For information Paper Ref: CSD/EDC/4/2006

Commission on Strategic Development
Committee on Economic Development and
Economic Cooperation with the Mainland

Recent performance and development prospects of selected creative industries in Hong Kong

I. Purpose

This paper informs members of the key findings of a study recently conducted by the Administration on the recent performance and development prospects of 3 selected creative industries in Hong Kong viz. advertising, design and software.

II. Background

2. At the second meeting of the Committee held on 6 February 2006 when the subject of creative industries was discussed, it was proposed that further market studies on selected creative industries be carried out as the existing statistical data could not provide an accurate measurement of the economic contributions of the creative industries. The Chairman subsequently tasked the Economic Analysis and Business Facilitation Unit (EABFU) to study the recent performance and development prospects of selected creative industries and report back to the Committee in due course. Advertising, design and software are selected for this study because they all encompass substantial creative element and support a wide range of economic activities.

III. Scope of study

3. This study assesses the recent performance and development prospects of the 3 selected creative industries, with a view to providing members with further background information on the subject of creative industries.

4. Apart from examining the existing data and information, EABFU met some stakeholders including business chambers and trade associations, companies, and related organisations to collect market intelligence on the

subject. Furthermore, EABFU in collaboration with the Census and Statistics Department (C&SD) conducted a small-scale ad hoc survey in March-April 2006 to collect views on specific areas where information is relatively scant.

5. Findings for each of the 3 creative industries in the study are detailed in Annex I - III. The organisations consulted are listed in Annex IV.

IV. Key issues

6. Existing statistics on the direct economic contribution of the 3 creative industries grossly underestimate the size and value added of the services concerned. The current statistical data gathering system is not geared towards such a measuring purpose. But to try to measure more accurately will involve significant resources.

7. In any case, the 3 creative industries make significant indirect contribution to Hong Kong's economic restructuring by supporting the transition by many companies towards high value-added and knowledge-based activities. Through supporting the business development efforts of many companies into the Mainland, the 3 creative industries also foster Hong Kong's economic integration with the Mainland and helped the Mainland economy to move up the value chain. Such indirect contributions could not be measured by direct GDP contributions.

8. The 3 creative industries have increased significantly their investment in the Mainland to tap the vast market potential there. While this has meant the relocation of many professionals from Hong Kong into the Mainland, the expansion of businesses in the Mainland is beneficial to the long-term development of these industries in Hong Kong by enabling them to re-orient the local operating base, focus more on creative and other high value-added activities, and enlarge their sources of income to finance efficiency drives and business expansion.

9. The demand for quality service has been escalating fast in breadth and depth, concurrent with the increase in market opportunities. Hong Kong has to continue upgrading its competitive edge in respect of flexibility and service quality in order to enhance its pricing power and market position in face of rising competition.

10. Hong Kong's competitiveness in the 3 creative industries will continue to hinge on a cluster of talent who can effectively channel creativity into technological and artistic innovations. Apart from training up more local

talent, it is necessary for Hong Kong to maintain an open, liberal and cosmopolitan society to the benefit of attracting talented people who have become increasingly geographically mobile.

11. Hong Kong's strength will also rest with the continued flourishing of entrepreneurship to serve as the vehicle of commercialising creative works. It is thus essential to maintain a business-friendly environment conducive to enterprise start-up and growth.

V. Summary of study findings

(a) Industry profile

12. The 3 creative industries share the common feature of gradually expanding into a wide spectrum of specialised activities, alongside growing sophistication of the restructuring Hong Kong economy (Table 1). Moreover, there is more and more room for inter-disciplinary collaboration for the sake of synergy, manifesting flexibility of our market structure. A pertinent example is large-scale brand-building project that often involves various design and advertising expertise as well as software application.

Table 1 : Core activities in advertising, design and software industries

Industries	**Examples of core activities**
Advertising	Brand building and consultancy, art direction, account servicing, media planning, market analysis, project implementation, public relations.
Design	Interior design, fashion design, graphic design, product design, multi-media design, packaging design.
Software	Project management, system consultancy and corporate solutions, software design and architecture, system integration and customisation.

13. It is difficult to measure precisely the direct economic contribution from producing advertising, design and software services in Hong Kong, due to data limitation. While the latest industry statistics compiled by C&SD show that the 3 core industries for the services concerned together contribute 0.8% of GDP and 1.4% of total employment, they do not cover the services produced by

companies in other industries as non-core businesses or for in-house consumption[(1)].

14. Yet judging from the employment data, the direct economic contribution of the 3 creative services is likely to be considerably larger than the aforesaid figures, though the precise magnitude is not known. According to the latest estimate by Vocational Training Council, about 70% of software-related professionals work in non-software industries. In the design industry, C&SD estimates that about 6 300 people (including all occupations) worked in the design industry in 2005, which were much less than the common industry guesstimate of at least 20 000 designers in Hong Kong.

15. Bearing in mind the technical limitations, C&SD's industry statistics could give some rough ideas of market structure and trend. For example, the statistics reflect a predominance of the small and medium sized enterprises (SMEs) commonly observed for the 3 creative industries, accounting for more than 95% of total business establishments. Most of them are small enterprises hiring less than 10 persons. It is estimated that in 2004, the SMEs contributed 76% of value added in the design industry, 66% in the advertising industry and 45% in the software industry (Table 2).

Table 2 : Number of business establishments and value added by firm size in the 3 creative industries in 2004

	Advertising	**Design**	**Software**	**All the 3 industries**
Number of business establishments	4 373	1 641	4 372	10 386
Of which : estimated % share by firm size				
Large (hiring ≥ 50 persons)	*0.6*	*0.5*	*1.2*	*0.9*
Medium (hiring 10-49 persons)	*3.5*	*3.4*	*7.2*	*5.3*
Small (hiring <10 persons)	*95.9*	*96.1*	*91.5*	*93.8*
Direct value added contribution ($ million)	3,625	533	5,831	9,989
Of which : estimated % share by firm size				
Large (hiring ≥ 50 persons)	*34.0*	*24.3*	*55.2*	*45.8*
Medium (hiring 10-49 persons)	*33.1*	*35.5*	*29.4*	*31.1*
Small (hiring <10 persons)	*33.0*	*40.1*	*15.4*	*23.1*

Source : Census and Statistics Department

(1) Examples include advertising services directly provided by some public transport operators and television broadcasting companies as non-core businesses, software services produced for in-house consumption by some banks, and design services produced in-house by some manufacturing companies. The industry classification underlying exclusion of these activities in C&SD's industry statistics is explained separately in the market reports annexed to this paper.

16. Direct impact apart, more importantly the 3 creative industries make significant indirect contributions to the Hong Kong economy by facilitating its restructuring into high value-added and knowledge-based activities, and its integration with the Mainland market. For example, the design and advertising industries support the original design manufacturing (ODM) and original brand manufacturing (OBM) activities pursued by Hong Kong manufacturers, and facilitate expansion of Hong Kong companies into the service markets of the Mainland. The software industry underpins efficiency drives of major economic sectors such as banking, trading and logistics, and retail trade. Though the indirect economic contribution of these activities cannot be readily quantified, anecdotal data reflect the increasing importance attached to them by the business community in recent years (Table 3).

Table 3 : Selected indicators on uses of creative services in Hong Kong's business sector

	Previous	**Latest**
% of business establishments		
- having internet connection	37.3 (2000)	54.7 (2005)
- having web pages/sites	7.3 (2000)	15.5 (2005)
- undertaking significant changes in the aesthetic appearances or design of goods	n.a.	25.2 (2004)
Of which : % of business establishments viewing positively the impact of design services	n.a.	88.2 (2004)
- incurring expenditure on design services in the selected sectors*	n.a.	67.6 (2005)
Software expenditure[#] in the business sector ($Bn)	7.6 (1998)	10.5 (2004)
- as ratio to GDP (%)	0.6 (1998)	0.8 (2004)

Notes : (*) Figures are compiled from the ad hoc survey conducted by C&SD in March-April 2006 covering selected sectors more likely using design services. They include manufacturing, wholesale and import/export trade of wearing apparel, leather products, footwear, furniture, rubber/plastic products, clocks and watches, jewellery and toys; media companies; and advertising companies and agencies.

(#) Including purchase of computer programmes, software and databases for own use, and cost of in-house development of computer programmes and databases for own use.

n.a. Not available.

Source : Census and Statistics Department.

(b) Performance in recent years

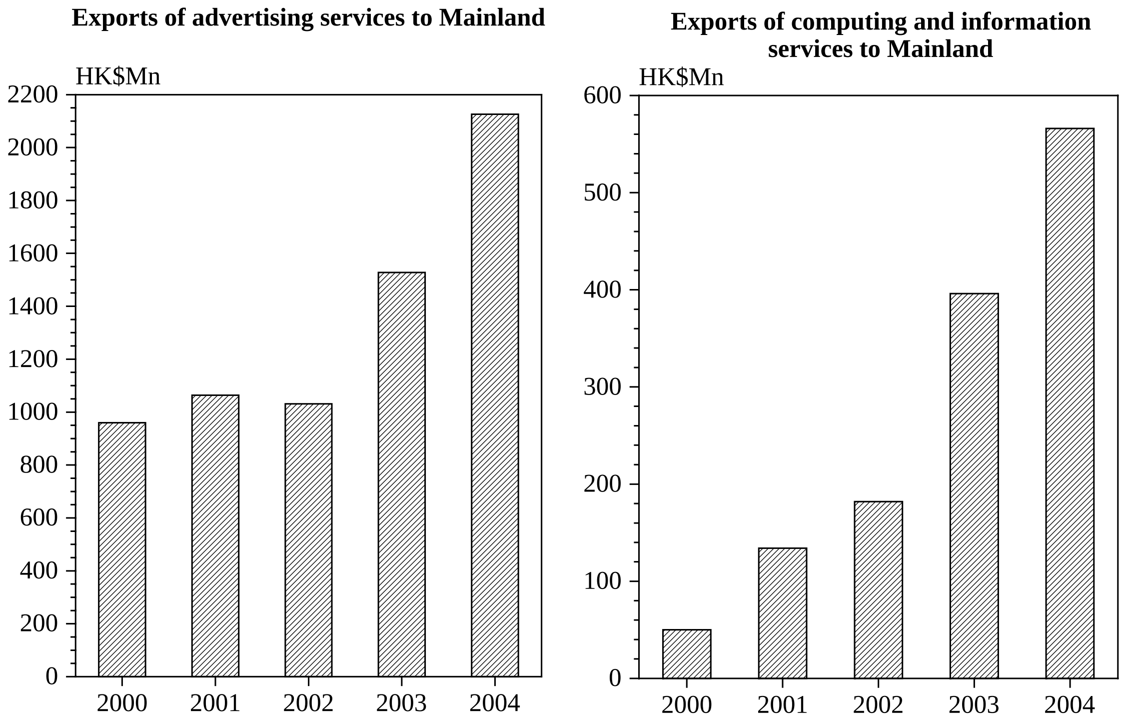
17. By virtue of their broad clientele, the performance of the 3 creative industries in Hong Kong is much vulnerable to the impact of economic cycle. The distinct contraction of domestic demand in early 2000s led to slackening in advertising and design businesses and induced fierce price competition, thereby cutting into their value added. Yet the situation improved in the more recent years alongside economic recovery. The software industry was relatively resilient to market changes after the burst of IT bubble, as the corporate sector continued to invest heavily in IT and software applications for the sake of cost savings and efficiency enhancement. The value added of the software industry resumed an uptrend after 2001, though the growth pace was steadier than in the earlier years.

18. Cyclical influences apart, the 3 creative industries in Hong Kong are affected by structural development of the Hong Kong economy. In the earlier years around turn of the decade, there appeared to be a more predominant impact of increased relocation of lower-end production activities by the industries in the Mainland, thereby restraining their local value added level. In the more recent years, however, the structural effect tended to be expansionary, as a result of increased demand generated by local economic restructuring and rapid expansion of the Mainland market.

19. More specifically, the domestic demand for the creative services in Hong Kong has broadened and deepened alongside increased sophistication of production processes and product features. More and more enterprises of different sizes come to realise the importance of using the services to improve their competitiveness. The orientation of user requirement has also gradually shifted from execution of instructions to consultancy services involving higher value-added content.

20. Outside the home market, the exports of creative services to the Mainland were buoyed by the rapid growth in demand from Hong Kong companies and foreign-funded enterprises in the increasingly open Mainland market. Demand from the indigenous Mainland enterprises has also emerged quickly, as more of them strived to upgrade their goods/services, enhance operational efficiency and build up their brands/corporate identities in face of keener competition. From 2000 to 2004, Hong Kong's exports of advertising services and computing and information services to the Mainland surged by annual averages of 22% and 83% respectively in value terms (Diagram 1).

Diagram 1 : The rapid growth of the Mainland market helps the creative industries to tide over the cyclical downturn in early 2000s and provides promising opportunities ahead



Note : Figures are compiled as from 2000. Corresponding statistics for design services are not available due to data limitation.

Source : Census and Statistics Department.

21. The vast business opportunities in the Mainland have also induced more companies in the 3 creative industries to set up or scale up operation in this rapidly growing market. Despite lack of data, the general impression is that the larger enterprises with bigger sales volume in both the Mainland and Hong Kong markets tend to split the entire operations territorially. Yet collaboration between the two operating bases is still frequent to capitalise the comparative advantages in terms of market intelligence and technical expertise. Regarding the SMEs, they are more inclined to set up sale offices and lower-end production lines in the Mainland, supported by the creative base and other higher value-added operation in Hong Kong. Compared with the large enterprises, their activities are more concentrated in the Pearl River Delta region.

(c) Strengths and weaknesses

22. *Talent* is the most important factor underlying competitiveness of all the 3 creative industries. Long period of learning-by-doing together with an

open, liberal and cosmopolitan society has nurtured a critical mass of creative workforce in the industries concerned who possess adequate skills and experience to meet diverse and complex requirements, as well as entrenched creativity and flexibility to move along and sometimes even lead market changes. Their service standards have generally established a reputation that commands a premium in the region, especially the Mainland.

23. In addition to the technical strength, the creative workforce in Hong Kong is rich in market knowledge that enables delivery of customised services increasingly emphasised by clients. This hinges on long-term exposure by our business community to international codes of businesses and overseas market situations through strong trade and investment links around the world. For the Mainland in particular, our familiarity with its business, social and cultural environment is a plus.

24. Also subsumed in our manpower strength is the *entrepreneurship* that motivates competition and drives efficiency, as manifested by the vast number of SMEs in the 3 creative industries. Entrepreneurship has flourished because of our sound *business environment*, including a transparent regulatory framework, fair competition, well-established intellectual property protection system, advanced infrastructures and a good supply of supporting services. With increased use of technologies in their activities, the industries also treasure the advanced information and communications technology support that provides quick access to state-of-the-art technologies.

25. However, *high operating cost* in Hong Kong is putting pressure on the 3 creative industries. Industry players are sometimes beset by the local cost pressure which crowds out the resources otherwise available for creative activities. This is particularly the case for the SMEs which are less capable of containing cost pressure through economies of scale and outward relocation of production activities, and which mainly pitch at the lower end of market poised to be more price sensitive. Apart from having limited resources to maintain their skills, technologies and market knowledge, the enterprises often afford rather small office space for each worker due to high office rentals that retards creativity. The low starting salary for trainees and long working hours under tight budgets also tend to discourage entry of young talent.

26. Besides, many small enterprises in the 3 creative industries face the same problem of *lacking capital and management skills* to seek business expansion. Some small business owners who devote most of their time to creative works do not possess adequate training, experience and enthusiasm in managing a large-scale operation. There is no lack of instances where the owners are unwilling to introduce new business partners into their own

businesses for fear of losing autonomy in creativity. This limits their capability to tap opportunities at home and from abroad, and impedes their ability to adapt to market changes.

(d) Opportunities and challenges

27. On-going *restructuring of the Hong Kong economy* is expected to boost further the demand for creative services in both quantity and quality. For example, corporate streamlining relies heavily on technological solutions through software application, while product upgrading cannot be achieved without commensurate improvement in functional design and aesthetic appearance. Escalation in quality and uniqueness of goods and services give rise to increasing need of marketing and branding activities.

28. The clientele in Hong Kong is expected to broaden along with the restructuring trend, as more and more SMEs come to realise the need of creative services to maintain their competitiveness. They are also motivated by the price reduction as a result of productivity improvement and market competition, making the creative services more affordable and value-for-money than before.

29. Outside Hong Kong, the *rapid growth of the Mainland market* for the 3 creative services seen over the past decade or so is expected to be unabated. A major source of growth is the rising penetration of Hong Kong companies, including Hong Kong-based multi-nationals, in the Mainland's domestic market. Many of them entrust the creative services to Hong Kong companies for better quality assurance and established working relationship.

30. Another growth impetus in the Mainland market is the rising propensity of indigenous Mainland enterprises to seek creative services. In face of increasing import penetration and competition, many indigenous Mainland enterprises have turned more aggressive in efficiency enhancement, product design, and marketing and branding activities in order to stay competitive. The fierce competition in the export markets also prompts the manufacturing sector to develop ODM and OBM activities.

31. Familiar with the Mainland and overseas market situation, Hong Kong companies especially the larger ones are well positioned to form *business partnership* with creative service providers of other origins. Reportedly, some foreign design companies seek business alliance with Hong Kong companies to invest in the Mainland market of interior design. In the other direction, some indigenous software vendors in the Mainland are keen to cooperate with Hong Kong companies in expanding overseas.

32. Yet there are *challenges* ahead before the ample market opportunities can be tapped more fully. A major challenge is the *rapid escalation of user requirement* that requires a corresponding rise in the scope and standard of creative services. Overall, there is a rising demand for customised services specific to the needs of clients of different background. In the advertising industry, for example, the service requirement has shifted towards greater emphasis on image uniqueness and brand identity. Design is evolving into more and more streams of specialised areas, while software application is increasingly geared towards tailor-made business solutions. However, the resources involved in meeting the evolving market requirement could be substantial and burdensome for smaller enterprises.

33. The hectic growth in the Mainland market is concurrent with *intensified competition* faced by Hong Kong companies. At the lower end of the market, the competition pressure mainly stems from the indigenous service providers that are catching up quickly in terms of skills, creativity and market knowledge, benefiting from market opening and advancement in information technology. Meanwhile, their charges remain much lower partly due to familiarity with the local market situation and business environment. At the upper end, there is rising competition from the service providers of other origins such as South Korea and Taiwan. Moreover, the middleman role of Hong Kong companies could fade as a result of increasing direct business contact between the Mainland and the rest of the world.

34. Increased *mobility of people* in a globalised environment means that both the entrepreneurs and talent are more ready to move from one place to another than before. Recognising that our strength rests with a pool of entrepreneurs and talent, Hong Kong has to maintain our sound business environment and an open, liberal and cosmopolitan society so that the talented people and their activities continue to cluster in the city.

(e) Suggestions from the consulted organisations

35. The organisations consulted are generally optimistic that Hong Kong will continue to be an important base for activities of the 3 creative industries, provided that our conducive environment is maintained. They generally appreciate the on-going efforts devoted by the Government to foster the development of the 3 creative industries in Hong Kong. The various measures to support and promote design, innovation, information technology and digital entertainment activities are viewed conducive to improvement in service

standard and creative content of the industries concerned[(2)].

36. Some suggestions are made by the consulted organisations to promote further the 3 selected creative industries in Hong Kong. They are not exhaustive nor necessarily representing market consensus, and will not be examined in detail in this paper. But they are listed under the respective industries in the annexes for reference.

Economic Analysis and Business Facilitation Unit
Financial Secretary's Office
June 2006

(2) For details, see Annexes 3 and 4 of the paper entitled "Promoting the Development of Creative Industries" for discussion by the Committee on Economic Cooperation and Economic Cooperation with the Mainland on 6 February 2006 (CSD/EDC/2/2006).

Annex I

Recent performance and development prospects of selected creative industries in Hong Kong

(Advertising)

I. Industry profile

Hong Kong's advertising industry has thrived in recent decades as more and more enterprises strive to establish their own brands and promote their products in competition increasingly by image, identity, quality and design. Over the years, advertising services have expanded into a wide spectrum of specialised activities such as branding, marketing strategy, product packaging, content production, media planning, market research, and public relations, etc. Most of these activities involve substantial creative input.

2. Latest statistics compiled by the Census and Statistics Department (C&SD) show that there are around 4 400 establishments in the advertising industry, directly contributing 0.3% of GDP and 0.5% of total employment in Hong Kong. Value added constitutes 64% of gross output in the industry (Table 1). Although 96% of these enterprises are small set-ups hiring less than 10 persons, the direct value added contribution of the industry is evenly spread among the groups of small, medium and large firms. The small companies generally focus on more specialised services including those outsourced by the larger ones, while most of the medium to large sized companies can provide one-stop solution. The large companies, mostly Hong Kong-based multinationals, also serve global brands with established working relationship worldwide.

Table 1 : Salient features of the advertising industry*

Number of business establishments (2005)	4 358
Gross output (representing business revenue) (2004)	$5,644 million
Direct value added contribution# (2004)	$3,625 million (0.3% of GDP)
Number of employed persons (2005)	15 642 (0.5% of total employment)

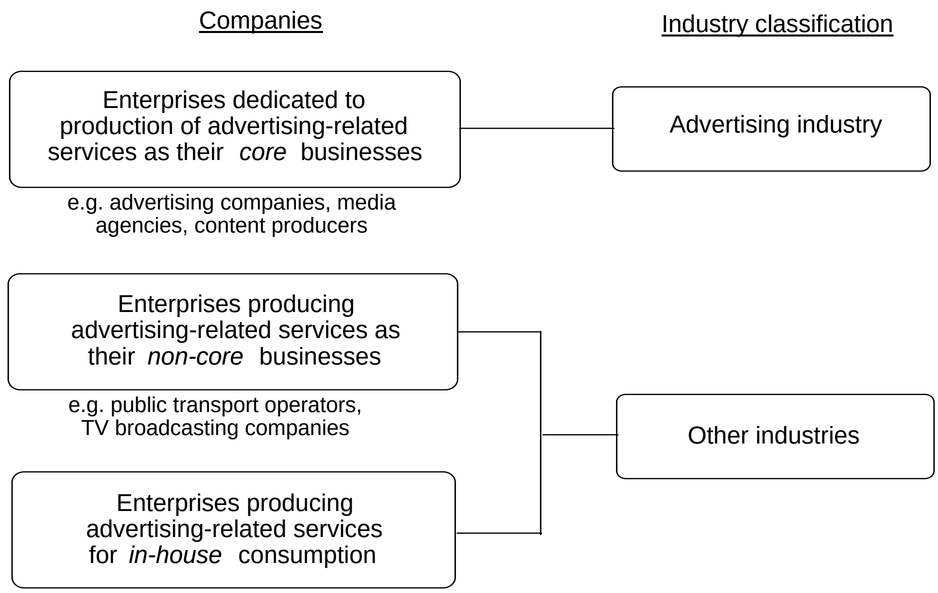
Notes : (*) Covering only enterprises dedicated to production of advertising-related services as their core businesses. Other enterprises producing advertising-related services as their non-core businesses or for in-house consumption are not included.

(#) Comprising profit income for entrepreneurs and labour income for workers.

3. It is note-worthy that the definition of advertising industry underlying C&SD's industry statistics covers only the companies dedicated to production of advertising-related services as their core businesses e.g. advertising companies, media agencies and market research companies. Other business enterprises producing advertising-related services as their non-core businesses or for in-house consumption[(1)] are not included, and are classified in other industries where their core businesses are featured.

4. Diagram 1 illustrates why the direct economic contribution of the advertising-related activities cannot be fully reflected by C&SD's industry statistics as shown in Table 1. If a broader coverage to include similar activities engaged by other industries is adopted, the contribution is likely to be considerably larger. Yet the magnitude involved is not known due to data limitation, as it is technically difficult to disaggregate and quantify the contributions by activity type to value added and employment of an enterprise.

Diagram 1 : Advertising services are not produced only in the advertising industry as defined by C&SD according to international standard

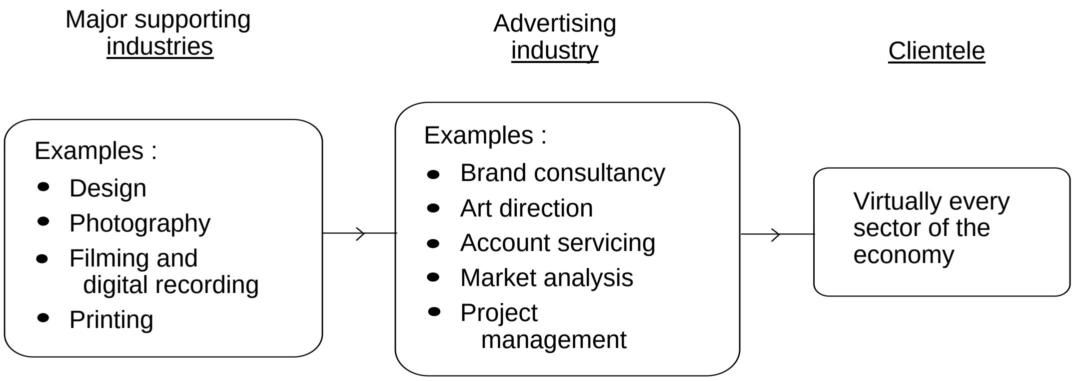


(1) An ad hoc survey conducted by C&SD in March-April 2006 reveals that almost 40% of the companies in the media and public passenger transport industries provide advertising services direct to the clients, apart from posting of commercials. Major services provided include art direction, concept formation, scripting writing and printing/graphic design.

5. Compared with the direct impact, the indirect economic contribution of the advertising industry is more important though it is not readily quantified[(2)]. In addition to inducing demand for such services as design and printing, more importantly the advertising industry helps a wide range of client enterprises to make known the value of their products and establish their brands in different markets (Diagram 2). This facilitates restructuring of our economy into higher value-added and knowledge-based production, and fosters outward expansion of Hong Kong companies into the Mainland and elsewhere in the world.

Diagram 2 : Advertising services indirectly supporting a wide range of economic activities

Supply chain of advertising services



II. Performance in recent years

6. Notwithstanding the technical limitations, C&SD's industry statistics can provide rough ideas of market trend. By virtue of its supporting nature, performance of the advertising industry in Hong Kong is much vulnerable to the impact of economic cycle. The occasional economic downturn in the several years up to 2003 restrained the demand for advertising services and induced fierce price competition in the market. Yet this was followed by a visible rebound in the more recent years as Hong Kong recovered strongly, with the gross output and value added bouncing up by more than 20% from their early troughs (Diagram 3).

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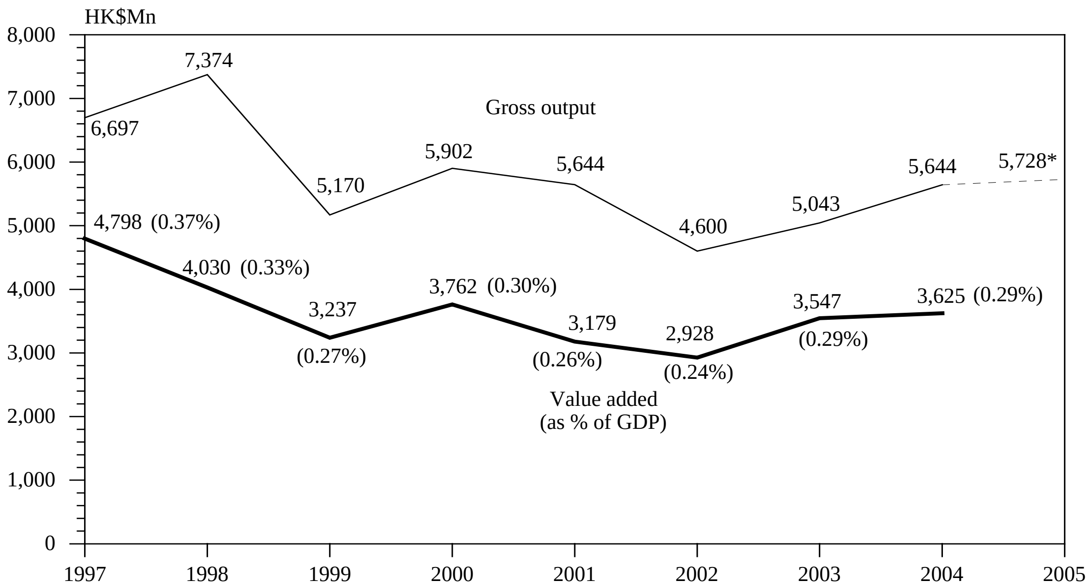
(2) Estimation of indirect economic impact by an individual industry is a massive and complicate exercise to disaggregate business data by activity type, involving a great deal of time and resources for the companies surveyed as well as technical complexities in compiling data and ensuring their reliability.

7. The advertising industry has been striving hard to enhance efficiency for greater resilience to market changes. A notable case is the spin-off of media planning and buying functions by the large advertising companies as specialist firms since the late 1990s. The industry also explores new media options, such as Internet and mobile communications, to improve advertising effectiveness and provide clients with more choices. Furthermore, corporate streamlining measures and increased use of technology have also led to a shift in labour demand from quantity to quality, resulting in a cumulative reduction in employment of the industry by 14% from 2000 to 2005. As manifested by the firmer performance by value added than business turnover, the efficiency drive helped alleviate the impact of cyclical fluctuation in recent years.

Diagram 3 : Business turnover of the advertising industry in Hong Kong was influenced by cyclical fluctuation in recent years, yet value added held up quite well on account of efficiency enhancement



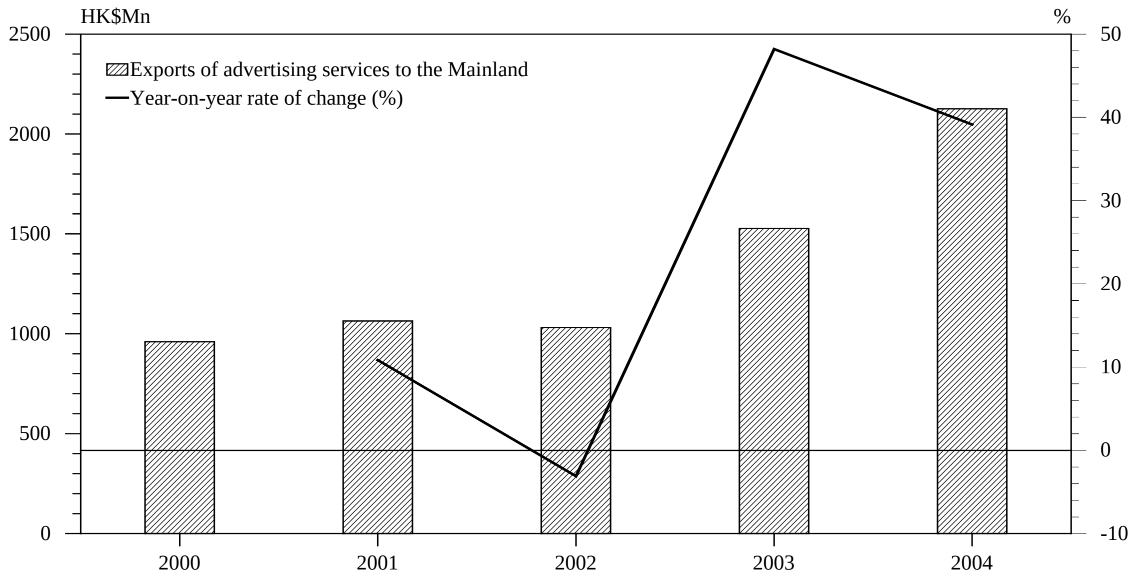
Note : (*) Crude estimate by EABFU based on latest market indications.

Source : Census and Statistics Department.

8. Cyclical influences apart, the advertising industry is affected by structural development of the Hong Kong economy. To a certain extent, the local output level of the industry is restrained by the on-going relocation of certain production processes from Hong Kong to the Mainland. Yet the impact was cushioned, if not outweighed, by the rapid growth of demand from the Mainland in the more recent years. Hong Kong's exports of advertising services to the Mainland more than doubled from $1.0 billion in 2000 to $2.1 billion in 2004 (Diagram 4). The clientele includes Hong Kong and foreign companies entering the domestic markets of the Mainland, and also the

indigenous Mainland enterprises with rising propensity to demand advertising services in face of competition pressure.

Diagram 4 : Buoyant exports of advertising services from Hong Kong to the rapidly growing Mainland market



Note : Compiled as from 2000, the figures for 2005 are not yet available.

Source : Census and Statistics department

9. The performance of the advertising industry has also benefited from increased tendency of Hong Kong's business community to develop high value-added and knowledge-based activities that require more marketing and branding services in parallel. Along with this trend, more and more small and medium sized enterprises (SMEs) come to realise the importance of advertising services. As a result of higher demand in breadth and depth, it is commonly believed that the advertising activities have expanded markedly in recent years(3).

(3) While no official data is available, a private sector estimate reveals that the advertising expenditure in the business sector almost doubled from 2001 to 2005. Though the statistics are derived from the listed prices of advertising services without adjusting for the enormous discounts offered by media companies especially in the down market, they are considered sufficient to broadly reflect that the level of advertising activities in the business sector is likely to have increased substantially over the period.

III. Strengths and weaknesses

10. The long history of development has nurtured a critical mass of advertising entrepreneurs and personnel of high service standard. Their strengths lie with a flexible mindset, creativity, experience and international perspective that give customised and quality deliverables. The larger advertising companies also excel in managing large-scale marketing project. A combination of creativity and modern management techniques underlies competitiveness of Hong Kong companies in the advertising market where requirement has gradually shifted from individual product promotion to a package of marketing and branding activities.

11. Environmental factor also contributes to the assemblage of advertising entrepreneurs and talents in Hong Kong. Our open, liberal and cosmopolitan society is widely treasured to inspire creative thinking and induce many companies to maintain their creative bases in the city. Also conducive is our business-friendly environment that encourages enterprise start-up and growth, and sophistication of business activities that facilitate familiarisation with modern business codes, norms and practices in different client industries.

12. Hong Kong owes its further attraction to strong global business network that enables the advertising industry to maintain a good sense of market trends and formulate effective marketing strategy accordingly. In particular, our business connection and familiarity with the Mainland market facilitates a good understanding of the diverse requirements in different parts of this giant market. In the other direction, our understanding about the international market warrants a premium for the Mainland clients to use our services for overseas expansion.

13. However, the advertising industry in Hong Kong is somewhat beset by the relatively high cost of operation that undermines competitiveness of the industry. This limits the capability of some advertising companies to spare out resources for investing in technology and capital equipment for longer-term development, and compete in the mass market of the Mainland where competition is still more by price than by service quality.

14. While larger enterprises manage to control cost by relocating part of their operation to the Mainland, the smaller ones with weaker capital base are less able to do so. In fact, the lack of capital has deterred business expansion of many small advertising companies into the Mainland especially those localities beyond the Pearl River Delta region. Some of them are even short of management training and experience in expanding abroad.

15. The squeeze in office space driven by cost concern is considered by some market players to result in a working environment that retards rather than fosters creativity. Together with low starting salary for trainees and long hours of work under tight budgets, absorption of creative talent has become increasingly difficult for some advertising companies.

IV. Opportunities and challenges

16. On-going restructuring of the Hong Kong economy is expected to boost further the importance of high value-added and knowledge-based activities and hence a rising demand for advertising services to promote the quality and uniqueness of goods and services. Now even the SMEs increasingly come to understand the importance of branding and marketing. Their inclination to spend on advertising is also prompted by availability of more media options that make the services more affordable and value-for-money than in the past.

17. The thriving trend of outward direct investment by Hong Kong companies especially in the Mainland also renders a promising prospect for the advertising industry. With increased liberalisation of the Mainland market generally and for Hong Kong in particular under CEPA, more and more Hong Kong companies strive to enter the Mainland's domestic markets in recent years. Many advertising companies have henceforth followed their clients into the Mainland and the trend is likely to continue. Some of them also aim to capture the foreign brand businesses concurrently.

18. Another source of growth is the rising propensity of Mainland enterprises to seek advertising services. In face of rising import penetration and fierce competition both in the home and export markets, Mainland enterprises generally have become more eager to develop their unique products and establish their own brands. Manufacturers in particular have turned more aggressive towards original design manufacturing (ODM) and original brand manufacturing (OBM) activities, notwithstanding higher risks than in the case of original equipment manufacturing (OEM). Besides, an increasing number of Mainland enterprises seeking to invest abroad also demand quality consultancy services for building corporate identity.

19. Yet there are challenges ahead before the advertising industry can benefit more fully from the positive market outlook. A major test is intensification of competition in the Mainland in recent years. The larger advertising companies generally face intense competition from a rising number of foreign counterparts in the Mainland. This is particularly the case as the CEPA concession for Hong Kong's advertising sector has converged with the

Mainland's commitment to World Trade Organisation (WTO) as from late 2005[4]. Regarding the small and medium sized advertising companies, the competition pressure mainly stems from indigenous service providers likewise pitching at the lower end of the market. The techniques and creativity of the Mainland's advertising agencies have improved fast, while their charges remain much lower partly due to familiarity with the local business environment and market situation.

20. Another challenge is adaptation of Hong Kong's advertising industry to the business environment in the Mainland. As the footprints of Hong Kong advertising companies have gradually extended beyond the Pearl River Delta region, many of them require lots of time and resources in order to become familiar with the commercial regulations and their enforcement in different regions of the Mainland, as well as the diverse consumer culture and preference in different places. Besides, some small enterprises still find it difficult to meet the Mainland's market entry requirement that wholly-owned foreign-funded advertising enterprises must have attained average annual sales of Rmb 20 million in the preceding three years.

21. Increased sophistication and territorial expansion of economic activities has made it necessary for the advertising companies to maintain up-to-date domain knowledge of different industries and markets, in order that their services can be customised to fit user requirements. While the resources involved are affordable to the larger enterprises, this is more of an issue to the smaller enterprises that limits their capability to expand.

V. Suggestions from the consulted organisations

22. The organisations consulted generally appreciate the on-going efforts devoted by the Government to maintain a vibrant business and creative environment for the advertising industry in Hong Kong. Some suggestions are made by the consulted organisations to promote further the advertising industry in Hong Kong. They are not exhaustive nor necessarily representing market consensus, and will not be examined in detail in this paper. But they are listed below for reference :

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(4) Under CEPA I, Hong Kong service suppliers can set up wholly-owned advertising companies in the Mainland as from 1 January 2004. This compares favourably with the general regulation that only permits joint ventures with maximum foreign ownership of 70%. The concession converges with China's corresponding commitment to WTO effective from 11 December 2005.

(i) The Government should step up efforts in enhancing public awareness especially among the SMEs on how the advertising services can contribute to business development. Measures may include allocation of more public facilities for displaying local brands, and organization of more promotional events such as awards and competitions. Improved public awareness is also considered important in facilitating understanding about the industry prospects to the benefit of talent absorption.

(ii) The Government should help the industry to incubate local talent by providing training support to workers in the industry that covers not only skill aspect but also business management skills and market knowledge. The efforts should also be geared towards the long-term target of setting up a professional qualification system for talent in the industry.

(iii) The Government should consider allocating specific localities with concessionary rents for the advertising and related industries to cluster, for the sake of strengthening inter-disciplinary collaborations and fostering creativity.

(iv) The Government should consider granting tax concessions to local enterprises engaging in brand building activities, such as profit tax credits/incentives on the basis of expenditure incurred.

(v) As a user of advertising services, the Government should review its procurement procedure to see if changes can be made to support the industry further. It is opined by some market players that under the current "free-pitch" practice, the smaller advertising companies find it difficult to participate in bidding for government projects. By virtue of creativity involved, there is substantial upfront expenditure at the stage of proposal preparation that puts pressure on the failed enterprises. Besides, there are some suggestions to increase the weighting of creativity relative to the price and other assessment factors in the process of awarding tenders.

(vi) The Government should seek further cooperation and coordination with the Mainland authorities to facilitate understanding of the commercial regulations and latest market situations in different parts of the Mainland. The Government should also seek the agreement by the Central Government to relax the entry requirements for Hong Kong companies in the Mainland's advertising market.

Key statistics of the advertising industry in Hong Kong#

		2000	2001	2002	2003	2004	2005
1.	Number of business establishments	4 074	4 089	4 265	4 529	4 373	4 358
	Estimated share by firm size (%)						
	- Small (hiring < 10 persons)	*93.8*	*95.9*	*96.0*	*95.8*	*95.9*	--
	- Medium (hiring 10-49 persons)	*5.4*	*3.4*	*3.4*	*3.7*	*3.5*	--
	- Large (hiring ≥ 50 persons)	*0.8*	*0.7*	*0.6*	*0.6*	*0.6*	--
2.	Gross output (HK$Mn)	5,902	5,644	4,600	5,043	5,644	5,728 *
	Estimated share by firm size (%)						
	- Small (hiring < 10 persons)	*34.1*	*34.0*	*26.6*	*27.1*	*41.6*	--
	- Medium (hiring 10-49 persons)	*35.8*	*34.0*	*41.5*	*44.8*	*27.7*	--
	- Large (hiring ≥ 50 persons)	*30.1*	*32.0*	*31.9*	*28.1*	*30.8*	--
3.	Value added (HK$Mn)	3,762	3,179	2,928	3,547	3,625	--
	Estimated share by firm size (%)						
	- Small (hiring < 10 persons)	*26.8*	*23.8*	*21.9*	*19.8*	*33.0*	--
	- Medium (hiring 10-49 persons)	*37.7*	*35.3*	*46.5*	*50.8*	*33.1*	--
	- Large (hiring ≥ 50 persons)	*35.5*	*40.8*	*31.6*	*29.4*	*34.0*	--
4.	Share of value added in GDP of Hong Kong (%)	0.30	0.26	0.24	0.29	0.29	--
5.	Number of employed persons	18 184	19 014	18 514	17 022	16 862	15 642
	Estimated share by firm size (%)						
	- Small (hiring < 10 persons)	*48.5*	*48.7*	*52.1*	*55.6*	*63.5*	--
	- Medium (hiring 10-49 persons)	*27.5*	*25.7*	*26.0*	*27.0*	*19.0*	--
	- Large (hiring ≥ 50 persons)	*24.0*	*25.6*	*21.9*	*17.4*	*17.6*	--
6.	Share in total employment of Hong Kong (%)	0.57	0.58	0.57	0.53	0.51	0.46
7.	Exports of advertising, market research and public opinion polling services	6,386	6,378	4,827	4,060	4,076	--
	Of which : to the Mainland	*960*	*1,064*	*1,031*	*1,528*	*2,126*	--

Notes : Data items sourced from different surveys are not strictly comparable, due to methodological differences involved.

(#) Hong Kong Standard Industrial Classification (HSIC) code 8336.

(*) Crude estimate by EABFU based on latest market indications.

(--) Figures are still being compiled.

Sources : Census and Statistics Department

- *All figures in breakdown by firm size (Annual Surveys of Storage, Communication, Banking, Financing, Insurance and Business Services)*
- *Items 1,5 and 6 (Quarterly Survey of Employment and Vacancies)*
- *Items 2, 3 and 4 (Annual surveys of Storage, Communication, Banking, Financing, Insurance and Business Services)*
- *Item 7 (Trade in Services Statistics)*

Annex II

Recent performance and development prospects of selected creative industries in Hong Kong

(Design)

I. Industry profile

The design industry in Hong Kong conventionally comprises 4 main disciplines viz. product design, fashion design, interior design and graphic design. Product and fashion design primarily serve the manufacturing sector, while the clientele of interior and graphic design is more diversified. General demand stemming from home and office renovation apart, interior design mainly serves the real estate and hotel sectors. For graphic design, advertising, media, printing and publishing industries are amongst the major clients.

2. Increased complexity of user requirement has led to emergence of new design disciplines. Examples include multi-media design due to growing demand for web-based design services along with advancement in information technology and digital entertainment activities, and advertising design arising from increased marketing and branding activities. There are also more and more incidents of inter-disciplinary collaboration, for example, large-scale brand building projects that involve uses of various inter-related design specialities.

3. According to the latest statistics compiled by the Census and Statistics Department (C&SD), there are around 1 700 establishments in the design industry, employing about 6 300 persons and contributing 0.04% of GDP (Table 1). About 96% of the design companies are small set-ups hiring less than 10 people, while only 0.5% are large set-ups hiring 50 people or more.

Table 1 : Salient features of the design industry*

Number of business establishments (2005)	1 746
Gross output (representing business revenue) (2004)	$922 million
Direct value added contribution[#] (2004)	$533 million (0.04% of GDP)
Number of employed persons (2005)	6 260 (0.18% of total employment)

Notes : (*) Covering only enterprises dedicated to production of specified design services as their core businesses. Other enterprises producing such services as their non-core businesses or for in-house consumption are not included.

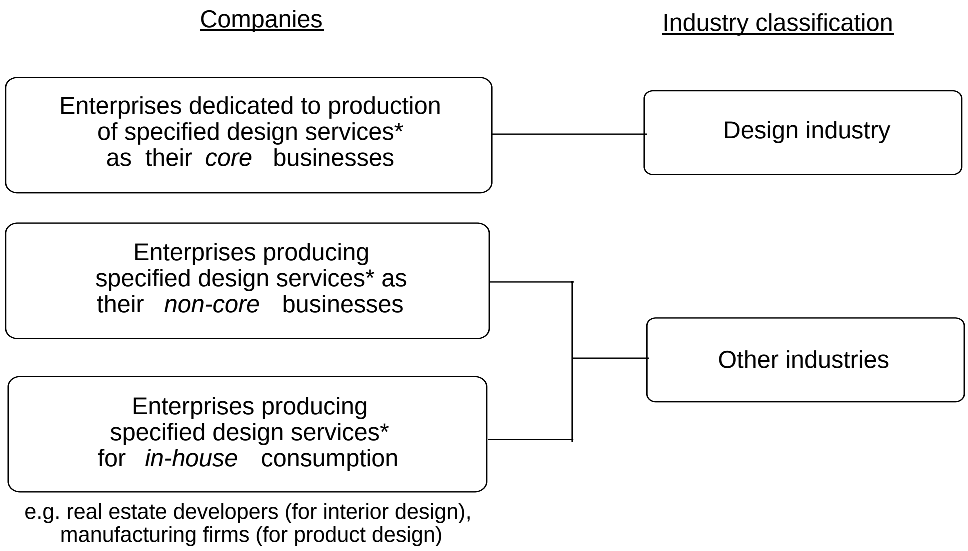
(#) Comprising profit income for entrepreneurs and labour income for workers.

4. As in the cases for the other two selected creative industries, the definition of design industry underlying C&SD's industry statistics is establishment-based rather than activity-based, by covering only the companies dedicated to production of design services as their core businesses. Other business enterprises producing such services as non-core businesses or for in-house consumption are not included, and are classified in other industries where their core businesses are featured. Besides, in line with international classification standard, those companies mainly engaging in some design services such as graphic and package designs are not included as part of the design industry. Their economic contributions are subsumed in other industries that cannot be separately delineated.

5. Diagram 1 illustrates why the direct economic contribution of the design services cannot be fully reflected by C&SD's industry statistics under the current industry classification. If a broader coverage is adopted to also include similar activities engaged by other industries, the contribution is likely to be considerably larger, in view of the discrepancy in employment data by industry versus by occupation. Based on C&SD's industry statistics, about 6 300 people (including all occupations) worked in the design industry in 2005. This was however much lower than the common industry guesstimate of at least 20 000 designers in Hong Kong. Besides, a recent survey by C&SD also reveals that roughly about 70% of the design expenditure incurred by the major user enterprises was incurred in-house in 2005[1].

(1) The survey was conducted on an ad hoc basis during March-April 2006 to collect broad-brush indications on design activities engaged by the industries which are more likely to use the services in Hong Kong. They include manufacturing, wholesale and import/export trade of wearing apparel, leather products, footwear, furniture, rubber/plastic products, clocks and watches, jewellery and toys; media companies; and advertising companies and agencies.

Diagram 1 : Design services are not produced only in the design industry as defined by C&SD according to international standard



Note : (*) Including interior design, fashion design and design of other industrial products (furniture, lace, mould, shoe pattern, textile and toys). Graphic design, package design and electronic circuit design are however excluded according to international classification standard.

6. Notwithstanding its modest direct contribution to GDP and employment, the design industry contributes significantly to Hong Kong in an indirect manner, though the impact is not readily quantified[(2)]. A major benefit pertains to upgrading of products and services in many economic sectors. For example, product and fashion design enhance value of manufactures by strengthening their functions and aesthetic appearance, to the benefit of on-going pursuit towards original design manufacturing (ODM) and original brand manufacturing (OBM) activities. Graphic and multi-media design support many service productions spanning from advertising, through digital entertainment, film production, printing to telecommunications, etc.

7. Besides, design services foster outward expansion of Hong Kong companies especially in the Mainland market which has opened wider in recent years. A notable example is the demand for interior design services from Hong Kong property and hotel developers that invest in the Mainland.

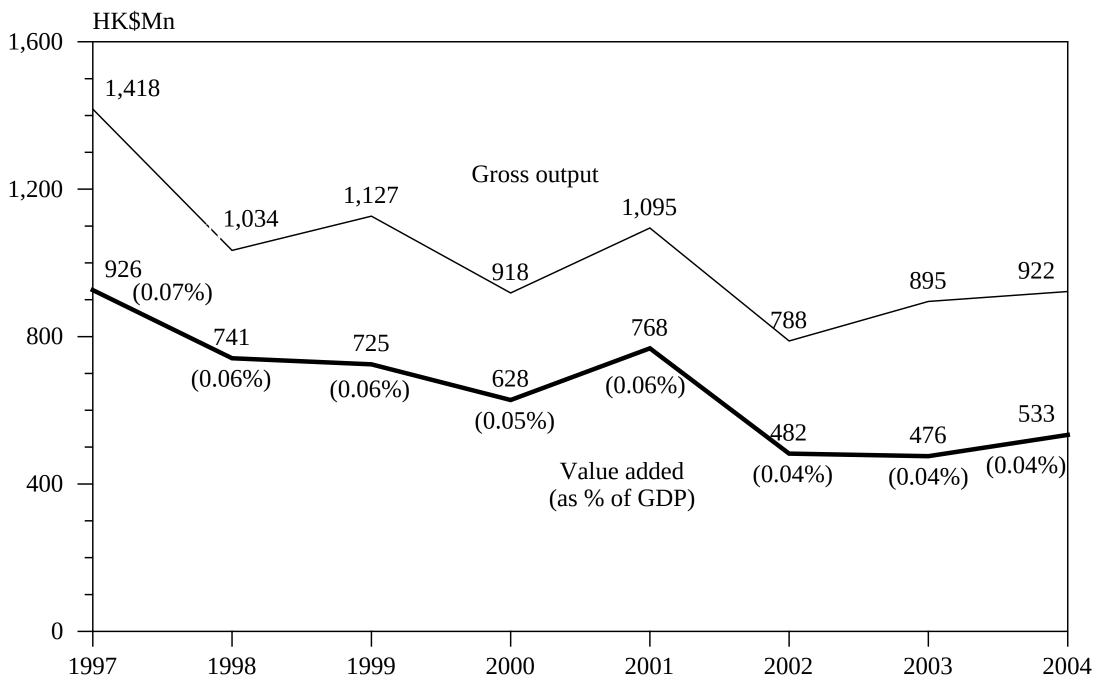
(2) See footnote (2) to Annex I.

II. Performance in recent years

8. Following the sharp setback amidst the distinct economic downturn in the late 1990s, the design industry exhibited volatility under the impact of market ups and downs so far this decade, reflecting vulnerability of the industry performance to overall economic situation. In 2003, value added of the industry hit a trough along with the distinct slackening in domestic demand under SARS impact. More specifically the interior design industry was beset by the property market downturn, while the graphic design industry was hard hit by the general squeeze in advertising budgets of the business community.

9. Yet the strong economic recovery since mid-2003 has led to a visible rebound of the design industry's performance. In 2004, value added of the industry bounced up sharply by 12%, recouping part of the ground lost in the earlier years (Diagram 2). An ad hoc survey recently conducted by C&SD reveals that almost 30% of the major user enterprises increased their budget on design services in 2005 while about 70% held the budget stable. This reflects that the performance of the design industry is likely to have improved further in 2005.

Diagram 2 : The design industry staged a visible rebound alongside economic recovery more recently, recouping partly the ground lost in the earlier part of this decade



Source : Census and Statistics Department.

10. Cyclical influences apart, the design industry has benefited from the growing emphasis on product upgrading and brand building activities across different economic sectors in Hong Kong. More and more SMEs now make use of design services to improve their trademarks, and product functions and appearance. Latest indications showed that in 2004, 25% of the business enterprises in the Hong Kong economy made significant changes in the aesthetic appearance or design of their products, of which more than 80% viewed positively the impact on their business performances(3).

11. The design industry has also leveraged on the emerging Mainland market that likewise showed a structural tendency towards design application. As in the case for Hong Kong manufacturers, there is a rising proportion of the indigenous Mainland manufacturing companies that strive to develop ODM and even OBM activities, in face of keener competition in the increasingly open domestic market and fierce competition in the export markets. Hong Kong companies and foreign-funded enterprises entering the service markets of the Mainland concurrently strived to promote their brands through trademark design and decoration of sale outlets that match with brand image. Despite lack of data, the market consensus is that service exports to the Mainland have constituted a rising share of income source for Hong Kong's design industry.

III. Strengths and weaknesses

12. Hong Kong's designers are renowned for creative thinking and flexible mindset that produce works lodging icons in user memories. They are also good at integrating Eastern and Western cultures into fusions of new styles. All these mainly rest with an open, liberal and cosmopolitan social environment and long period of learning-by-doing. The creative niche together with reliability under tight schedule command a premium that Hong Kong's designers enjoy at home and in other regional economies in particular the Mainland. For many clients especially from the Mainland, it remains a selling point that all the design work processes take place in Hong Kong.

13. A competitive environment manifested by the critical mass of small design houses also contributes to the reputation of our design industry. Encouraged by the sound business environment and entrepreneurial freedom, lots of designers with good potentials and aspiration tend to set up their own

(3) For details, see "Report on 2004 Annual Survey of Innovation Activities in the Business Sector " published by C&SD.

businesses, thereby motivating competition and quality improvement in the industry.

14. Notwithstanding the creativity strength of Hong Kong's designers in general, it is opined by some clients that there is still room for improvement in respect of their service breadth and depth. One view is that Hong Kong's designers are generally not quite familiar with the client needs in areas that the local economy has not actively engaged, such as design of heavy industrial products and design of environmentally friendly products. Another opinion is that many Hong Kong's designers, whilst good at producing creative works along market trend, do not excel in predicting market trend and producing works that can lead market changes.

15. There are some worries that the high operating cost in Hong Kong has been putting pressure on the design industry directly and indirectly. One concern is that the local cost pressure erodes the price competitiveness of Hong Kong's design companies in the export markets, especially at the lower end of the Mainland market. Besides, high office rents force some design companies to move to industrial premises that may not be ideal for creative works.

IV. Opportunities and challenges

16. Structural transformation of the Hong Kong economy is expected to bring about a promising development prospect for the design industry. The various design disciplines are expected to benefit one way or another from the growing emphasis on style, image and identity in the production and marketing of goods and services. It can be expected to have a rising number of businesses that recognise and treasure the intrusive value of design services as a magnet in attracting the desired group of customers.

17. Outside the home market, the Mainland is expected to be the most prominent market for Hong Kong's design industry to expand. Pursuit of ODM and OBM activities in the Mainland is widely regarded as a secular trend, providing ample opportunities for product and fashion designers. Also, the rapid development of the property sector requires interior design services, while buoyant marketing activities in the highly competitive local market have to be supported by graphic design and multi-media design services.

18. However, the competition in the Mainland market for design services has turned keener in parallel. The service standard of the indigenous designers in the Mainland has improved remarkably in recent years. Whilst still generally lagging behind Hong Kong's designers especially in respect of

creative content, their services are offered at lower charges that can draw away some of the demand at the lower end of the market. The competition pressure is reportedly more apparent for light industrial product design and simpler graphic design. At the upper end, Hong Kong's design industry mainly faces competition from designers of other origins such as South Korea, Taiwan and Japan. This is particularly the case in the northern part of the Mainland where the footprints of Hong Kong's designers are less solid in general.

19. In face of intensified competition yet growing market size, it has become increasingly necessary for Hong Kong's designers to set up sales office in the Mainland and relocate part of the production processes northward. This poses a challenge for some of them who are lack of capital and management experience in expanding businesses abroad.

V. Suggestions from the consulted organisations

20. The organisations consulted generally appreciate the on-going efforts devoted by the Government to foster the development of the design industry in Hong Kong. Establishment of the Hong Kong Design Centre and implementation of the DesignSmart Initiative are among the measures highlighted that contribute to escalation in service standard and creativity of the industry(4).

21. Some suggestions are made by the consulted organisations to promote further the design industry in Hong Kong. They are not exhaustive nor necessarily representing market consensus, and will not be examined in detail in this paper. But they are listed below for reference :

(i) The Government should step up efforts in enhancing public awareness of how design services can benefit businesses and living, in order that the market potentials can be better unleashed. Measures may include allocation of more public facilities for displaying and showcasing local design works, and organisation of more promotional events such as awards and competitions. These will also enhance public understanding about the industry prospects to the benefit of talent absorption.

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(4) For details, see Annex 4 of the paper entitled "Promoting the Development of Creative Industries" for discussion by the Committee on Economic Cooperation and Economic Cooperation with the Mainland on 6 February 2006 (CSD/EDC/2/2006)

(ii) The Government should in collaboration with the education sector and the industry strive to set up a professional qualification framework for designers in Hong Kong. This is considered important to long-term development of the industry by raising professional image and service standard, and hence strengthening the industry's competitiveness and facilitating its outward expansion.

(iii) The Government should consider granting tax concessions to local enterprises that use design services for business development, such as profit tax credits/incentives on the basis of expenditure incurred.

(iv) As a user of design services, the Government should review its procurement procedure to see if changes can be made to support the industry further. It is opined by some market players that under the current "free-pitch" practice, the smaller design companies find it difficult to participate in bidding for government projects. By virtue of creativity involved, there is substantial upfront expenditure at the stage of proposal preparation that puts pressure on the failed enterprises. Besides, there are some suggestions to increase the weighting of creativity relative to the price and other assessment factors in the process of awarding tenders.

(v) The Government should seek further cooperation and coordination with the Mainland authorities to facilitate understanding of the commercial rules and regulations as well as their enforcement details, especially in the more remote localities beyond the Guangdong Province.

Key statistics of the design industry in Hong Kong[#]

		2000	2001	2002	2003	2004	2005
1.	Number of business establishments	1 586	1 725	1 797	1 720	1 641	1 746
	Estimated share by firm size (%)						
	- Small (hiring < 10 persons)	*97.3*	*94.5*	*96.1*	*95.0*	*96.1*	--
	- Medium (hiring 10-49 persons)	*2.7*	*5.5*	*3.7*	*4.8*	*3.4*	--
	- Large (hiring ≥ 50 persons)	*0.0*	*0.0*	*0.2*	*0.2*	*0.5*	--
2.	Gross output (HK$Mn)	918	1,095	788	895	922	--
	Estimated share by firm size (%)						
	- Small (hiring < 10 persons)	*55.4*	*57.8*	*62.6*	*42.3*	*52.1*	--
	- Medium (hiring 10-49 persons)	*44.6*	*42.2*	*	*	*28.7*	--
	- Large (hiring ≥ 50 persons)	*0.0*	*0.0*	*	*	*19.2*	--
3.	Value added (HK$Mn)	628	768	482	476	533	--
	Estimated share by firm size (%)						
	- Small (hiring < 10 persons)	*53.6*	*51.7*	*65.7*	*30.9*	*40.1*	--
	- Medium (hiring 10-49 persons)	*46.4*	*48.3*	*	*	*35.5*	--
	- Large (hiring ≥ 50 persons)	*0.0*	*0.0*	*	*	*24.3*	--
4.	Share of value added in GDP of Hong Kong (%)	0.05	0.06	0.04	0.04	0.04	--
5.	Number of employed persons	5 062	5 547	5 659	4 899	6 355	6 260
	Estimated share by firm size (%)						
	- Small (hiring < 10 persons)	*66.0*	*62.5*	*62.1*	*63.2*	*65.7*	--
	- Medium (hiring 10-49 persons)	*34.0*	*37.5*	*32.3*	*30.6*	*21.4*	--
	- Large (hiring ≥ 50 persons)	*0.0*	*0.0*	*5.6*	*6.2*	*12.8*	--
6.	Share in total employment of Hong Kong (%)	0.16	0.17	0.17	0.15	0.19	0.18
7.	Proportion of establishments that have undertaken significant changes in the aesthetic appearance or design or other subjective changes in at least one of the products (%)	n.a.	n.a.	n.a.	27.6	25.2	--
	Corresponding proportion in selected sectors :						
	- Manufacturing	*n.a.*	*n.a.*	*n.a.*	*30.8*	*27.8*	--
	- Wholesale, retail and import/export trades, restaurants and hotels	*n.a.*	*n.a.*	*n.a.*	*35.4*	*29.6*	--
	- Financing, insurance, real estate and business services	*n.a.*	*n.a.*	*n.a.*	*18.2*	*18.6*	--
	- Other sectors	*n.a.*	*n.a.*	*n.a.*	*10.4*	*16.6*	--

Notes : Data items sourced from different surveys are not strictly comparable, due to methodological differences involved.
(#) Hong Kong Standard Industrial Classification (HSIC) code 833904.
(*) Figures are suppressed in order to preserve confidentiality of information relating to individual establishments.
n.a. Figures are not available for the years concerned.
(--) Figures are still being compiled.

Sources : Census and Statistics Department
- *All figures in breakdown by firm size (Annual Surveys of Storage, Communication, Banking, Financing, Insurance and Business Services)*
- *Items 1,5 and 6 (Quarterly Survey of Employment and Vacancies)*
- *Items 2, 3 and 4 (Annual Surveys of Storage, Communication, Banking, Financing, Insurance and Business Services)*
- *Item 7 (Annual Survey of Innovation Activities in the Business Sector)*

Annex III

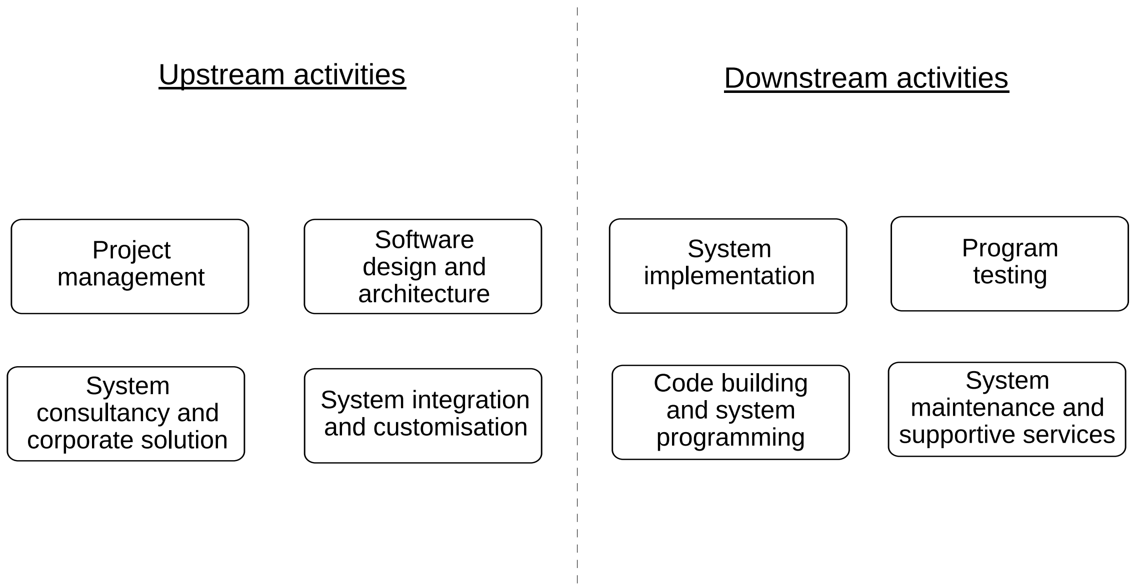
Recent performance and development prospects of selected creative industries in Hong Kong

(Software)

I. Industry profile

In tandem with the growing demand for information technology (IT) services in Hong Kong, the software industry as a major subset of the IT sector has developed a chain of specialised activities. At upstream, major activities include project management, software design and architecture, system consultancy and corporate solution, and system integration and customisation, etc. Downstream activities mainly consist of system implementation, program testing, code building and system programming, and system maintenance and supportive services. Creative element is particularly important for upstream activities (Diagram 1).

Diagram 1 : Major activities of software services



2. Latest statistics compiled by the Census and Statistics Department (C&SD) show that there are around 4 400 business establishments in the software industry, directly contributing 0.5% of GDP and 0.7% of total employment (Table 1). It is estimated that 92% of these establishments are small enterprises hiring less than 10 persons, which mainly provide supporting services outsourced by the in-house software departments of large corporations and directly serve business clients of smaller scale. The larger software

companies are more specialised in providing high-level consultancy in respect of project management and system integration. As the standardised software product market is dominated by foreign suppliers, the local software companies are primarily service-oriented.

Table 1 : Salient features of the software industry*

Number of business establishments (2005)	4 399
Gross output (representing business revenue) (2004)	$11,199 million
Direct value added contribution# (2004)	$5,831 million (0.5% of GDP)
Number of employed persons (2005)	25 344 (0.7% of total employment)

Notes : (*) Covering only enterprises dedicated to production of software-related services as their core businesses. Other enterprises producing software-related services as their non-core businesses or for in-house consumption are not included.

(#) Comprising profit income for entrepreneurs and labour income for workers.

3. As in the cases for the other two selected creative industries, the definition of software industry underlying C&SD's industry statistics is establishment-based rather than activity-based, by covering only the companies dedicated to software-related services as their core businesses. Other business enterprises producing software-related services as non-core businesses or for in-house consumption are not included, and are classified in other industries where their core businesses are featured.

4. Diagram 2 illustrates why the direct economic contribution of the software services cannot be fully reflected by C&SD's industry statistics under the current industry classification. If a broader coverage to include similar activities engaged by other industries is adopted, the contribution is likely to be considerably larger. Whilst unknown due to data limitation, the magnitude involved is reckoned to be substantial in view of the estimate by Vocational Training Council that about 70% of software-related professionals worked in non-software sectors in 2004[(1)]. This is broadly consistent with the estimate by C&SD that about two-thirds of the business investment in computer software in Hong Kong was incurred on in-house development in the same year.

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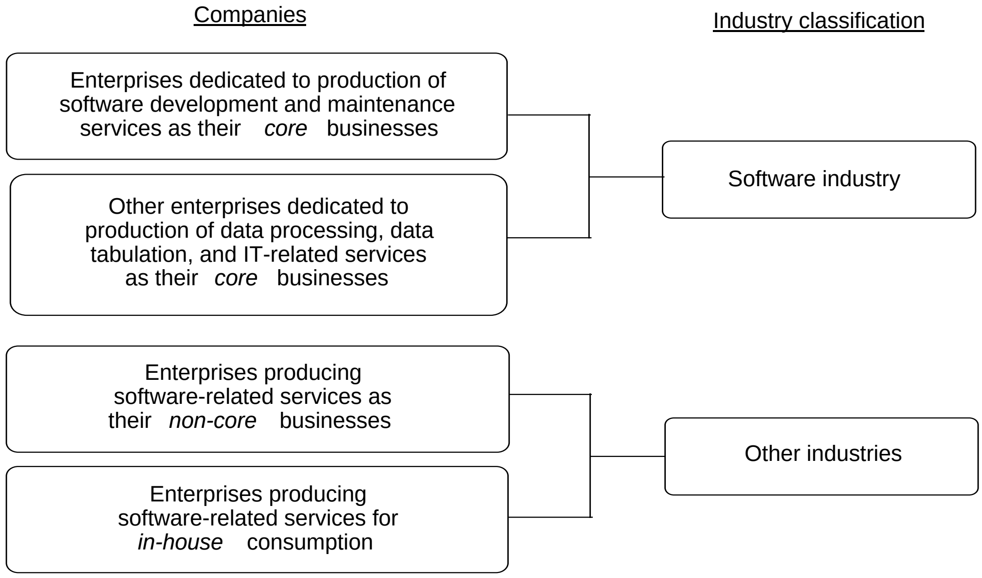
(1) For details, see "2004 Manpower Survey Report: Information Technology Sector" published by Vocational Training Council.

Diagram 2 : Software services are not produced only in the software industry as defined by C&SD according to international standard



5. The contribution of the software industry should not be confined to its direct economic impact. More importantly, attention should be given to their indirect support to a wide range of economic activities, though the impact is not readily quantified(2). Over the years, many enterprises in different sectors have strived to improve efficiency and productivity with the aid of software services such as enterprise resources planning (ERP), customer relationship management (CRM), and office automation/administration. Some of them also make use of software and information system in planning their marketing campaigns as well as enhancing their sales and distribution network (Table 2).

Table 2 : Pertinent examples of software application in different economic sectors

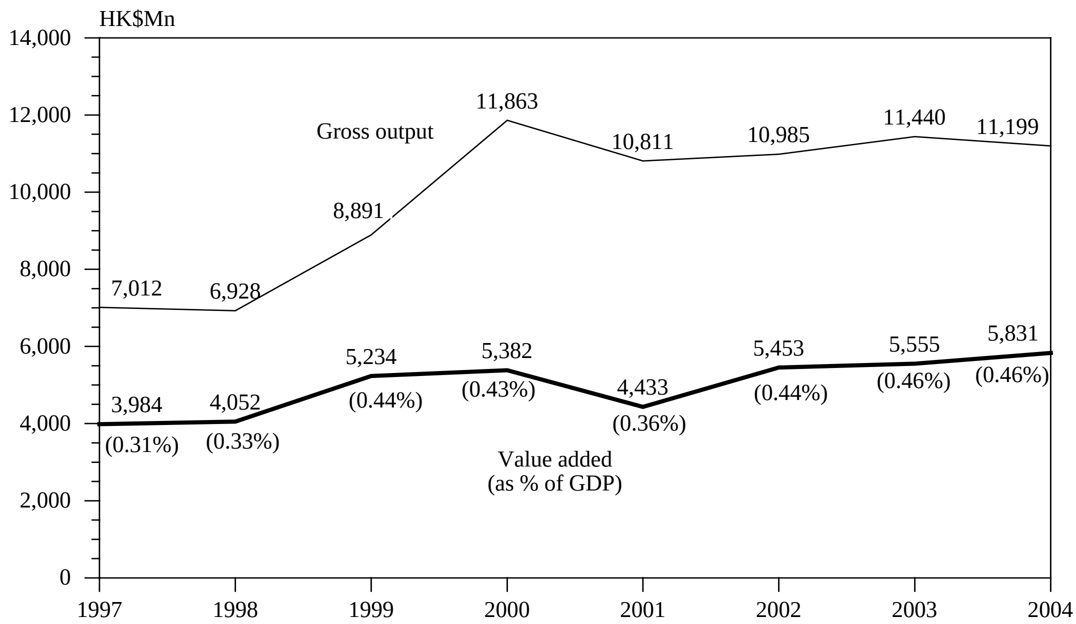
Client industries	**Facilities/services supported by software**
Manufacturing	Computer-aided design and manufacturing system
Wholesale and retail trade	Bar coding and point-of-sale system
Trading	Tradelink system
Logistics	Digital Trade and Transportation Network
Transportation	Octopus Card system
Banking and finance	On-line and wireless investment, securities and banking services
Film and digital entertainment	Computer-generated animation, special effects

(2) See footnote (2) to Annex I.

II. Performance in recent years

6. Notwithstanding the technical limitations, C&SD's industry statistics can provide rough ideas of market trends. After consolidating briefly in 2001 upon burst of the IT bubble, the software industry re-gathered momentum in recent years even though the growth pace turned relatively steadier. Compared with 2001, the value added of the software industry grew by an annual average of 10% in nominal terms to $5.8 billion in 2004, with the share in GDP rising from 0.4% to 0.5% (Diagram 3). Despite the economic downturn in 2003, the software industry continued to fare strongly, benefiting from the structural tendency of the business community to adopt IT and software for cost saving and efficiency enhancement.

Diagram 3 : Performance of the software industry in Hong Kong steadily improving after a brief consolidation in 2001 upon burst of IT bubble

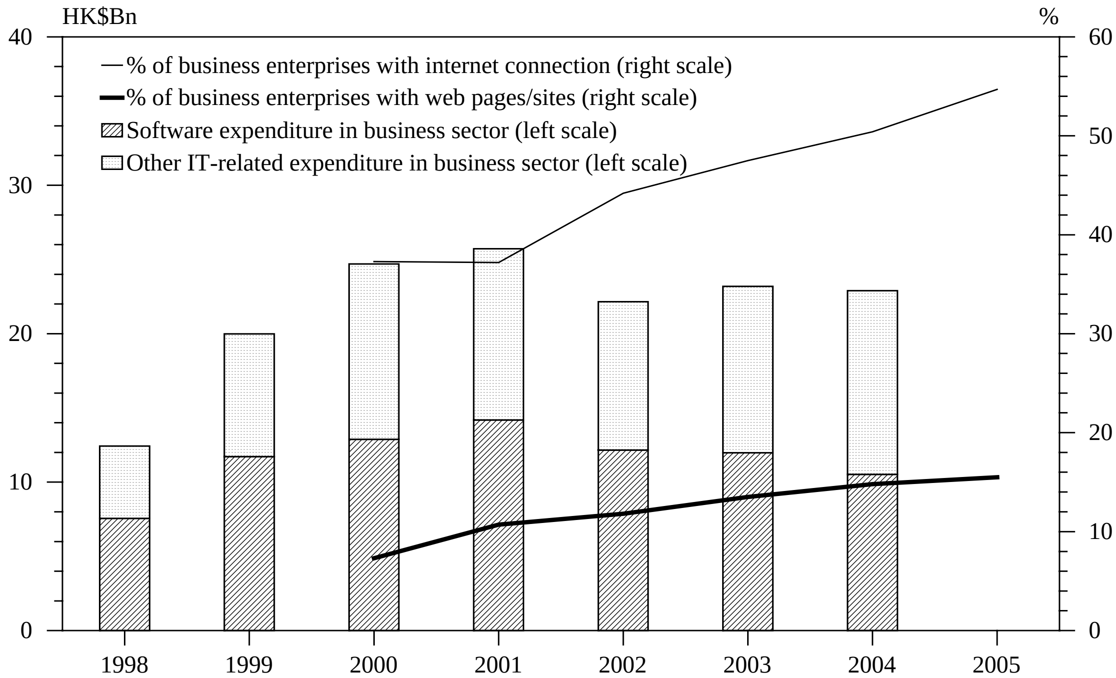


Source : Census and Statistics Department

7. Concurrent with rising application of software in the business community, the proportion of business enterprises with internet connection and web pages/sites rose to 55% and 15% in 2005, as compared to the respective figures of 37% and 7% in 2000. Expenditure on purchase and in-house development of software for own-use in the business community reached $10.5 billion or 0.8% of GDP in 2004 (Diagram 4). Though lower than the corresponding figures of $12.9 billion and 1.0% in 2000, the reduction was largely due to the sharp decline in prices of software-related products and

services(3).

Diagram 4: IT adoption in the business sector on a distinct rise in recent years, along with sustained investment by enterprises in software application



Note : Figures for business establishments with internet connection and web pages/sites prior to 2000 are not available.

Source : Census and Statistics Department

8. Apart from local demand, the software industry has also benefited from buoyant external demand especially from the Mainland on the service front. Compared with 2000, the exports of computer and information services in 2004 surged by an annual average of 42% in value terms, with the corresponding increase in the exports to the Mainland almost double at 83%. The domestic exports of software products also increased markedly, by an annual average of 8% from 2000 to 2005, with those to the Mainland rising by 6% concurrently. The Mainland is now the largest single market for these two streams of exports, accounting for 30% and 36% of the respective totals (<u>Diagram 5</u>). As the more standardised software products and lower-end services are already provided by the indigenous Mainland enterprises at competitive prices, Hong Kong companies mainly pitch for mid-price system integration service projects. Some of them also moved part of their lower-end operation to the Mainland for cost saving.

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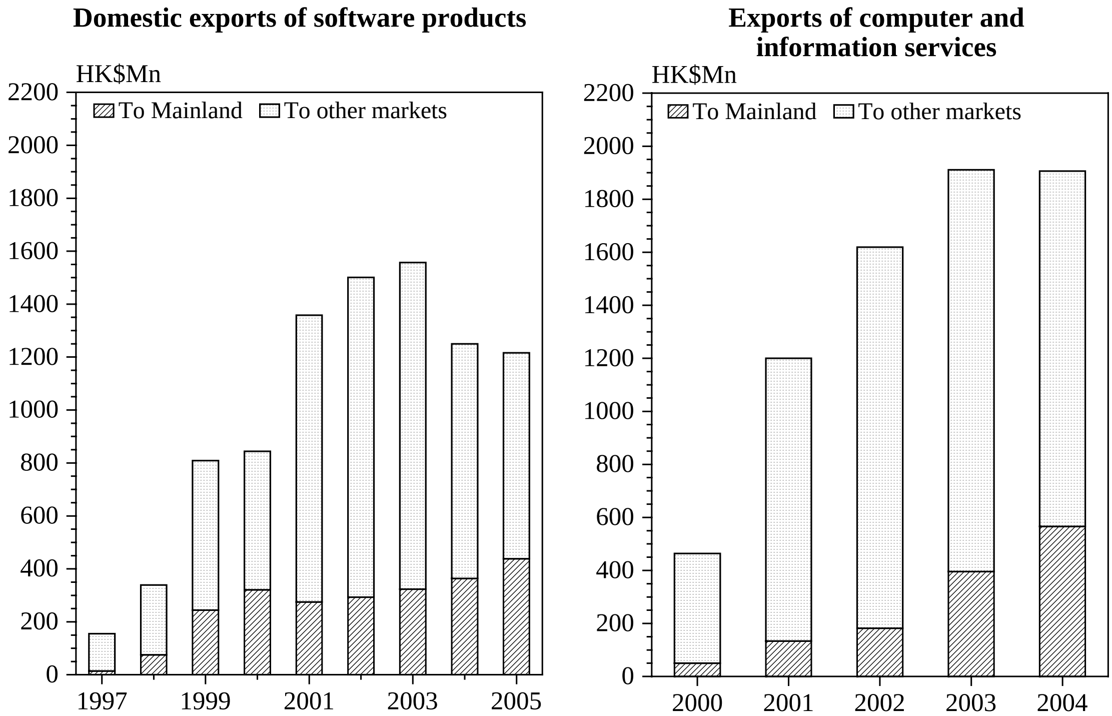
(3) According to C&SD, the implicit price deflator for investment in computer software declined by 8% between 2000 and 2004, affected by the deflationary spiral and productivity improvement.

Diagram 5 : Strong demand from the Mainland underlying buoyant performance of exports of software products and related services



Note : Figures for exports of computer and information services are compiled since 2000. The figure for 2005 is not yet available.

Source : Census and Statistics Department

III. Strengths and weaknesses

9. Effective software solution requires thorough understanding of user requirements. One of our key strengths is the rich experience that the software industry has amassed over the years in meeting the technological demand associated with a wide range of sophisticated business activities. Familiar with the modern codes of businesses, norms and practices in different client industries, the software companies can combine their technical strength with industry-specific knowledge to deliver services that fit the client need.

10. Creative and flexible mindset of software talents is also our niche. In line with increased complexities of modern business operation, there is a growing demand for customised software services that requires tailor-made adaptation of technologies and system modification. Creativity and flexibility are essential elements to make this process happen. Very often the software talent also has to strike a good balance among various essential factors in project delivery such as affordability, system reliability and diversity of functions.

11. The business and social environments in Hong Kong are conducive to innovative activities in the software industry. The well-established intellectual property protection regime is considered an important attraction for the market players to develop their own software packages in Hong Kong. Our effective media network and advanced infrastructure of information and communications technology enable them to have quick access to technology and market information around the globe. The free market system also encourages entrepreneurship as the vehicle of transforming innovative ideas into new service packages. Besides, the liberal and cosmopolitan social environment is conducive to creative thinking and international exposure necessary for the talent in this industry.

12. It is however note-worthy that the knowledge and technology requirements for software talents have been escalating rapidly. It is increasingly demanding in terms of capital and other resources that a software vendor has to devote in order to stay competitive. As most of the software companies in Hong Kong are small set-ups, some of them may not possess adequate resources to acquire knowledge and technologies required to remain competitive. Their ability to spare resources for investment activities is sometimes also restrained by the squeeze in profit margin amidst high operating cost and intense price competition.

13. Many owners of software enterprises in Hong Kong, whilst delivering good service standard, do not excel in business management and strategy formulation that inhibit their expansion particularly outside of the home market. Partnership and merger of small enterprises to facilitate expansion are henceforth not popular. Some small and medium sized software companies are also cautious in expanding abroad due to lack of capital and management experience.

IV. Opportunities and challenges

14. Despite rising penetration of software services in Hong Kong, there remain lots of market opportunities to be explored as the economy moves towards high value-added and knowledge-based orientation. The market potential is particularly apparent among the small and medium sized enterprises (SMEs), many of which are yet to be fully aware of how software application can improve their business performances and how much the software solutions have become more affordable and value-for-money than before. For example, only 13% of enterprises in the distributive and catering trade and 11% in the

community, social and personal services sector allocated budget for consuming IT and software-related services in 2005[(4)]. Besides, for those enterprises already adopting software, a rising demand for the quality of related services is anticipated.

15. Compared with the home market, the potentials of markets abroad are generally viewed to be even more promising under the global trend of IT adoption. The Mainland is in particular at top priority for many software companies in Hong Kong, due to the favourable geographical, cultural and market factors. Currently, many Hong Kong and foreign investors in the Mainland require advanced software services to support their business operations. Meanwhile, there is a rising propensity of Mainland enterprises to make use of advanced software services to improve operational efficiency. With their solid experience in commercial software applications such as ERP and CRM, and more effective communication with the Mainland clients due to language factor, Hong Kong software companies are well positioned to benefit from the market growth, particularly in relation to 3G and other wireless technologies on which they have an edge.

16. On challenges, the software industry in Hong Kong has to be more equipped with industry domain knowledge in order to tap the rather unfulfilled local SME market successfully. In particular, the industry players have to adapt to the difference in user requirement often existing between larger and smaller clients even in the same field of activities. They should also be aware that lots of those SME clients not yet using IT services intensively are usually less knowledgeable in technical aspects so that more introductory, training and after-sales services are required.

17. Upgrading of service standard and application of technologies creatively to differentiate the products and services are also important for Hong Kong companies to seize business opportunities. For example, the hectic growth in the Mainland market is concurrent with intensified competition, mainly from the indigenous software companies that catch up quickly in terms of service quality. Yet their service charges remain lower partly due to familiarity with the local business environment and market situation, making it necessary for Hong Kong companies to compete more by service standard.

18. Regarding longer-term development, it is a consensus that the software industry should strive for even better quality assurance in order to justify their price premium against rising competition. This partly hinges on absorption of

(4) For details, see "Report on 2005 Annual Survey of Information Technology Usage and Penetration in the Business Sector" published by C&SD.

talents with good academic background to fill such high-skill positions as project managers and IT strategists. Escalation of professional standard is also important to meet the ever-rising user requirements, explaining why an increasing number of small software vendors strive to obtain quality assurance qualification under International Standard Organisation and Capability Maturity Model.

V. Suggestions from the consulted organisations

19. The organisations consulted generally appreciate the on-going efforts devoted by the Government to foster development of the software industry in Hong Kong. The various measures to promote and support technological innovations and applications are in particular highlighted to facilitate improvement in service standard and creativity of the industry(5).

20. Some suggestions are made by the consulted organisations to promote further the software industry in Hong Kong. They are not exhaustive nor necessarily representing market consensus, and will not be examined in detail in this paper. But they are listed below for reference :

(i) The Government should in collaboration with the industry strive to set up professional standards of software services, covering not only technological aspect but also knowledge and experience in market application. This can be expected to increase customer confidence and encourage the industry to improve their service standard.

(ii) A proposed measure to uphold professional standard is to tighten the professional requirement in awarding tender for the Government's software projects. There is a view that enterprises not fulfilling the requirement should be debarred from bidding for the Government's projects.

(iii) The Government as a market enabler should step up efforts to facilitate software businesses. The assistance should be geared towards availability of technological infrastructure, dissemination of technology and market information, support in export marketing activities, and promotion of public awareness on the benefit of

(5) For details, see Annexes 3 and 4 of the paper entitled "Promoting the development of Creative Industries" for discussion by the Committee on Economic Cooperation and Economic Cooperation with the Mainland on 6 February 2006 (CSD/EDC/2/2006).

software services. These are all what the vast number of SMEs in the industry often find difficult to achieve on their own.

(iv) The Government should consider granting tax concessions to local enterprises engaging in technological innovations, such as profit tax credits/incentives on the basis of expenditure incurred.

(v) Outside the home market, the Government should step up the efforts to assist Hong Kong software companies in entering and competing in the Mainland market. Apart from facilitating understanding of the commercial regulations in different parts of the Mainland, the Government should explore the possibility that the Mainland authority accords same priority as indigenous service providers to Hong Kong software companies in awarding government projects under the national programme to promote the software industry. It is further proposed that the value added tax incentives for user enterprises of local software services under the national programme be extended to cover services provided by Hong Kong companies as well.

Key statistics of the software industry in Hong Kong[#]

		2000	2001	2002	2003	2004	2005
1.	Number of business establishments	3 304	3 756	4 245	4 288	4 372	4 399
	Estimated share by firm size (%)						
	- Small (hiring < 10 persons)	*89.2*	*91.2*	*91.5*	*90.4*	*91.5*	--
	- Medium (hiring 10-49 persons)	*9.4*	*7.7*	*7.6*	*8.5*	*7.2*	--
	- Large (hiring ≥ 50 persons)	*1.4*	*1.1*	*0.9*	*1.1*	*1.2*	--
2.	Gross output (HK$Mn)	11,863	10,811	10,985	11,440	11,199	--
	Estimated share by firm size (%)						
	- Small (hiring < 10 persons)	*5.8*	*16.2*	*12.8*	*19.8*	*13.4*	--
	- Medium (hiring 10-49 persons)	*49.2*	*30.3*	*29.0*	*34.2*	*28.3*	--
	- Large (hiring ≥ 50 persons)	*45.0*	*53.5*	*58.2*	*46.1*	*58.3*	--
3.	Value added (HK$Mn)	5,382	4,433	5,453	5,555	5,831	--
	Estimated share by firm size (%)						
	- Small (hiring < 10 persons)	*2.5*	*3.3*	*11.8*	*13.8*	*15.4*	--
	- Medium (hiring 10-49 persons)	*59.7*	*31.1*	*31.7*	*33.8*	*29.4*	--
	- Large (hiring ≥ 50 persons)	*37.8*	*65.6*	*56.5*	*52.4*	*55.2*	--
4.	Share of value added in GDP of Hong Kong (%)	0.43	0.36	0.44	0.46	0.46	--
5.	Number of employed persons	21 933	27 116	26 925	25 330	25 086	25 344
	Estimated share by firm size (%)						
	- Small (hiring < 10 persons)	*19.2*	*28.4*	*30.1*	*31.1*	*34.3*	--
	- Medium (hiring 10-49 persons)	*41.9*	*33.2*	*33.1*	*35.4*	*29.8*	--
	- Large (hiring ≥ 50 persons)	*38.9*	*38.4*	*36.8*	*33.4*	*35.9*	--
6.	Share in total employment of Hong Kong (%)	0.68	0.83	0.83	0.79	0.76	0.75
7.	Total number of IT employees in software-related services	46 456	n.a.	49 199	n.a.	53 489	n.a.
8.	Domestic exports of software products (HK$Mn)	844	1,358	1,501	1,557	1,250	1,216
	Of which : to the Mainland	*321*	*275*	*293*	*323*	*364*	*438*
9.	Exports of computer and information services (HK$Mn)	464	1,200	1,619	1,911	1,906	--
	Of which : to the Mainland	*50*	*134*	*182*	*396*	*566*	--
10.	Software expenditure (including purchases and in-house development of computer programs, software and database for own use) (HK$Mn)	12,883	14,187	12,159	11,983	10,525	--
11.	Proportion of establishments in the business sector (%)						
	- having internet connection	37.3	37.2	44.2	47.5	50.4	54.7
	- having web pages/sites	7.3	10.7	11.8	13.5	14.8	15.5

Notes : Data items sourced from different surveys are not strictly comparable, due to methodological differences involved.
(#) Hong Kong Standard Industrial Classification (HSIC) code 8333.
(--) Figures are still being compiled.
n.a. Figures are not available for the years concerned.

Sources : Census and Statistics Department
- *All figures in breakdown by firm size (Annual Surveys of Storage, Communication, Banking, Financing, Insurance and Business Services)*
- *Items 1,5 and 6 (Quarterly Survey of Employment and Vacancies)*
- *Items 2, 3 and 4 (Annual surveys of Storage, Communication, Banking, Financing, Insurance and Business Services)*
- *Item 8 (Trade Analysis Statistics)*
- *Item 9 (Trade in Services Statistics)*
- *Item 10 (Annual Survey of Innovation Activities in the Business Sector)*
- *Item 11 (Annual Survey of Information Technology Usage and Penetration in the Business Sector)*

Vocational Training Council
- *Item 7 (Manpower Survey of the Information Technology Sector)*

Annex IV

Recent performance and development prospects of selected creative industries in Hong Kong

(List of organisations consulted)

1. ESRI China (Hong Kong) Limited
2. Federation of Hong Kong Industries
3. Hong Kong Advertisers Association
4. Hong Kong Cyberport Management Company Limited
5. Hong Kong Designers Association
6. Hong Kong Fashion Designers Association
7. Hong Kong Design Centre
8. Hong Kong General Chamber of Commerce
9. Hong Kong Independent Advertising Agencies Association
10. Hong Kong Information Technology Federation Limited
11. Hong Kong Productivity Council
12. Hong Kong Polytechnic University (School of Design)
13. Association of Accredited Advertising Agents of Hong Kong
14. Hong Kong Trade Development Council (Department of Services Promotion)
15. Hong Kong Wireless Development Centre
16. Interior Design Association Hong Kong
17. Brandworks Limited
18. Maxi Communications Limited
19. Microsoft (Hong Kong) Limited