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Edwin L.-C. Lai

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The Economic Implications of the Reunification of Hong Kong with China

Edwin L.-C. Lai*

ABSTRACT

Professor Lai presented this essay at the Vanderbilt Journal of Transnational Law Symposium 1997: Hong Kong's Reintegration into the People's Republic of China. Professor Lai has updated his work since Hong Kong and China reunified. The author questions whether Hong Kong will really be able to remain an independent economic entity while also being a dependent political entity under the unprecedented "one country, two systems" concept.

In this essay, the author identifies the conditions under which Hong Kong's economy can prosper, both in the short term and the long term. After reviewing Hong Kong's recent economic performance, the author assesses the potential economic problems of political integration. Potential problems include corruption, threats to the rule of law in Hong Kong, self-censorship by the press, and disruption of Hong Kong's tax system. The author concludes that, despite these problems, prosperity will likely be sustained in the short term. For economic prosperity to continue in Hong Kong in the long term, however, the continued expansion of the Chinese capitalist class must continue. As Hong Kong becomes increasingly integrated with China economically, it will also be increasingly susceptible to China's economic woes. Thus, for Hong Kong's economy to prosper in the long term, China must remain stable both politically and economically.

* Assistant Professor of Economics, Department of Economics and Business Administration, Vanderbilt University. B.Sc., University of Hong Kong, 1980; A.M., Stanford University, 1988; Ph.D., Stanford University, 1991. The author would like to thank Anthony Tang for his useful comments on an earlier draft of this paper.

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I. INTRODUCTION

On July 1, 1997, Hong Kong reunified with China, ending 156 years of British colonial rule. This reunification took place under the concept of "one country, two systems," a concept unprecedented in history. According to the Sino-British Joint Declaration signed in 1984, China promises to maintain the status quo of Hong Kong for fifty years by establishing a highly autonomous "special administrative region" (hereinafter Hong Kong SAR) in Hong Kong.¹ Specifically, Hong Kong is to maintain the existing British-style legal system, establish its own court of final appeal, retain fiscal independence from the central government, and retain its own currency. Hong Kong is to remain an independent customs territory, a free port, and a separate entity in most international economic and cultural organizations, such as the World Trade Organization, the Multi-fiber Agreement, and the Asian-Pacific Economic Co-operation forum.²

Under the "one country, two systems" concept, although Hong Kong cannot be an independent political entity, it can be a

1. See Joint Declaration of the Government of the United Kingdom and Northern Ireland and the Government of the People's Republic of China on the Question of Hong Kong, Sept. 26, 1984, P.R.C.-U.K., 23 I.L.M. 1366 [hereinafter Joint Declaration].

2. *Id.* See also Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China, Apr. 4, 1990, 29 I.L.M. 1511.

highly economically independent entity from the rest of China. The first reason China is willing to allow such a special status for Hong Kong is the vast economic importance of Hong Kong to China. After Deng Xiaoping adopted the open-door policy for China in 1978, Hong Kong emerged as the most important source of foreign investment in China. About sixty percent of foreign direct investment in China between 1979 and 1995 came through Hong Kong.³ Hong Kong also serves as an important bridge connecting China to the rest of the world and is a source of managerial technology transfer into China. Maintaining the economic status quo of Hong Kong ensures that China can continue to benefit from it. Second, China hopes to lure Taiwan to reunify with the mainland under the "one country, two systems" concept. China's leaders think that, if all goes well with Hong Kong, it will be difficult for Taipei to reject Beijing's offer to reunify under an even more generous package than Hong Kong's.

China is a developing country with an authoritarian government and largely rudimentary economic infrastructure; in contrast, Hong Kong is a modern capitalistic society with a British-style legal system, the rule of law, and one of the most free-wheeling economies in the world. In fact, it is widely believed that the pillars of Hong Kong's past economic successes are the rule of law, the freedom to transmit information and conduct economic activities, and a small, clean, efficient, and non-interventionist government. China is grossly inadequate in these aspects. Given such a big gap between the two systems, it is natural for one to doubt the feasibility of a smooth integration as promised by China.

The fact is, whether one likes it or not, China is in control. Given that China is very sensitive to any potential challenge to its regime, one should be pessimistic about Beijing permitting any real democratic reform. Moreover, civil liberties in Hong Kong will very likely be rolled back. The new Hong Kong SAR government has already reversed some laws that have been modified in accordance with the Bill of Rights introduced by the British shortly before July 1, 1997.⁴ In short, what the highest leadership in China would like to implement in Hong Kong is the Singapore model—economically free but politically paternalistic. The question is, putting aside political pessimism, how optimistic can one be about Hong Kong's economy after 1997?

3. *A Survey of China—Ready to face the world?*, *ECONOMIST*, Mar. 8, 1997, at 9.

4. Bill of Rights Ordinance, No. 59, Legal Supp. No. 1, Hong Kong Government Gazette A399-A433 (June 7, 1991).

In this essay, the author attempts to identify the conditions under which Hong Kong's economy can prosper, in the short term as well as the long term. Part II reviews Hong Kong's recent economic performance. Part III analyzes the factors that will affect Hong Kong's short-term prosperity. Part IV suggests a scenario that would support long-term economic prosperity in Hong Kong. Finally, Part V present the author's assessment of Hong Kong's short-term and long-term prospects for economic success.

II. HONG KONG'S RECENT ECONOMIC PERFORMANCE

One must realize that, political reintegration or not, economic integration of Hong Kong with China began in 1978, when Deng Xiaoping opened China's door. As a result of such economic integration, the structure of Hong Kong's economy underwent tremendous change:

1. Hong Kong re-emerged as a major entrepôt, with trade in goods expanded by forty-four times and trade in services by twenty-six times over the two decades from 1975 to 1995.⁵ In 1995, re-export was eighty-three percent of the total value of exports, and eighty-eight percent of re-exports involved China as either a source or destination.⁶
2. Of the total \$133.2 billion worth of foreign direct investment in China between 1979 and 1995, 58.8% was channeled through Hong Kong, followed by 8.7% through Taiwan.⁷ Most of these firms produce goods for export. By 1995, 31.5% of China's exports was from foreign-invested enterprises.⁸
3. More than four million people were estimated to be working in the southern province of Guangdong for Hong Kong companies by 1995.⁹
4. Hong Kong now serves as a major funding center for China. Hong Kong serves not only as a direct source of funding, but also as a window through which China can gain access to external borrowing through syndicated loans, issuing certificate of deposits, and bonds.¹⁰
5. The economic integration led to an unprecedented, accelerated structural transformation of the Hong Kong

5. Hong Kong 1996, at 48 (Info. Serv. Dep't ed., 1996).

6. *Id.* at 54, 93.

7. *See supra* note 3 and accompanying text.

8. *Id.* at 10.

9. Hong Kong 1996, *supra* note 5, at 54.

10. *Id.* at 80-81.

economy. Manufacturing output as a percentage of Gross Domestic Product (hereinafter GDP) declined from twenty-four percent in 1980 to nine percent in 1994, and manufacturing employment dropped from forty-two percent of total employment in 1980 to eighteen percent in 1995.¹¹ This occurred because most factories moved to the mainland, where the cost of labor is one-tenth of that in Hong Kong.¹²

6. As a result of cost cutting in manufacturing and tremendously increased trade opportunities, real GDP per capita grew by an average of about six percent from 1975 to 1995.¹³ In 1995, Hong Kong's stock market was the world's eighth largest in total market capitalization, and the second largest in Asia.¹⁴
7. As for China's presence in Hong Kong, "in the last decade, and particularly in the last five years, Chinese companies have flooded Hong Kong, buying property, wooing foreign deal makers, looking for capital and perhaps not least, finding a safe haven for great piles of hot money from China."¹⁵ It is estimated that "the vast percentage of Chinese companies [in Hong Kong] are busily transferring assets from China, to the tune now of [US]\$65 billion annually."¹⁶

III. SHORT-TERM PREDICTIONS ABOUT HONG KONG'S ECONOMY

Will the above promising economic performance become history after July 1, 1997? This Part discusses the potential harm of the political reintegration to Hong Kong's economy, how these problems might be partially mitigated, and under what circumstances the political reintegration will not excessively jeopardize Hong Kong's economy.

11. *Id.* at 49.

12. *Id.* at 92-93.

13. *Id.* at 49.

14. *Id.* at 48.

15. Edward A. Gargan, *China Already Entrenched as a Hong Kong Capitalist*, N.Y. TIMES, Dec. 5, 1996, at A1.

16. *Id.*

A. *Potential Economic Problems After Reunification*

The greatest potential problem of political integration, as far as the economy is concerned, is probably corruption. The author's concern is that the Chinese Communist Party princelings—the sons and daughters of the high level officials in the Chinese government and the Communist Party—will bring with them the business practice of exchanging favors (which is effectively giving and receiving bribes) to get things done, and that the Hong Kong SAR government will not have the authority to restrict such practices if those involved have connections with the highest officials and influential figures in China.

Before July 1, 1997, Hong Kong had the Independent Commission Against Corruption (hereinafter ICAC), which was highly independent and was directly under the governor.¹⁷ It is doubtful that such independent status of the ICAC can be maintained after 1997. Even if it is maintained, however, there will not be a truly level playing field for business without a truly independent judiciary. This leads to the author's next concern—the rule of law.

Although the Joint Declaration promises that an independent judiciary will remain, many worry that the courts cannot remain truly independent after reunification. For example, many people are concerned that the highest leadership in the central government may intervene into the operation of Hong Kong's judiciary system when people with close ties to high officials in the central government are prosecuted under Hong Kong's laws.

The third problem is self-censorship by the press and media for fear of political retribution by China. Although there is not yet any evidence of political retribution against the press resulting from criticism of Chinese policies, the fact that the People's Liberation Army is stationed in Hong Kong is a forceful reminder of the presence of an authoritarian regime in the North. This self-censorship will in time erode the freedom of expression and creativity of the citizens, which will in turn harm the traditional competitive edge of Hong Kong.

The fourth potential problem is that the tax system in Hong Kong might not remain intact and that fiscal independence in Hong Kong might not be maintained. Given that the central government has an acute shortage of revenue, it might be tempted to break the promise of fiscal independence for Hong Kong and tap into its huge foreign exchange reserves. If the central government has an acute shortage of funds, it might be tempted to "invite" the government of the Hong Kong SAR to

17. Hong Kong 1996, *supra* note 5, at 19.

"voluntarily" (and, possibly, temporarily) siphon some of Hong Kong's reserves to Beijing. It might also want to increase the tax rate on some Hong Kong companies to deter mainland firms from establishing shell companies in Hong Kong to avoid the higher taxes of the mainland.

B. *Factors Favorable to Short-Term Prosperity*

Despite the above potential problems, there are several important factors that will tend to sustain economic prosperity in Hong Kong, at least in the short term.

The first is the Taiwan factor. The Chinese government wants to use Hong Kong as a showcase to lure Taiwan to unify with the mainland under the umbrella of "one country, two systems." The Chinese government regards reunification with Hong Kong and Taiwan as a matter of national pride. In this regard, Taiwan is worth many Hong Kongs. Although Beijing could use force as a last resort to take back Taiwan, it has every reason to strive to achieve reunification by peaceful means. Taiwan is watching closely how Hong Kong is handled by the mainland, because what happens in Hong Kong will be an indicator of how Taiwan would be handled under reunification with the mainland. Any missteps in Hong Kong by the Chinese government, and the Taiwan question becomes more complicated. As soon as the Taiwan question is resolved, however, this incentive will dissipate.

Second, the maintenance of Hong Kong as a venue for external funding, banking, insurance, and enforcement of contracts will benefit the emerging capitalists in China. Some of these people have strong connections with the establishment in the central government and they can have significant influence over policies toward Hong Kong. For the same reason, foreign capital, which China badly needs, has a strong stake in maintaining the integrity of Hong Kong's legal system and rule of law. These interest groups can provide strong leverage for the reform-minded factions in the Chinese Communist Party and the central government.

For the above reasons, in the short term it is likely that the central government has the will to give the Hong Kong SAR government the authority to act like an "independent economic entity." In the near future, it is also likely that the central government has the power to prevent units such as the military, the foreign ministry, or local governments in the mainland from bypassing central control and interfering with the affairs of Hong Kong.

IV. LONG-TERM PREDICTIONS ABOUT HONG KONG'S ECONOMY

There is no doubt that many things can go wrong to jeopardize Hong Kong's economy in the long run. But are there scenarios of a sustained prosperity in Hong Kong after 1997? If so, how likely are they?

The crucial factor for Hong Kong to remain prosperous is, of course, for the three pillars of economic success to be maintained. In this regard, the strongest ally of Hong Kong is the emerging Chinese capitalist class and the affiliated Chinese middle class that serves its interests. To them, maintaining Hong Kong as a level playing field and a free economy is important to sustaining and perpetuating their existence. The continued expansion of this capitalist class is crucial to sustained growth in the Chinese economy, which in turn is crucial to the survival of the Chinese Communist Party.

One can draw an analogy to Europe between the middle of the fifteenth century and the middle of the eighteenth century. This period was marked by the emergence of a merchant class that shaped the development of capitalism, as well as challenged the political power of the feudal aristocracy.¹⁸ In the end, the weak became strong, and capitalism won. Interestingly, many members of the aristocracy may have prospered from the emergence of capitalism by converting to capitalists themselves.¹⁹ Similar developments could happen in China in the next fifty years. With the emergence of the telephone, airplane, fax machine, and the Internet in the twentieth century, it is possible that what took Europe three centuries to develop could happen in China in fifty years.

If this scenario prevails, in time, China could gradually strengthen the rule of law (especially with respect to property rights and enforcement of contracts), reduce government involvement in the economy (especially the state sector), develop better market infrastructure, and allow for a less restricted flow of information. The government could become more transparent in order to gain legitimacy.

18. See generally NATHAN ROSENBERG & L. E. BIRDZELL JR., *HOW THE WEST GREW RICH: THE ECONOMIC TRANSFORMATION OF THE INDUSTRIAL WORLD* 71-109 (1986).

19. *Id.*

V. AN ASSESSMENT OF THE POST-1997 HONG KONG ECONOMY

A. *Summary of Short-Term Prospects*

Corruption, especially in the form of exchanging favors, will likely become more common than before reunification. The rule of law will probably be undermined, because people with strong ties to the central government may have incentives to interfere with the operation of the legal system to their favor. Provided that the central government has the will and power, however, these problems can still be confined to manageable limits. If that is true, Hong Kong's status as a regional and international financial center can be maintained. In fact, it can continue to prosper *because of China*, at least in the next five years.

Real estate prices will be an increasing burden to growth because of the limited quantity of land in Hong Kong. One possible solution is for Hong Kong to extend its urban development to neighboring cities of Shenzhen and Macao, or Zhongshan county to become a Greater Hong Kong metropolitan area; however, the fact that these neighboring areas have a different socio-political system from Hong Kong means that many Hong Kongers may not be willing to move to these areas, and that the expansion of Hong Kong's city boundary might be slow.

Economic integration with southern China and beyond will continue. Hong Kong's manufacturing and services will continue to move to the mainland. Hong Kong's structural transformation to a service-dominated economy will also continue. Businesses and professionals in Hong Kong will continue to benefit from China's growth, but Hong Kong's unskilled and less-educated workers will continue to suffer. Income inequality will probably continue to increase for this reason. The Hong Kong government will probably resist the demand for more grassroots democracy or labor rights because the executive and legislative branches will very likely continue to be overwhelmingly dominated by business interests.

China will continue to benefit from Hong Kong's investment and technology transfer, as well as its position as a venue for external financing, enforcing contracts, settling accounts, banking, and insurance.

B. *Summary of Long-Term Prospects*

Hong Kong's economy will be increasingly integrated with that of China. For this reason, the Hong Kong economy will be increasingly vulnerable to Chinese economic woes, such as economic downturns. Hong Kong will prosper only if China is

politically stable and economically healthy. Long-term political prospects in China are uncertain, however. Income inequality, regional disparity, corruption, and legitimacy of the Communist government can all lead to power struggles in the party, resulting in problems ranging from policy swings to chaos to civil war in more serious circumstances.

Nonetheless, a civil war in China is still a remote possibility. The more likely scenario is that of policy swings between tight (*shou*) and loose (*fang*), without undermining the general direction of further market reform. If this is the case, then there will be high potential for the Hong Kong economy, because there are good reasons to believe that China can continue to grow as reform deepens, despite the many problems. Hong Kong will then further specialize in services, especially finance, insurance, and banking. It could become an even more important international financial center and bridge between China and the advanced world than it is today.

The author's long-term assessment of Hong Kong's post-1997 economy can be summarized by an analogy. The long-term investments in Hong Kong will carry "high risk but high (average) return." Whether one is willing to invest depends on one's preferences. If one is willing to take the risks that are inevitably associated with high average returns, this is a good opportunity. Risk-averse investors might have second thoughts.

VI. CONCLUSION

The idea of Hong Kong as a highly independent economic entity but not a political or legal entity independent from mainland China is a paradox to most western academics. Nonetheless, this dualism could be sustained and eventually eliminated if China itself continues to evolve in favor of the interests of the emerging capitalist class and its affiliated middle class. After 1997, Hong Kong will likely be a battlefield between the newly emerging Chinese capitalist class and the Chinese Communist aristocrats. One knows who is more likely to win in the end, having seen what happened in Europe in the eighteenth century. Viewed in this light, the uncertainty in the interim seems more bearable.

Furthermore, reunification with China is probably not the most important factor determining Hong Kong's economy after July 1, 1997, especially in the short-term. Barring drastic and unfavorable political developments in China, Hong Kong's future economy depends more on what happens inside Hong Kong than on China or any other external factors. For example, because the prices of real estate have soared in the last five years, the cost of

doing business has increased tremendously. The fact that neighboring areas have a different system from that of Hong Kong means that Hong Kongers will still want to live within the old territorial boundaries, unless the social and physical infrastructures of these neighboring areas can quickly catch up with those of Hong Kong. The current educational system produces graduates of rather low quality, who are weak in skills, creativity, and language ability (both Chinese and English). Such a workforce is incompatible with a modern capitalist economy that depends on innovative individuals with independent thinking. Such problems, internal to Hong Kong, outweigh those associated with reunification in the next five to ten years.²⁰

After July 1, 1997, the new government of the Hong Kong SAR vowed to put both housing and education reform on the top of its policy agenda. These are clearly areas that have been neglected by the British colonial government. This is an opportunity for the Hong Kong SAR government to demonstrate to Hong Kong and to the world that reunification of Hong Kong with China makes Hong Kong even better than before. The world must wait and see whether the Hong Kong SAR government can fulfill its promises.

20. Louis Kraar, *The Real Threat to China's Hong Kong*, FORTUNE, May 26, 1997, at 84.
