

Operating Environment in the Pearl River Delta

Introduction

This paper briefs members on the recent developments that have an impact on the operating environment in the Mainland of China, particularly in the Pearl River Delta (PRD).

Recent Policy Changes

2. Currently, there are about 72,000 foreign-owned manufacturing operations in the PRD; about 56,000 of them are owned by Hong Kong enterprises. These factories employ over 10 million workers. Many of them are involved in the processing trade. Recent changes in several policy areas in the Mainland, especially those related to the processing trade, would have an impact on these factories. Some of the more significant changes in recent months are outlined in paragraphs 3 to 9 below.

(a) Adjustments to Policies related to the Processing Trade

3. Since late 2006, the Mainland has been introducing a series of measures related to the processing trade. The objectives are to restrict the operation of polluting, resource-intensive and energy-intensive industries, and encourage enterprises to move up the value chain, upgrade their production technologies or shift their operation to the central and western regions of the Mainland.

4. An example of these measures was Announcement No.44 of 2007, made by the Ministry of Commerce (MoC) and General Administration of Customs (GAC) on 23 July 2007. It promulgated a list of restricted commodities for the processing trade, and stipulated that enterprises importing these commodities would need to pay standing book deposits. Although the deposits would be returned to the enterprises with interest

when the latter export the final products, many enterprises were concerned about the possible cashflow problem that might arise from such a requirement. The Hong Kong Special Administrative Region (HKSAR) Government immediately reflected the trade's concern to MoC and relevant ministries. Eventually, the MoC, GAC and the China Bank Regulatory Commission promulgated Announcement No. 71 of 2007 on 5 September 2007, allowing enterprises to pay the standing book deposit by a number of means, including cash and bank guarantees, thus alleviating the pressure on their cashflow.

5. Given the general policy objectives mentioned in paragraph 3 above, the processing trade could expect new measures to be introduced by the Mainland authorities from time to time.

(b) Labour Contract Law

6. Since 1 January 1995, the Labour Law had been the major piece of labour legislation in the Mainland. It regulates employer-employee relationship and labour contracts. On 29 June 2007, the Standing Committee of the National People's Congress of the Mainland enacted the new Labour Contract Law to further strengthen labour protection. The new legislation was implemented on 1 January 2008.

7. The Labour Contract Law elaborates and strengthens provisions of the Labour Law relating to labour contracts, including the terms and conditions of employment contracts, and the associated labour rights, benefits and protection. It has introduced a number of new requirements, such as the need to consult labour unions on key issues affecting the interests of employees, the provision of written contracts to employees within one month of hiring, the need to enter into permanent contracts with an employee once he has served for a certain period of time, a maximum duration for probationary periods, the conditions under which an employee contract may be terminated, and the need for severance payment upon expiry of labour contracts.

(c) Tightening of Environmental Standards

8. The Mainland authorities have introduced more stringent environmental standards. Apart from the policy changes on the processing trade which discourage the operation of polluting,

resource-intensive and energy-intensive industries, manufacturing operations in the PRD are also required to meet more stringent standards with regard to air emission, waste treatment and wastewater discharge. Accordingly, many factories would need to upgrade their production systems and facilities to meet the new requirements. Another option for the operators is to relocate their factories to dedicated environmental or industrial parks with treatment facilities in order to continue their operations. For example, Guangdong has set up industry-specific bases or parks for electroplating operation, as well as for paper and leather processing.

(d) Enterprise Income Tax Law

9. Announced on 16 March 2007, the Enterprise Income Tax Law took effect on 1 January 2008. This legislation aims at following international practices in providing a level-playing tax regime for all enterprises. Under the new legislation, the corporate tax rates for foreign-owned enterprises would be the same as those for Mainland enterprises. For instance, the income tax rate for foreign-owned enterprises would follow that of Mainland enterprises i.e. 25%. The legislation also stipulates the same principles for deduction of expenditure items, such as research and development expenses, or employment of disabled staff, for Mainland and foreign-owned enterprises.

Impact Assessment

10. It is difficult to assess accurately the impact or cost implications of the abovementioned policy changes per se, partly because some of the implementation details have not yet been promulgated, and partly because different enterprises have different modus operandi and cost structure, and thus would be affected in different ways.

11. However, if we take all these changes together with the rising costs of raw materials and appreciation of Renminbi, it could be expected that generally speaking the cost of production for enterprises would increase, especially in the short to medium term. How this would affect

the enterprises would depend on the strength and competitiveness of individual operators. Understandably, small and medium-size enterprises (SMEs) would likely be more affected.

Measures Undertaken by the Hong Kong SAR Government

12. The HKSAR Government has adopted a multi-pronged approach to assist Hong Kong-owned enterprises in the PRD to meet the challenges arising from the changing business environment. These measures include:

- (i) reflecting the trade's views and making recommendations to the Mainland authorities;
- (ii) through the "Task Force to Support the Processing Trade" established last year, exploring with the trade measures to cope with the adjustments in the Mainland's processing trade policy;
- (iii) cooperating with the Guangdong Province, through the "Hong Kong/Guangdong Expert Group on the Restructuring and Upgrading of the Processing Trade", to assist enterprises to restructure and/or upgrade;
- (iv) organizing seminars to enhance the understanding of the trade on new legislation and measures¹;
- (v) organizing trade delegations to visit the central and western regions of the Mainland with a view to encouraging Hong Kong enterprises to relocate their operations and to explore new markets;
- (vi) through the "SME Funding Schemes", assisting SMEs to acquire new equipment that meet the latest environmental requirements, to restructure or relocate, and to explore

¹ Two visits were organized so far, one to Chenzhou (in Hunan Province) in July 2007; the other to Ganzhou (in Jiangxi Province) in December 2007.

overseas markets. Hong Kong enterprises may also apply for the “Innovation and Technology Fund” to improve their technological level, and to introduce more innovative concepts to their businesses; and

- (vii) through industry support bodies such as the Hong Kong Trade Development Council and the Hong Kong Productivity Council, assisting enterprises to upgrade their technological knowhow and environmental performance, restructure their modus operandi and develop new markets etc.

Conclusion

13. As explained above, these new legislation and measures aim to improve the Mainland’s industrial structure. We believe this will bring about sustainable and healthy development to the Mainland’s economy in the long term, and will provide fresh impetus to Hong Kong’s growth. Nevertheless, we are mindful of the difficulties that our enterprises face in the short to medium term in adjusting to the changes, and will continue our efforts in assisting them to rise to the challenges.