Economic Analysis of Individual Visit Scheme in Hong Kong

From *Policy Address 2014*:

“Tourism is one of our economy’s pillar industries. However, an excessive number or over-concentration of visitors may exert pressure on various aspects of Hong Kong… The healthy development of the tourism sector can create a large number of jobs for lower-skilled workers and facilitate the diversification and growth of our economy. We must expand our receiving capacity, focusing on high-spending visitors, to achieve the greatest economic benefits with limited resources. We must also take appropriate and effective steps to ensure that the daily lives of our people will not be affected…”

“The Government has discussed the Individual Visit Scheme and multiple entry permit arrangement with the Central Government over the past year. We have also conveyed the different views of Hong Kong people about the expansion of the IVS. The Central Government has agreed to a temporary freeze on the number of pilot cities for the IVS and the scope of the multiple entry permit arrangement. The SAR Government will continue to communicate and co-ordinate with the relevant mainland authorities to attract mainland visitors in an appropriate and orderly manner in light of Hong Kong’s economic and social situations…”

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1. Background of Individual Visit Scheme and Tourism Performance

As a key measure to liberalize the trading boundaries under the Closer Economic Partnership Arrangement (CEPA), the Individual Visit Scheme (IVS), an agreement between the Hong Kong SAR, Macao SAR, and the mainland government, was launched in July 2003. Residents with permanent household registration from the mainland could apply for an exit endorsement from mainland authorities, and were allowed to visit Hong Kong and Macao in their individual capacity. Visitors could stay for no more than 7 days each visit, and could come to Hong Kong and Macao for one or two visits only with simple procedures. There was no quota on the number of endorsements to be issued by the mainland government. IVS has resulted in a large number of mainland visitors and contributed greatly to the inbound tourism of Hong Kong since then.
1.1. Individual Visit Scheme (IVS)

- Why IVS?

- The main reason for launching IVS was that Hong Kong and Macao experienced a serious economic downturn during the period of Severe Acute Respiratory Syndrome (SARS) outbreak in 2003. In fact, data reveals that the economic outlook of Hong Kong had grown weak since year 2000. In particular, the growth rates of real gross domestic product from year 2001 to 2003 were merely 0.56%, 1.66%, and 3.06% respectively. The unemployment rate rose from 5.1% in 2001 to 7.9% in 2003. These figures indicated that Hong Kong was undergoing an economic downturn.

- The governments launched IVS to speed up the post-SARS economic recovery through increasing the number of visitors to Hong Kong and Macao.

Figure 1-1 Real GDP of HK from 1997 to 2012 (Constant 2011 HK Dollars)

Source: International Monetary Fund
Figure 1-2 Unemployment Rate of HK from 1997 to 2012

Source: Hong Kong Annual Digest of Statistics, various years

- **Phases of Implementation**

  - IVS was implemented at different phases as summarized in the following table. It targeted at only 4 cities, namely Dongguan, Foshan, Zhongshan, and Jiangmen in Guangdong province when it was first introduced. It was then extended for a few times and currently it covers 49 cities (including direct-controlled municipalities) from 18 provinces.
## Table 1-1 Phrases of Implementation of IVS in HK

<table>
<thead>
<tr>
<th>Effective Date</th>
<th>Cities / Province</th>
<th>Registered Population (in 2010, million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>28 Jul 2003</td>
<td>Guangdong Province: Dongguan, Foshan, Zhongshan, Jiangmen</td>
<td>11.0</td>
</tr>
<tr>
<td>20 Aug 2003</td>
<td>Guangdong Province: Guangzhou, Shenzhen, Zhuhai, Huizhou</td>
<td>15.0</td>
</tr>
<tr>
<td>1 Sep 2003</td>
<td>Direct-Controlled Municipalities: Beijing and Shanghai</td>
<td>26.7</td>
</tr>
<tr>
<td>1 Jan 2004</td>
<td>Guangdong Province: Shantou, Chaoshan, Meizhou, Zhaoqing, Qingyuan, Yunfu</td>
<td>24.3</td>
</tr>
<tr>
<td>1 May 2004</td>
<td>Guangdong Province: Shanwei, Maoming, Zhanjiang, Yangjiang, Shaoguan, Jieyang, Heyuan</td>
<td>34.7</td>
</tr>
<tr>
<td></td>
<td>(Open to the whole Guangdong Province)</td>
<td></td>
</tr>
<tr>
<td>1 Jul 2004</td>
<td>Fujian Province: Fuzhou (only for urban district), Xiamen, Quanzhou</td>
<td>46.5</td>
</tr>
<tr>
<td></td>
<td>Jiangsu Province: Nanjing, Suzhou, Wuxi</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Zhejiang Province: Hangzhou, Ningbo, Taizhou</td>
<td></td>
</tr>
<tr>
<td>1 Mar 2005</td>
<td>Direct-Controlled Municipalities: Tianjin, Chongqing (only for 15 counties)</td>
<td>25.5</td>
</tr>
<tr>
<td>1 Nov 2005</td>
<td>Sichuan Province: Chengdu</td>
<td>30.5</td>
</tr>
<tr>
<td></td>
<td>Shangdong Province: Jinan</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Liaoning Province: Dalian, Shenyang</td>
<td></td>
</tr>
<tr>
<td>1 May 2006</td>
<td>Jiangxi Province: Nanchang</td>
<td>29.0</td>
</tr>
<tr>
<td></td>
<td>Hunan Province: Changsha</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Guangxi Province: Nanning</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Hainan Province: Haikou</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Guizhou Province: Guiyang</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Yunnan Province: Kunming</td>
<td></td>
</tr>
<tr>
<td>1 Jul 2007</td>
<td>Hebei Province: Shijiazhuang</td>
<td>38.1</td>
</tr>
<tr>
<td></td>
<td>Henan Province: Zhengzhou</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Jilin Province: Changchun</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Anhui Province: Hefei</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Hubei Province: Wuhan</td>
<td></td>
</tr>
</tbody>
</table>

Source: Communiqué of the National Bureau of Statistics of People’s Republic of China on Major Figures of the 2010 Population Census
In April 2009, a one-year Individual Visit endorsement with multiple entries (M permit) was introduced by the mainland government. Eligible permanent residents from Shenzhen, holding this new visa, can visit Hong Kong and Macao for multiple times with a single endorsement. The new measure has made the trips of frequent visitors more convenient and at the same time encouraged visitors from Shenzhen to visit Hong Kong for leisure and shopping more often. The M-permit has been playing a very significant role. In 2012, for instance, the number of M-permit visitors reached 9.83 million, accounting for 42.5% of inbound visitors under IVS. \(^1\) Starting from December

\(^1\) Hong Kong Monthly Digest of Statistics, Jan 2014
2009, eligible non-Guangdong residents who reside in Shenzhen most of their time are allowed to apply for IVS in Shenzhen in order to visit Hong Kong. This policy has later been expanded to cover most of the non-Guangdong residents working in Shenzhen in December 2010. These expansions have added to the convenience of Shenzhen residents who want to visit Hong Kong.

1.2. Tourism Performance

In this section, we will look at some statistics of inbound tourists and IVS visitors. Generally speaking, the number of inbound tourists has been increasing since 1997, with only a few exceptions due to the outbreak of SARS (2003) and the global financial crisis (around 2007 – 2009). The total number of visitor arrivals in 2013 was as high as 54.3 million, which was an increase of 11.7% when compared to 2012, and it increased by 3.5 times comparing to the figure a decade ago.

![Figure 1-4 Figures of Visitor Arrivals in HK from 1997 to 2013](source: Hong Kong Annual Digest of Statistics.)
• The huge increase of visitor arrivals was mainly led by visitors from the mainland. As shown on the diagram, the number of mainland visitor arrivals (blue and red) had increased rapidly since year 2000, especially after the introduction of IVS in 2003.

• In 2013, visitors from the mainland accounted for around 75.0% of the total visitor arrivals. Among these visitors, 67.4% of them were visiting Hong Kong under IVS. Compared with the figures in year 2000, we can see that the percentage share of mainland visitors had increased by from only 29% to 75%.

**Figure 1-5 Proportion of Visitor Arrivals by Country or Territory of Residence in 2000**
In 2013, among the 54.3 million visitor arrivals, 25.6 million, or about 47.1%, tourists stayed in Hong Kong overnight. Compared with year 2012, the number of overnight arrivals had increased by about 8%. The average length of stay was 3.4 nights. These overnight visitors spent an average of $8,123 in Hong Kong in 2013, and the figure had increased by 3.9% compared to 2012.
According to the statistics from the Hong Kong Tourism Board, the major source cities of IVS in the first half of 2013 were Shenzhen, Guangzhou, and Dongguan, accounting for 48.8%, 16.3%, and 4.7% of the total arrivals respectively. Compared to other visitors, IVS visitors tended to stay for a shorter duration but with higher frequency. In the first half of 2013, for instance, there were 12,625,000 IVS visitor arrivals, and 65.4% were same-day visitors. Overnight visitors accounted for only 34.6%.
**Figure 1-7 Proportion of IVS Visitors by Cities of Residence from January to June in 2013**

- **Beijing, 3.0%**
- **Shanghai, 4.2%**
- **Shenzhen, 48.8%**
- **Guangdong Province, 30.8%**
- **Others, 13.2%**

Source: Hong Kong Tourism Board

*Seven cities in Guangdong province are Guangzhou (16.3%), Dongguan (4.7%), Foshan (4.1%), Jiangmen (1.8%), Zhongshan (1.3%), Huizhou (1.2%), and Zhuhai (1.3%)*
2. Economic Benefits of Inbound Tourism

In this part we will discuss the economic benefits of inbound tourism. We will start with a general discussion and then look into the case of Hong Kong.

- Inbound tourism brings economic benefits to the host community. The direct benefits include the spending of tourists and the related employment opportunities. When tourists spend, income, employment, and in many cases, tax revenue will be generated in the community. Their expenditure is then re-spent in other business sectors relevant to tourism to further stimulate economic growth. Tourists also bring about foreign exchange, which is necessary for imports and direct investment, which help boost productivity and technological level of the local community.

- There are also possible indirect economic benefits brought by inbound tourism. For example, with a greater demand for goods and services, an increased scale of production is made possible, resulting in lower prices under economies of scale. A larger market can also support the operation of more companies, and thus a greater variety of goods will be available to both local residents and visitors. In addition, further investment will possibly be facilitated if the market is larger.
2.1. Evaluation of the benefits of Inbound Tourism

- Inbound tourism is different from other conventionally defined industries — instead of fitting into a single product or service category, the expenditure on tourists brings benefits to various sectors of the economy. In other words, inbound tourism cannot simply be defined by the supply side of a particular product or service, but has to be defined by the customer’s status, i.e., whether the customer is a visitor or a local resident. Because of this, it is sometimes difficult to compare the economic impacts of tourism with other traditionally defined industries like manufacturing.

- In 1999, a new statistical tool, the Tourism Satellite Account (TSA, 旅遊附屬帳戶，亦稱觀光衛星帳), has been proposed by the World Tourism Organization (WTO, 世界旅遊組織) to estimate the economic contributions of tourism. The TSA of Hong Kong follows closely the framework proposed by WTO and ‘divides economic activities of each industry into tourism and non-tourism activities, so that the direct contribution of tourism to the economy can be measured on a basis consistent with conventionally defined industries.’ However, one should pay special notice that when estimating the value-added of inbound tourism, only direct economic contributions of tourism activities are considered. That is to say, for an economic activity to be included as a part of inbound tourism, the producer of the goods or services must be engaged in direct transactions with the visitor. No indirect or induced contribution of inbound is considered in the TSA.

- According to the statistics, the major industries with a close relationship with inbound tourism include retail trade, food and beverage services industry,

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3 Tourism Satellite Account for Inbound Tourism of Hong Kong, Feature Article, Hong Kong Monthly Digest of Statistics, Mar 2011.
land passenger transport services industry, air transport and water passenger transport service industry, and accommodation services industry. Other industries like cultural and amusement services industry, travel agency, reservation service and related activities industry as well as convention and trade show organizing services industry are also related to inbound tourism. These industries are usually called ‘tourism industries’.

Table 2-1 Four Major Tourism-related Industries in HK

<table>
<thead>
<tr>
<th>Four Major Tourism Industries in Hong Kong</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail Trade</td>
</tr>
<tr>
<td>Accommodation Services</td>
</tr>
<tr>
<td>Food and Beverage Services</td>
</tr>
<tr>
<td>Air and Water Passenger Transport</td>
</tr>
</tbody>
</table>

Source: Tourism Satellite Account for Inbound Tourism of Hong Kong, Feature Article, Hong Kong Monthly Digest of Statistics
2.2. Value-Added

- The direct economic contribution of an industry is measured by the value added. Value added is defined by the net output, i.e. the value of gross output less the value of intermediate consumption (the value of goods and services used in the course of production). Likewise, the Tourism Value Added (TVA) is the value added generated in the economy by industries providing goods and services directly to visitors. The table below shows the value-added of inbound tourism from 2009 to 2013 and the figures contain only the parts provided to visitors.

Table 2-2 Tourism Value-Added at Current Prices from 2009 to 2013

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tourism in total</td>
<td>51,000</td>
<td>74,600</td>
<td>86,200</td>
<td>94,600</td>
<td>105,900</td>
</tr>
<tr>
<td></td>
<td>(3.22%)</td>
<td>(4.29%)</td>
<td>(4.53%)</td>
<td>(4.70%)</td>
<td>(5.05%)</td>
</tr>
<tr>
<td>Inbound Tourism</td>
<td>40,300</td>
<td>59,200</td>
<td>72,100</td>
<td>79,100</td>
<td>89,000</td>
</tr>
<tr>
<td></td>
<td>(2.55%)</td>
<td>(3.41%)</td>
<td>(3.79%)</td>
<td>(3.93%)</td>
<td>(4.24%)</td>
</tr>
<tr>
<td>Retail Trade</td>
<td>13,300</td>
<td>16,900</td>
<td>22,700</td>
<td>26,400</td>
<td>32,000</td>
</tr>
<tr>
<td>Accommodation Services*</td>
<td>9,800</td>
<td>16,100</td>
<td>23,200</td>
<td>25,000</td>
<td>25,600</td>
</tr>
<tr>
<td>Food &amp; Beverage Services</td>
<td>4,500</td>
<td>6,300</td>
<td>7,900</td>
<td>9,100</td>
<td>10,000</td>
</tr>
<tr>
<td>Cross-Boundary Passenger Transport Services</td>
<td>8,000</td>
<td>13,800</td>
<td>10,500</td>
<td>10,000</td>
<td>11,700</td>
</tr>
<tr>
<td>Others</td>
<td>4,700</td>
<td>6,100</td>
<td>7,700</td>
<td>8,600</td>
<td>9,700</td>
</tr>
</tbody>
</table>

Source: Census and Statistics Department, HKSAR Government

* Accommodation services cover hotels, guesthouses, boarding houses and other establishments providing short-term accommodation

Note: Numbers in blankets represent the percentage share of GDP

4 Hong Kong Monthly Digest of Statistics, Mar 2011.
In general, the value added of inbound tourism contributes around 2.5% to 4.2% to the nominal GDP of Hong Kong in recent years. The percentage has been increasing gradually, implying that inbound tourism has been contributing more significantly over the years.

Estimated by professor Yun-Wing Sung (2014)\(^5\) from the Chinese University of Hong Kong, the direct value-added generated by IVS visitors in 2012 was about $27.2 billion, which was 1.4% of the GDP, while the direct value-added generated by non IVS visitors was 51.9 billion, or 2.6% of the GDP in the same year.

2.3. Employment Opportunities

Like many other countries, tourism is an essential contributor to employment since it involves different sectors of the economy, including retail trade, accommodation services, catering services, transportation, and such. Most of these industries are labour-intensive, i.e. the industries that require a relatively large amount of labour to produce its goods and services. In addition, employment opportunities in these sectors usually have greater flexibility in the types of work (both part-time and full-time positions available) and the job positions require relatively lower skills and educational qualification. These features are particularly important to Hong Kong because Hong Kong is transforming into a knowledge-based economy which is in line with jobs of a more complicated nature. Tourism can provide job opportunities for workers who have difficulty fitting into a position with higher job requirements.

\(^5\) Economic Benefits of the Independent Visitor Scheme for Hong Kong: How Large are They? (2014), Yun-Wing Sung.
As we can see from the chart below, in 2013, around 47% (112,600) of workers in inbound tourism served as employees in the retail trade sector. More than 20% (48,800), workers were working in the food and beverage services sector, and over 17% (39,800) workers belonged to the accommodation services sector.

**Figure 2-1 Percentage Share of Employment of HK Major Tourism Industries in 2013**

Source: Census and Statistics Department, HKSAR Government
We can evaluate the importance of inbound tourism in relation to the employment structure of Hong Kong by looking at the percentage share in the total employment of inbound tourism in different tourism industries. Tourism industries (both inbound and outbound) in total contributed 269,700 job positions in 2013, and 88.2% (237,800) were contributed by inbound tourism. From the figure below we can see that the importance of inbound tourism in employment has been increasing in the past decade. The percentage share in total employment had increased from 2.73% in year 2000 to 6.38% in 2013. The number of jobs had raised from 87,700 in 2000 to 237,800 in 2013.

**Figure 2-2 Percentage Share of Total Employment of HK Inbound Tourism from 2000 to 2013**

Source: Census and Statistics Department, HKSAR Government
The government has been trying to evaluate the impacts of IVS in terms of employment. For instance, a research study conducted by the Hong Kong Monetary Authority with the application of the data from 2003 to 2005 revealed that the total number of people working in tourism-related industries (restaurants, hotels, wholesales and retails, and transportation) had increased by 7.8% in the period. HKMA estimated that 1 percentage of such a growth was attributed to the mainland visitors. ⁶ In a report prepared by the Financial Secretary’s Office in 2010, it was estimated that more than 50,000 jobs were created to cater to the demand of IVS visitors in 2009⁷. Professor Sung (2014) estimated that the employment opportunities created by IVS was 86,600 in 2012, which accounted for around 40% of the total employment of inbound tourism.

⁶ Sources of Employment Growth in Hong Kong, 2007, Hong Kong Monetary Authority.
⁷ 2010 Update of CEPA’s Impact on the Hong Kong economy (Individual Visit Scheme), Economic Analysis and Business Facilitation Unit, Financial Secretary’s Office.
3. Economic Costs of Tourism

In general, the economic costs of inbound tourism are represented by value of the directed resources which were previously non-tourism, or alternatively, production sacrificed for tourism. For example, a piece of land can be turned into either a hotel or a sports complex. To satisfy the large demand for accommodation services from tourists, a hotel is finally built. In this case, the opportunity cost of providing such accommodation services includes not only the construction costs of the hotel, but also the value of the alternative use of land, which is, the potential value of a sports complex. From the government’s point of view, the costs of inbound tourism may include greater expenses on administration, resources invested on infrastructure such as roads and airports, and larger spending on maintaining public order, refuse collection, and such. Obviously these costs are usually unclear and difficult to measure — for example, the value of a garden yet to be built unless inbound tourism was limited can hardly be measured.

In addition, inbound tourism often involves external costs — the part of costs to society which is not considered by either tourists or tourism products producers.
3.1. External Costs of Inbound Tourism

Externalities arise when third parties are affected by a transaction or an activity uncompensated. Externalities can be both positive and negative (also referred to as external benefits and external costs respectively), depending on the nature of the specific impacts on the third parties. A typical example of external costs (or negative externality) is pollution — by-standers or even the society as whole are adversely affected when there is air pollution as a result of factory production. Externalities can be classified as production or consumption externalities, and the following table, Table 3-1, shows some externalities associated with inbound tourism.

Table 3-1 Externalities of Inbound Tourism

<table>
<thead>
<tr>
<th>Activity Effect</th>
<th>Production</th>
<th>Consumption</th>
</tr>
</thead>
<tbody>
<tr>
<td>Positive</td>
<td>More and better leisure facilities and attractions</td>
<td>More employment opportunities</td>
</tr>
<tr>
<td>Negative</td>
<td>Rising rental cost for local businesses in tourism areas</td>
<td>Congestion and noise in tourism areas</td>
</tr>
</tbody>
</table>

Externalities happen because the social costs of these activities are not taken into consideration by the firms and / or individuals. For instance, a pharmacy in Mongkok may consider only the wholesale price paid to suppliers, rents, and labour costs. The congestion problem and inconvenience brought to pedestrians when doing business may well be ignored. In this case, the cost of goods, rental and labour costs represent the ‘private costs’ to the firm, whereas the congestion and inconvenience caused are the ‘external costs’. The following figure, Figure 3-1, illustrates the case when such a part of cost is not taken in account during a production process:
The problem of over-production occurs when there is an external cost — the quantity of goods or services produced and transacted in the market is greater than the social optimum. The reason is that the producers fail to internalize all the production costs, i.e., they do not consider the entire social production costs but rather take into account only private costs. Thus, producers are over-producing from the perspective of society. When we look at the outputs between market equilibrium quantity and social optimal quantity, we can find that their social marginal costs of production (SMC) are higher than the social marginal benefits (SMB, represented by the demand curve). According to the cost-and-benefit principle, these outputs should not be produced if we want to maximize the net social benefit, which is sometimes called the ‘total surplus’. However,
from the private firms’ point of view, the private costs of production of these units (PMC, represented by the supply curve) are low enough for them to earn profits, and thus these units of output are produced. The difference between SMC and SMB, as shown by the triangular area in the diagram, is the ‘loss’ to society as a whole, and it is called ‘deadweight loss’.

- The problem of external cost and overproduction has been studied by economists all over the world. For example, Gooroochurn and Sinclair (2003, 2005) looked into the problem of congestion and environmental degradation caused by inbound tourism. Similarly, Gago and Labandeira (2006) attempted to explore the external cost associated with tourism and analyzed the impacts of imposing tourism tax to relieve the negative effects of inbound tourism. In theory, the problem caused by external costs could be solved if the government imposed a ‘corrective tax’ in order that a firm takes into account the social problems generated by its own business. Such a situation is illustrated by the figure, Figure 3-2, below:
The private marginal cost before tax is represented by the initial supply curve S1. Supposedly, the government imposes a tax that equals the size of the external cost (the vertical distance between SMC and PMC before tax). The firms’ production cost will increase accordingly. The production cost after tax is equivalent to (C + t) while C denotes the original production cost and t denotes the size of tax. Thus, the production cost after tax equals the SMC. As a result, market equilibrium quantity goes down and reaches the social optimum.

In the case of Hong Kong, the main economic costs of inbound tourism are the increased rent and pressure of inflation.
3.2. Rising Rental Costs of Private Premises

- The demand for commercial property is a derived demand. With a stronger demand for retail services brought by IVS, there will be higher demand for commercial property. Given the fact that the supply of these properties is highly inelastic (at least in the short run), the rental rate of commercial property will necessarily increase. The figure below shows the rental rates of private premises in Hong Kong by location and the Consumer Price Index (base year = 2009/10).

![Figure 3-3 Private Retail Rental ($/sq.m. per month) by Location and Composite Consumer Price Index from 1999 to 2012](chart)

Source: Rating and Valuation Department and Census and Statistics Department, HKSAR Government
Since 2003, both the rental rates of private retail premises and the Composite Consumer Price Index (composite CPI) have been increasing significantly. The increase in rental rates was higher than that in the composite CPI, indicating an increase in real terms. The skyrocketing rent of store location has tremendous impacts on the types of operating business. Traditional businesses and other small and medium enterprises (SMEs) lost in the competition of rent and were forced to close down or move to areas with lower rent. Multi-national and prestigious brands and corporations, which are usually more preferred by mainland visitors, expanded their retail outlets and replaced the original local stores. For instance, it was reported that the number of watches and jewellery retailers had surged by 380% from year 2010 to 2011.\(^8\) It was also observed that the rent of one of the Chow Sang Sang Jewellery’s branches in Russell Street had increased from $730,000 in 2011 to $2,300,000 in 2012, which amounted to a growth of more than 210%.\(^9\) These dramatic rises were obviously not possible without the huge demand for store location supported by IVS visitors.

These changes in local areas not only affect local, and usually smaller, businesses, but also have considerable impacts on the living of Hong Kong residents. First, since some local stores selling goods with lessen value (e.g., groceries stores) were forced to move to a new place given the high rental cost, purchasing daily necessities may become more inconvenient for local residents. Second, inbound visitors, especially IVS visitors, do not only eye on prestigious products, but also daily necessities in recent years. Stronger demand caused by tourists also contributes to the general inflationary pressure in Hong Kong. Price increases, on one hand, foster the businesses of firms. On the other hand, they also have adverse impacts on residents in the neighbourhood. As we have seen from Figure 3-3 above, the Composite CPI of Hong Kong has been on a rise since 2004, implying an increasing price level in the past decade.

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\(^9\) Mingpao 2012/11/15 《黎永滔：明年核心舖租料加 1 成》.
4. Macroeconomic Theory: Aggregate Demand and Aggregate Supply Model

4.1. Aggregate Demand

The aggregate demand of an economy can be broken down into four categories, namely consumption, investment, government spending, and net exports i.e. the difference between exports (of goods and services) and imports (of goods and service):

Equation 4-1 Composition of Aggregate Demand

\[ AD = C + I + G + (X - M) \]

In general, the spending of visitors is mainly included in the export of services. A stronger demand from inbound tourists will have positive impacts on the aggregate demand of Hong Kong, as illustrated by the figure, Figure 4-1, below:
IVS visitors’ spending pattern is largely inclined to retail business. According to the data from the Financial Secretary’s Office, in 2009, approximately 80% of IVS visitors’ spending comes from the category ‘retail trade’. The number for same-day visitors was as high as 92.2%. Among different products sold in Hong Kong, beauty products and cosmetics, consumer electronics, and clothing were the most popular ones.
Table 4-1 Spending Pattern of IVS visitors in 2009

<table>
<thead>
<tr>
<th>Spending pattern in 2009</th>
<th>Overnight visitors</th>
<th>Same-day visitors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hotel and boarding houses</td>
<td>8.3%</td>
<td>0.2%</td>
</tr>
<tr>
<td>Restaurants</td>
<td>7.9%</td>
<td>2.7%</td>
</tr>
<tr>
<td>Retail trade</td>
<td>77.8%</td>
<td>92.2%</td>
</tr>
<tr>
<td>Local transport</td>
<td>2.8%</td>
<td>2.9%</td>
</tr>
<tr>
<td>Others</td>
<td>3.3%</td>
<td>2.1%</td>
</tr>
</tbody>
</table>

Source: 2010 Update of CEPA's Impact on the Hong Kong Economy (Individual Visit Scheme), Economic Analysis and Business Facilitation Unit, Financial Secretary's Office, HKSAR Government

- The spending of visitors stimulates the economy by generating additional incomes for local citizens, who would then be likely to raise their spending, and sustain the cycle of further transactions and revenue. This process is called the multiplier effect. The induced consumption, which may include food and beverages, recreation, clothing, housing, and household goods, adds to the increase in aggregate demand of the economy. The World Travel and Tourism Council has estimated that in 2013, the induced contribution of tourism in Hong Kong was as high as $36.3 billion\(^\text{10}\).

\(^\text{10}\) Travel & Tourism, Economic Impact 2013, Hong Kong, World Travel and Tourism Council.
More visitors also boost investment. The capital investment on tourism, including new visitor accommodation, passenger transport equipment, restaurants and leisure facilities, and other relevant aspects, increased from $18 billion in 2004 to $28 billion in 2013, according to *Third Quarter Economic Report 2013* by the HKSAR government. In the report prepared by the World Travel and Tourism Council, Hong Kong ranked 52 out of 184 economies in the world in terms of the travel and tourism investment contribution (as a share of total capital investment) in 2012.\(^{11}\)

To conclude, tourism has significant impacts on the aggregate demand of Hong Kong economy. Since IVS is the largest source of tourists in the city (47.5% of total visitor arrivals in 2012), we can conclude that IVS undoubtedly contributes a significant deal to the aggregate demand of the economy of Hong Kong.

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\(^{11}\) Travel & Tourism Economic Impact 2013 Hong Kong, World Travel and Tourism Council (WTTC).
4.2. Aggregate Supply

The aggregate supply of an economy is confined by the production capacity, i.e., how much the economy can possibly produce in a given period of time. In this section, we will examine whether Hong Kong is reaching its production capacity in various aspects. In December 2013, the Commerce and Economic Development Bureau of the HKSAR Government carried out a study to examine Hong Kong’s carrying capacity to receive tourists, and presented the findings in the Assessment Report on Hong Kong’s Capacity to Receive Tourists. Part of our discussion below will be based on this report.

4.2.1. Accommodation Service

- Hotels in Hong Kong are classified into different categories by the Hong Kong Tourism Board (HKTB). According to the Hong Kong Hotel Industry Review (2005), the classification system takes into consideration factors including hotel room rate, staff-to-room ratio, location, facilities, and business mix of hotels. HKTB does not make public the listings of hotels by category even though individual hotels are informed of their category.

- The table below (Table 4-2) shows the room occupancy rates and the achieved room rates of different categories of hotels in 2012. The room occupancy rate of high tariff A, high tariff B and medium tariff hotels were 85%, 91% and 95% respectively, and the average room occupancy of all hotels was 89%. That rate of tourist guesthouses was 85%. These extremely high room occupancy rates indicate that the accommodation service of Hong Kong is of tight supply and would easily reach the full capacity. We can expect that a ‘full house’ situation is not uncommon especially in peak seasons.
The figure below (Figure 4-2) shows the trends of room occupancy rates of hotels and tourist guesthouses from year 2000 to 2012. As we can see, the average room occupancy rate of all hotels has been over 85% since the launch of IVS in 2003 (except in 2009 when it fell to 78% after the global financial crisis in 2008 and 09). Notice that the occupancy rate of medium tariff hotels has been on the top of the list, overtaking that of high tariff B hotels starting from 2010 when the multiple-entry Individual Visit endorsement (M permit) was introduced in April 2009.
Despite the increase in the quantity supplied of hotel rooms, the average achieved room rate has priced up by more than 120% (and 101% for tourist guesthouse) since the launch of IVS in 2003. The increase in high tariff B and medium tariff hotels were the highest, reaching 138% and 134% respectively.
The rapidly soaring prices of hotels reflect the high demand (and relatively inelastic supply) for accommodation services. Except in 2007 — 08 and 2008 — 09 when the global financial crisis heavily hit the global economy, the room rates have been increasing in the past decades. Notice that the room rates have increased rapidly since 2009 due to the endorsement of the multiple-entry Individual Visit endorsement (M permit). Another point that we can see from the data is that the increase in the rates of high tariff B and medium tariff hotels, which are believed to be preferred by most visitors under IVS, are on the top of the list.
4.2.2. Public Transportation Services

- Railway and franchised buses are the most commonly used means of public transport by local residents and inbound tourists, including IVS visitors. For instance, in 2012, railway and franchised buses accounted for 73% of total passenger journeys in Hong Kong. In particular, a market research conducted by the MTRCL stated that the railway system accounted for 55% of the transport modes used by the inbound tourists.

- According to the *Assessment Report* (2013), the current overall loading of the railway network during non-peak hours is below 40%, while the loading and waiting time for peak hours vary in different locations without being written. Even though the MTR Corporation Limited (MTRCL) is constrained by the existing infrastructure, it is able to increase the frequency of train services for the sake of catering to the demand during peak hours and in busy interchange stations. For example, it is reported that MTRCL ran 1,200 additional train trips per week in 2012, raising the carrying capacity by 3 million passenger trips. However, there is still a production capacity and MTRCL is constrained by the maximum train frequency, especially for the East Rail Line which is much used by both local residents and visitors from the mainland. As a result, it is not uncommon to see a fully loaded train but large crowds of passengers are still waiting, usually with cases, bags or even little trolleys, in the East Rail Line.

- It is worth paying attention to that fact that the Shatin to Central Link (SCL) Project, connecting Tai Wai to Admiralty, has commenced in 2012. According to the estimate by MTRCL, the new SCL can, ‘relieve the pressure on the Tai Wai to Kowloon Tong section of the East Rail, the Shek Kip Mei to Prince Edward section of the Kwun Tong Line and the Nathan Road corridor of the Tsuen Wan Line’ \(^{12}\), and the Assessment Report (2013) suggests that 23% of the

Individual Visit Scheme in Hong Kong

Southbound passengers of the New Territories should switch to the SCL. It is believed that the present congestion during peak hours may be alleviated.

4.2.3. Retail and Catering Services

- The challenges facing the retail sectors are mainly the availability of retail premises for stores and labour constraints. We have already discussed the impacts of IVS on rental rates and gained the understanding that retail businesses, especially the SMEs, are suffering a lot from the skyrocketing rents in popular areas for tourists like Tsim Sha Tsui, Mongkok, and Causeway Bay. We will focus on the labour constraints here.

- It is often reported that restaurants find it difficult to hire workers, especially dishwashers.\(^\text{13}\) According to the *Quarterly Report of Employment and Vacancies Statistics* (Third Quarter 2013), the vacancies and vacancy rates of retail sector and accommodation and food services were high compared with many other industries.

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\(^{13}\) Mingpao 2013/12/15 《月薪逾萬 翠華太興全線缺洗碗》, Hong Kong Economic Times 2014/02/24 《「有碗無人洗」冷氣 + 月薪 1.6 萬搶人》。
Table 4-3 Job Vacancies and Vacancy Rates in Selected Industries of HK in September 2013

<table>
<thead>
<tr>
<th>Industry</th>
<th>Vacancies</th>
<th>Vacancy Rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail</td>
<td>9,186</td>
<td>3.4%</td>
</tr>
<tr>
<td>Accommodation and Food</td>
<td>14,362</td>
<td>4.9%</td>
</tr>
<tr>
<td>Import / export trade and wholesale</td>
<td>10,135</td>
<td>1.8%</td>
</tr>
<tr>
<td>Financing and insurance</td>
<td>5,840</td>
<td>2.7%</td>
</tr>
<tr>
<td>Professional and business services</td>
<td>8,778</td>
<td>2.5%</td>
</tr>
</tbody>
</table>


The vacancy rate is defined as ‘the ratio (in the form of percentage) of the number of vacancies to the number of ‘job opportunities’ (i.e. the sum of the number of persons engaged and the number of vacancies)’. The high vacancy rate indicates that businesses in retail and accommodation and food industries have difficulty hiring suitable people. In view of this, whether it is easy for the businesses to further expand their scale of production is much doubted.

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4.3. Policy Analysis and Evaluation

Policy under consideration: A further expansion of IVS in terms of cities covered and/or enlarging the scope of multiple-entry Individual Visit endorsement (M permit)

4.3.1. Aggregate Demand

- Note that further expanding IVS may not bring as outstanding economic benefits as it did in the past. First, the expected growth rate of income of mainlanders, which was 12% in 2012, is anticipated to lower in 2013, which may very likely mean a lower growth rate for mainland visitor arrivals in Hong Kong. At the same time, the price of goods and the standard of living in Hong Kong have continued to rise. The worsening economic conditions may undermine tourists’ intention to come to Hong Kong, and it implies that the expansion of IVS may not bring a larger number of tourists.

- Individual Visit Scheme currently covers 49 mainland cities. If the Individual Visit Scheme continues to expand in terms of coverage, it would only bring more people from the West or some second and even third tier cities. It is not likely that these visitors will consume a lot given the relatively backward economic development of these areas. In fact, if we look at the development of IVS, we can see that between 2005 and 2006, IVS was extended 3 times to cover 12 more cities (Chengdu, Kunming, etc.) in the mainland. However, the number of employed persons has just increased by 7300 (increases from 137,400 in 2005 to 144,700 in 2006). The percentage share of the employment for tourism in the total employment only increased 0.1% from 4.1% in 2005 to 4.2% in 2006. This reveals that expanding the city coverage of IVS can hardly create a large impact on aggregate demand or significant stimulations to the Hong Kong economy.
The data from HKTB shows that the largest source of IVS visitors was Shenzhen (48.8% in Jan — Jun 2013), in which the multiple-entry Individual Visit endorsement (M permit) has been introduced. If the M- permit is imposed on Guangdong Province, the second largest source which accounted for 30.8% of IVS visitors in the first half year of 2013, it is expected to have a positive impact on the aggregate demand of Hong Kong.

4.3.2. Aggregate Supply

In case further expanding IVS can stimulate visitor arrivals and demand, the economic impact will be dependent on the ability of the Hong Kong to produce.

Figure 4-4 Illustration of the AD-AS Model
If Hong Kong is reaching the top of the production capacity, even if IVS can further stimulate the aggregate demand, only inflationary pressure without significant increase in real production will be resulted. The Assessment Report (2013) suggested that, given the plans to expand the current capacities in infrastructure, Hong Kong would generally be able to receive the visitor arrivals in 2017, except that accommodation services will be in tight supply. Yet, it is worth mentioning that the report does not consider the labour constraints that we have discussed in the previous section. If the retail and accommodation and food sectors continue to face a high vacancy rate, businesses would find it difficult to cater to the increased demand as a result of IVS expansion. Furthermore, the Assessment Report (2013) only stated that MTRCL arranged additional train trips to relieve the pressure at the interchange stations, but it did not mention and analyze the situation in the busiest hours. The pressure facing the public transportation system will be tremendous in case the visitor arrivals increase significantly.

In addition, the high rental rate of private premises implies that the current capacity utilization is high, probably reaching the full capacity. It raises an idea that the current situation of the Hong Kong economy is likely to be described as the intersection of SRAS and AD2 or even AD3. Moreover, since firms are dealing with increasing production costs (e.g., higher rental cost), we expect that the short run aggregate supply curve will be shifting to the left, as illustrated by the figure, Figure 4-5 below:
Thus, it is likely that a further expansion of IVS can hardly bring an increase in the real output and there might be serious inflationary pressure on prices.
5. **Discussion Questions**

**Question 1**

Using the model of aggregate demand and aggregate supply, analyze the impacts of Individual Visit Scheme on the economy in the early 2000s. Do you think the impacts will be the same if the policy is implemented in 2013? Explain with diagrams.

**Question 2**

The HKSAR government is undergoing a study on the possibility of developing shopping malls and hotels in Lok Ma Chau and Lantau Island\(^{15}\) to divert visitors from the currently overcrowded tourism areas. Identify the positive and negative externalities involved in the projects.

**Suggested Solution**

**Question 1**

In early 2000s, Hong Kong’s economy was relatively weak, as shown in Figure 2-1 and Figure 2-2. The growth rates of gross domestic product at constant prices were as low as 0.56% and 1.66% in 2001 and 2002 respectively. The unemployment rates of those two years were 5.10%, 7.31% and even rose to 7.92% in 2001, 2002 and 2003 respectively. These figures show that the economy of Hong Kong was stagnant back then. Introducing the Individual Visit Scheme and allowing mainland visitors to come to Hong Kong at their own capacity can of no

\(^{15}\) Legislative Council of Hong Kong, Press Release, retrieved on 27 Jan 2014  
http://www.info.gov.hk/gia/general/201401/08/P201401080613.htm
doubt stimulate the exports of services. Income earned by residents will then be re-spent on different sectors (the multiplier effect) and the aggregate demand will be encouraged. The following figure, Figure 5-1, illustrates the situation:

Figure 5-1 The Impacts of IVS in Early 2000s

IVS pushes up the aggregate demand (from AD1 to AD2), and the equilibrium moves from e1 to e2. Output level increases from Y to Y', and the price level rises from P to P'. Notice that the economy was in the lower part of the short run aggregate supply (SRAS) since Hong Kong was undergoing a recession. The impact of price level in relation to the increase in aggregate demand was relatively little.
However, in 2013, the economic condition was different from that of the early 2000s. The economy was relatively stronger in 2013, implying that it was operating close to the capacity. Compared to the previous diagram we can see that the increase in real output is limited while the impact on the overall price level becomes more significant.

![Figure 5-2 The Impact of IVS in 2013](image-url)
Question 2

Developing shopping malls and hotels in the relatively remote areas like Lok Ma Chau and Lantau Island brings external effects of various kinds to the local communities. Positive externalities (external benefits) may include more job opportunities in the region, stronger demand for food, beverage, and other services, and the increase in the values of nearby properties. Negative externalities (external costs) may include congestion problem, heavier traffic, and more crimes.
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