesses as a developing country. Corruption is still perceived as widespread in China, having been ranked 83rd out of 168 countries by Transparency International in its Corruption Perceptions Index 2015. President Xi Jinping's high profile anti-corruption campaign seeks to address this problem, but much remains to be done.
- **Weak rule of law.** Despite repeated attempts to encourage the government to update its laws – for example, the revision to the Chinese company law in 2005 and 2013 respectively – the country's rule of law is still perceived as weak, as exemplified by the World Bank Governance Indicators 2015 placing the country on the 44th percentile in this regard.
- **Weak intellectual property rights protection.** As indicated by the U.S. embassy in Beijing, despite stronger statutory protection following China's WTO accession, China "continues to be a haven for counterfeiters and pirates". Lax legal protection is not necessarily a disadvantage; for example, several tech giants in China have allegedly imitated their Western counterparts. Tencent's QQ messenger is believed to be an imitation of the Israeli service ICQ and Xiaomi is hailed as the "Apple of the East".
- **Adverse effects of enhanced labor protection.** After the introduction of the Labor Contract Law in 2007, the resulting rising cost of China's famously cheap labor immediately dented the labor intensive manufacturing sector in Guangdong Province.

Ecosystem Players

Since 2011, the Shenzhen Science and Technology Innovation Commission has played an influential role in strengthening the city's positions as a key zone for innovation and technology in China. One notable effort is the "peacock plan," an incentive plan to lure overseas talents to bring their advanced ideas, techniques, and business to Shenzhen. From 2011–2015, 61 "peacock" teams were attracted to the city, benefiting successful hi-tech enterprises such as DJI.

Strategies Employed

Deng Xiaoping's vision of development was that some people and regions should get rich first so that they can provide "demonstration effects" for the rest of the country. This was evidenced by the Chinese government's determination to nurture Shenzhen and some other coastal cities such as Shanghai.

Shenzhen's Special Economic Zone status is one example of the central government's support to develop the city. Furthermore, the National Medium to Long-term Plan for Scientific and Technological Development (2006–2020) showed the central government's determination to strengthen the technology sector. The city's Twelfth Five-Year Economic Plan was accordingly tailored around the national goal to set out the necessary actions.

Results

The establishment of Special Economic Zones was meant to attract global foreign investment, but the reality was investors almost solely came from Hong Kong. Since the late 1970s, many Hong Kong manufacturers have relocated their labor-intensive production processes to China. Owing to the influx of capital and skills from Hong Kong, Shenzhen's economy has been well developed relative to the rest of China, and therefore has been able to attract talent from all over China.

Shenzhen's Nanshang district is home to 8,000 hi-tech companies. The district's per capita GDP reached RMB 308,700 in 2014, overtaking its neighbor Hong Kong, approaching the standard of Singapore, and ranking first among China's counties and districts. The city is the cradle of tech giants such as Tencent, Huawei, and ZTE.

Lessons and Conclusions

- Shenzhen has successfully evolved from a production base of light industrial products to a high value-added technology center, to avoid the adverse impact of the ever-increasing labor and other operational costs in China.
- The city has fully utilized its first mover advantage. It took advantage of the early investments brought into the country by Hong Kong's entrepreneurs as a result of its Special Economic Zone status. This significantly boosted the city's economy and its ability to attract talent.
- Shenzhen may be a lesson to other economies. The central government made a concerted effort to create the success of Shenzhen. It is a classic example of sheer decision and resources that created value. The city started with almost nothing, as opposed to Shanghai, its main rival city, which had been highly developed already before the Second World War.