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The 2016-2017 Budget

March 2016

The 2016-2017 Budget continues the trend seen in the previous budgets with the reliance of government revenue on profits and salaries taxes, land premium, and stamp duties. Revenue from these sources varies with the state of the economy. Apart from the "China factor", economic development is also important in determining the contributions of various major revenue sources to the Government's coffers.

Looking ahead, the deepening economic integration between Hong Kong and the Mainland and the Mainland's "One Belt One Road" Initiative should reinforce the importance of the "China factor" to the Government's coffers.

As to the issue of economic development, the 2016-2017 Budget focuses on fostering new growth areas and exploring new markets for the pillar industries while setting out targeted relief measures for the tourism industry. The Budget also features various policy initiatives to diversify the economy and promote new engines of growth. In this regard, the innovation and technology ("I&T") industry receives the most financial commitment from the Government.

Hong Kong is a late starter in the I&T industry and has a lot to catch up with other developed economies such as Singapore and South Korea. These two economies provide specific financial incentive schemes to promote the I&T industry. They also set out medium-term strategic plans to support the research and development activities over the next five years.

The Council will resume the Second Reading debate on the Appropriation Bill 2016 at its meeting of 13 April 2016.

1. Background

1.1 The Financial Secretary delivered his ninth budget speech on 24 February 2016. He announced a budget surplus of HK$30.5 billion for the Financial Year ("FY") 2015-2016, adding to the fiscal reserves which have more than doubled over the past decade. As at end-March 2016, the Government's fiscal reserves are estimated to reach HK$859.0 billion, representing 35.8% of GDP or equivalent to 24 months of government expenditure.

1.2 However, the Government's financial allocation for the healthcare reform and retirement protection from FY2016-2017 onwards will result in a budget deficit of HK$29.0 billion in FY2018-2019 and HK$22.5 billion in FY2019-2020. This will require the Government to tap into its fiscal reserves to finance the deficits.[1] The expected increase in government expenditure, coupled with the possible appearance of a structural fiscal deficit in the coming years[2], warrants the Government to sustain, or even grow, its revenue streams to maintain the fiscal health of Hong Kong.

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[1] The amount of fiscal reserves will dwindle to HK$832.7 billion at end-March 2020, representing 29.4% of GDP or equivalent to 18 months of government expenditure.

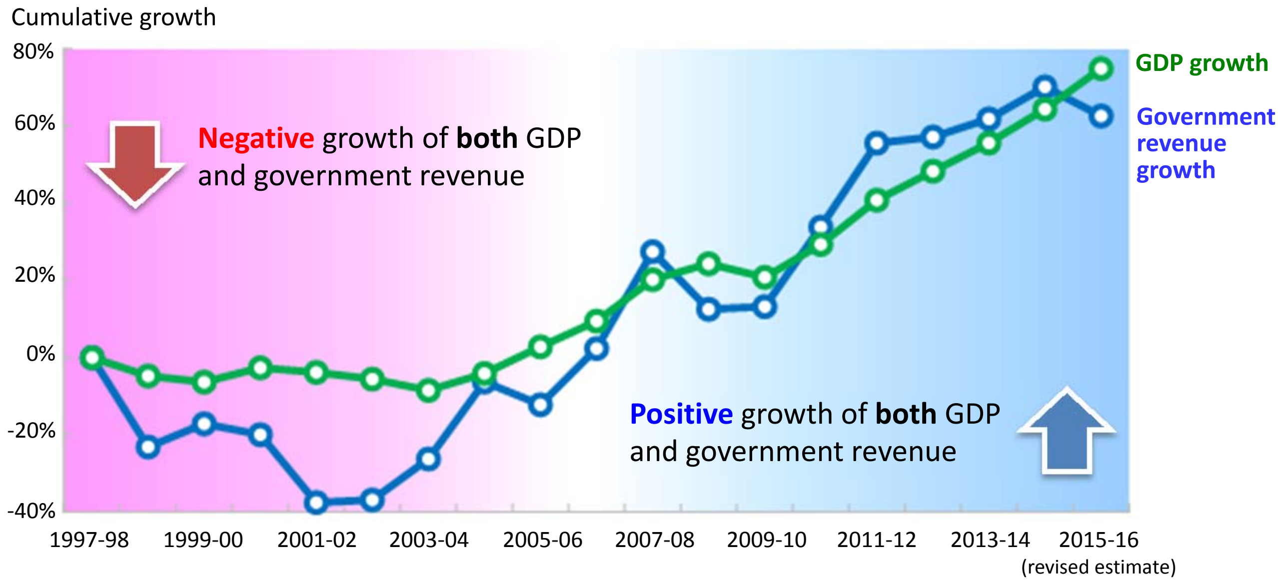
[2] According to the report released by the Working Group on Long-Term Fiscal Planning in March 2015, the ageing of Hong Kong's population will bring about a structural fiscal deficit within a decade under most of the scenarios tested by the Working Group.

1.3 Over the past decade, Hong Kong has seen a reliance on revenue from profits and salaries taxes, land premium and stamp duties. Revenue from these sources consistently accounted for about two thirds of government revenue. Such trend will continue in FY2016-2017 with 27.7% of government revenue sourced from profits tax, 13.4% from land premium, 12.2% from salaries tax, and 10.0% from stamp duties.

1.4 Inflows from profits and salaries taxes, land premium and stamp duties vary with the state of the economy.[3] Hong Kong has benefited from the ample business opportunities provided by the rapid development and liberalization of the Mainland economy, as well as from the preferential treatments received when entering the Mainland market. Furthermore, Hong Kong serves as a two-way platform helping Mainland companies to go abroad and facilitating overseas companies to access the Mainland market. Amid the resulting increased economic integration between Hong Kong and the Mainland, the latter has played an important part in determining the contributions of various major revenue items to the Government's coffers.

1.5 In addition to the "China factor", economic development is of equal importance as government revenue has grown broadly in line with GDP over the past years[4] (**Figure 1**). As such, economic development has always been a mainstay in every year's Budget. In his 2016-2017 Budget speech, the Financial Secretary has set aside government resources for the pillar industries as well as other industries including technology, start-ups, fashion and film.

Figure 1 – Cumulative growth of government revenue and GDP since 1997-1998



Data source: 2016-2017 Budget.

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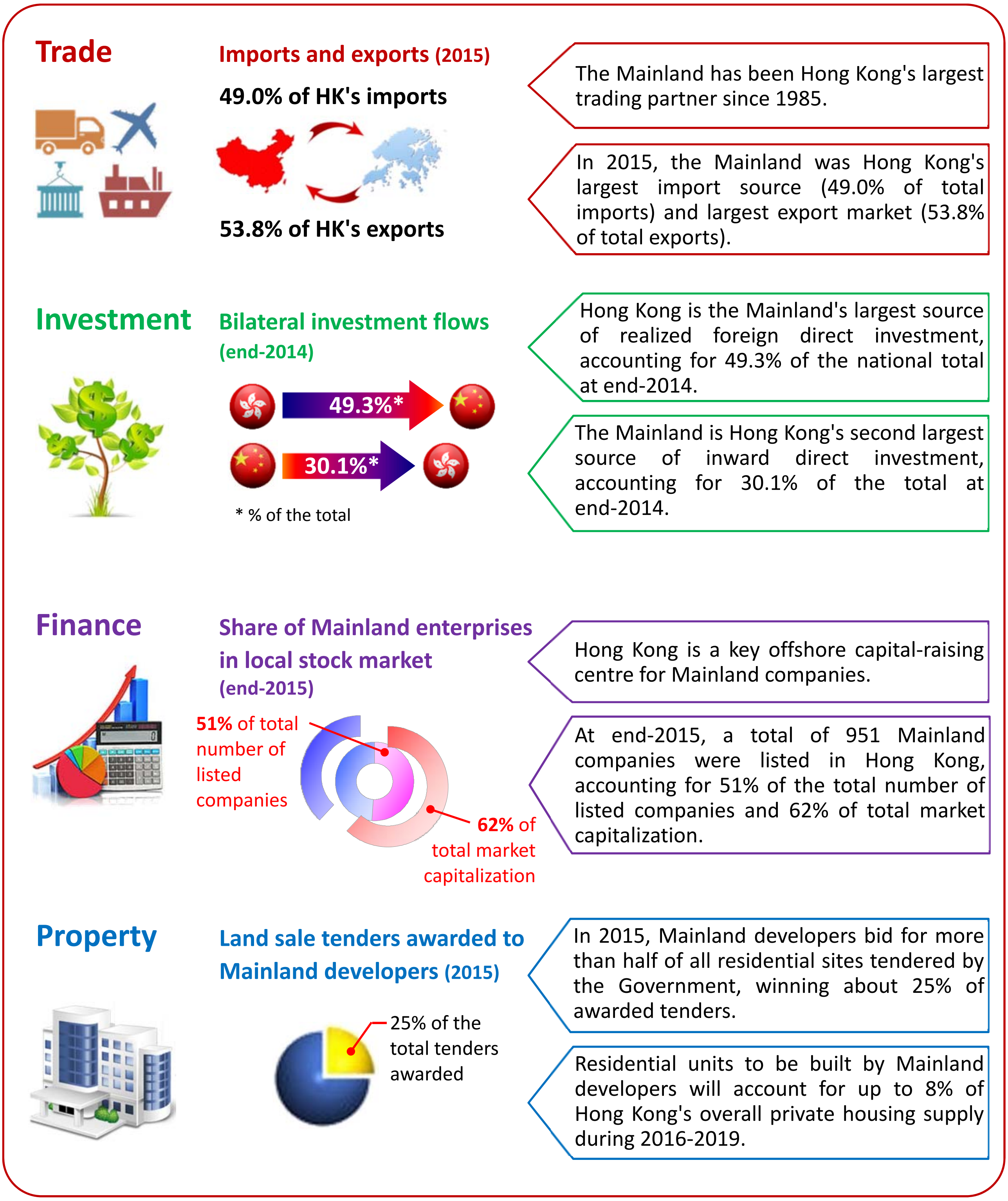
[3] See Scott (2010).

[4] See Hong Kong Special Administrative Region Government (2014).

2. Importance of "China factor"

2.1 As shown in **Figure 2**, Hong Kong has established close financial and trade linkages with the Mainland.

Figure 2 – Hong Kong-Mainland economic relations

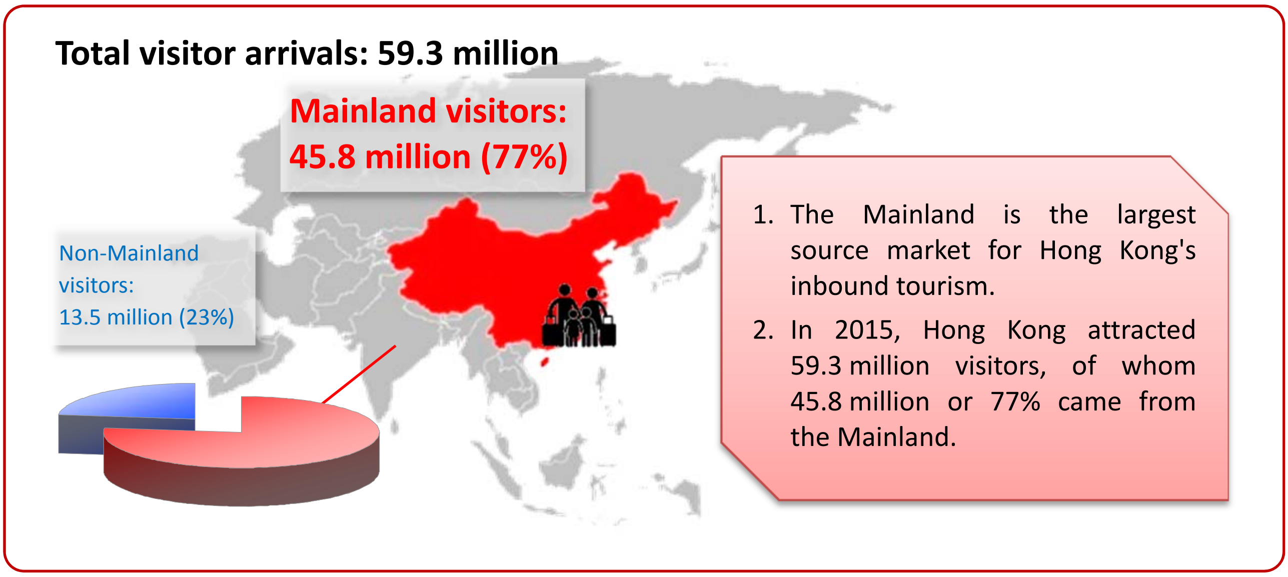


Data sources: Census and Statistics Department, Hong Kong Exchanges and Clearing Limited, Hong Kong Trade Development Council, and Jones Lang LaSalle.

2.2 Hong Kong has made use of its physical and financial infrastructures as well as favourable geographical location to establish close economic ties with the Mainland. Over the years, the Hong Kong-Mainland economic relations have been reinforced by several policy initiatives such as the Mainland and Hong Kong Closer Economic Partnership Arrangement ("CEPA"[5]), the Individual Visit Scheme ("IVS"), the Stock-Connect Pilot Programme[6] and the Mainland-Hong Kong Mutual Recognition of Funds[7].

2.3 Against its deepening economic integration with the Mainland, Hong Kong has seen increased number of Mainland visitors (**Figure 3**) and companies (**Figure 4**) coming to the territory in recent years. This has benefited the local economy and by extension, the Government's coffers. For example, the influx of IVS visitors has fuelled the growth of tourism-related industries and provided the employment opportunities in these industries. In addition, Mainland property developers have contributed to the profits tax and land premium collected by the Government. The trading of the residential units built by them also attracted stamp duties. Furthermore, the listing of Mainland companies in Hong Kong have enhanced the depth and breadth of the local stock market, resulting in more hectic trading and larger stamp duty revenue collected.

Figure 3 – Number of Mainland visitors (2015)



Data source: Hong Kong Tourism Board.

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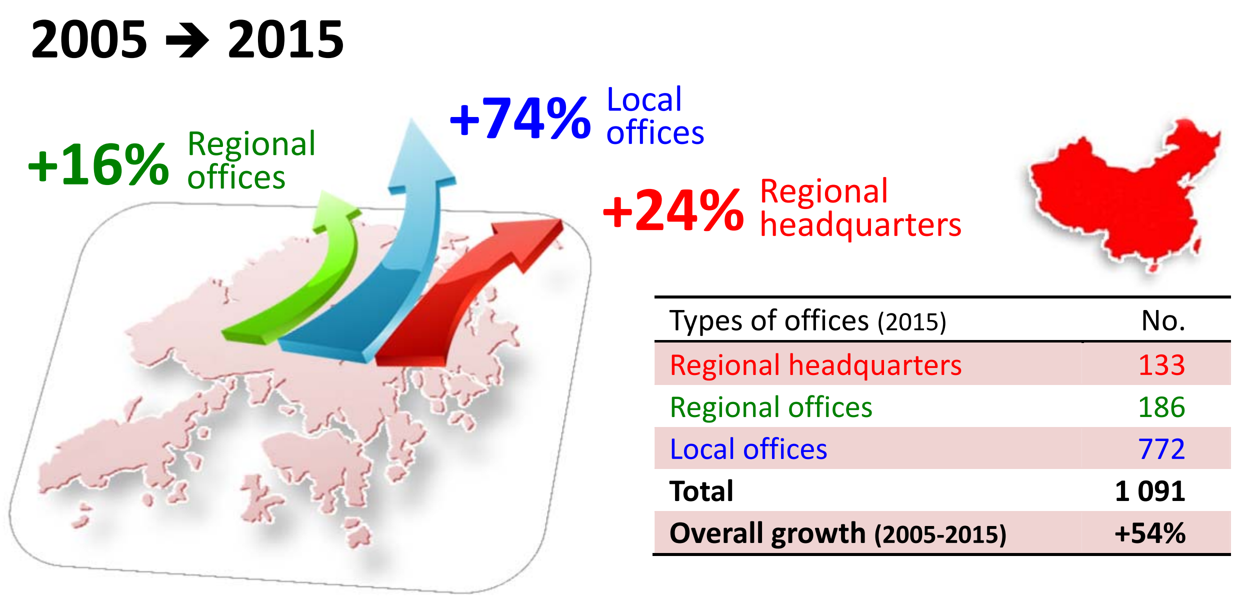
5 CEPA is a free trade agreement concluded by the Mainland and Hong Kong which makes way for liberalization of trade in goods, trade in services, as well as trade and investment facilitation. It offers Hong Kong products, companies and residents WTO-plus access to the Mainland market.

6 In November 2014, the Shanghai-Hong Kong Stock Connect was launched to establish mutual stock market access between Hong Kong and the Mainland.

7 The scheme was implemented in July 2015, allowing Mainland and Hong Kong funds that met the eligibility requirements to follow streamlined procedures to obtain authorization or approval for offering to retail investors in each other's market.

Figure 4 – Number of business operations in Hong Kong with parent companies in the Mainland, 2005-2015



Types of offices (2015)	No.
Regional headquarters	133
Regional offices	186
Local offices	772
Total	**1 091**
Overall growth (2005-2015)	**+54%**

Data source: Census and Statistics Department.

2.4 According to the Government, the Mainland will continue to feature prominently in Hong Kong's external direct investment, both as a source and as a destination.[8] In addition, investment activities between Hong Kong and the Mainland should continue to grow in view of the expected deepening financial reforms in the Mainland. For example, the Mainland is likely to launch the Shenzhen-Hong Kong Stock Connect and expand the scope of investment for the Shanghai-Hong Kong Stock Connect later this year.[9] Furthermore, the International Monetary Fund decided in November 2015 to include the Renminbi ("RMB") in the basket of currencies that make up the Special Drawing Rights. This will add impetus to continued internationalization of RMB, thereby strengthening further development of offshore RMB business in Hong Kong.

2.5 Looking further ahead, finding new markets along the "Belt and Road" routes has been identified as a future growth driver in the 2016-2017 Budget, which should reinforce the importance of the "China factor" to the Government's coffers. According to the Government, the "One Belt One Road" Initiative encompasses over 60 economies and Hong Kong is well positioned to serve these economies as a fund-raising and financial management platform, a trade and logistics hub, as well as an investment springboard.[10]

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8 See Hong Kong Special Administrative Region Government (2015).
9 See 香港電台網站 (2016).
10 See Hong Kong Special Administrative Region Government (2016).

3. Development of the pillar industries

3.1 Economic development has always been a mainstay in the previous budgets, and there is no exception this year. In the 2016-2017 Budget, the focus is on fostering new growth areas and exploring new markets for the pillar industries. For example, for the financial services industry, the Government will pursue the launch of the Shenzhen-Hong Kong Stock Connect and promote green finance, as well as establishing an office under the Hong Kong Monetary Authority to facilitate the financing of infrastructure projects under the "One Belt One Road" Initiative.

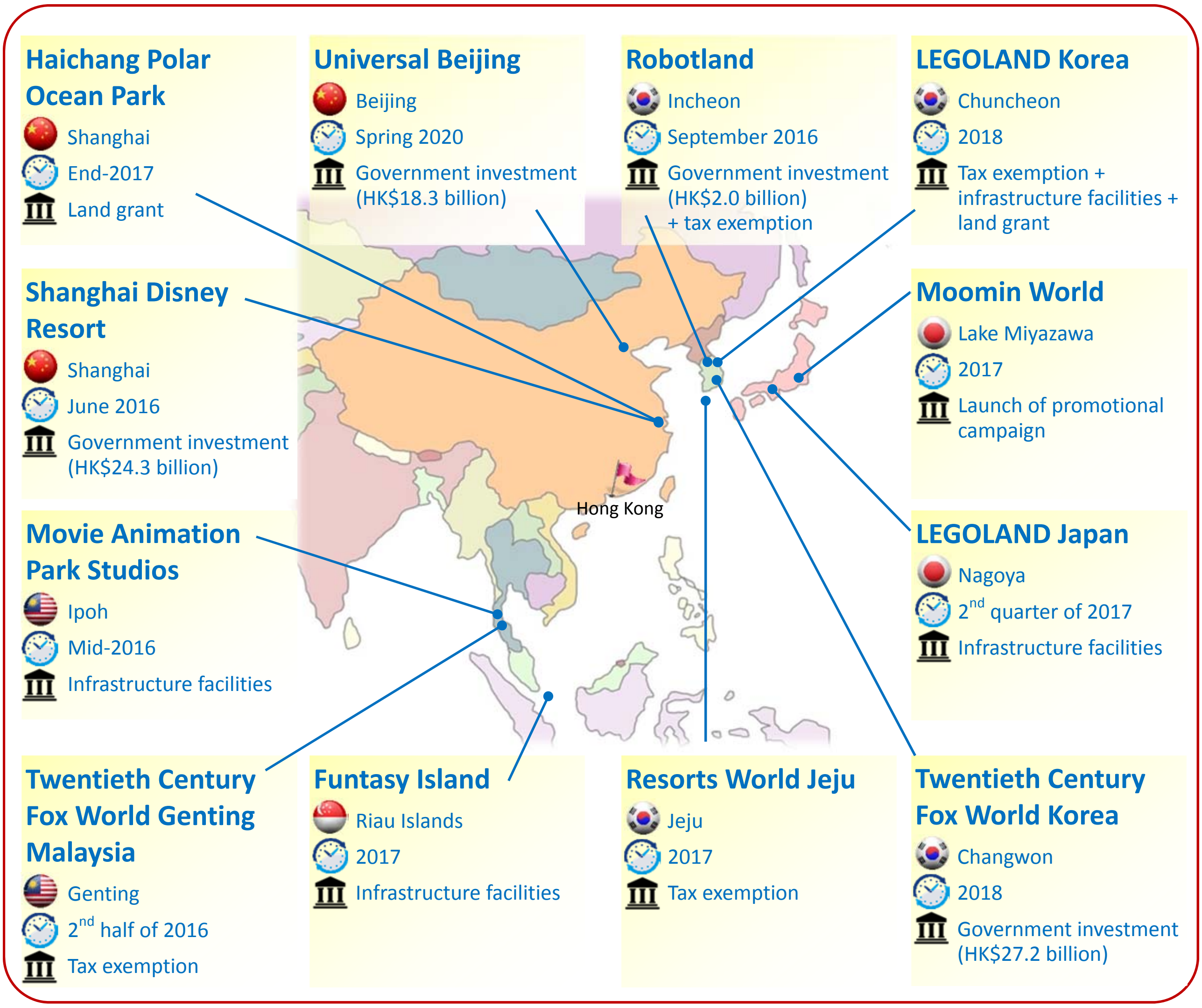
3.2 As to the spending initiatives for the pillar industries, the 2016-2017 Budget only sets out targeted relief measures for the tourism industry. Amid a marked slowdown in inbound tourism, the Financial Secretary sets aside HK$140 million for waiving the annual licence fees of hotels and guesthouses, travel agents, restaurants, hawkers and operators with restricted food permits for one year, as well as HK$240 million for promoting Hong Kong and attracting more tourists through various entertainment and sports events.

3.3 While the short-term relief measures should provide some support for the weakening tourism industry, the competitiveness of Hong Kong's tourist attractions remains an area of concern. Hong Kong has seen very few well-received new tourist spots coming on stream after the opening of the Hong Kong Disneyland in 2005. As unveiled in the 2016-2017 Budget, the Hong Kong Disneyland will open a new themed area based on Marvel's Iron Man franchise in 2016 and a new hotel with a theme dedicated to the spirit of exploration in 2017. In addition, the first hotel in Ocean Park and the Water World in Tai Shue Wan are also scheduled for completion in 2017 and 2018 respectively. Yet, the above projects only represent new developments at existing attractions designed to enhance the market appeal of the site.

3.4 On the other hand, there is a recent rush of theme park construction across Asia. New theme parks are scheduled to open from China, Japan and South Korea to Singapore and Malaysia over the coming years (**Figure 5**), targeting at Asia's rapidly growing middle class. Some of them will not only serve as a standalone attraction catering to family visitors, but also as part of an integrated resort to attract diversified types of visitors.[11] The expected increasing competition among various theme parks in Asia will add to the concern over the competitiveness of Hong Kong's tourist attractions.

[11] For example, the Twentieth Century Fox World Genting Malaysia will serve both family and MICE visitors. MICE visitors refer to those who travel for meetings, incentive travels, conventions and exhibition events. Meanwhile, South Korea's Resorts World Jeju will be an integrated resort with a theme park, hotels, a large adventure waterpark, gaming entertainment, cultural facilities, and leisure and entertainment amenities.

Figure 5 – Ongoing major theme park projects in Asia



Note: = expected opening date, = government support measure(s).

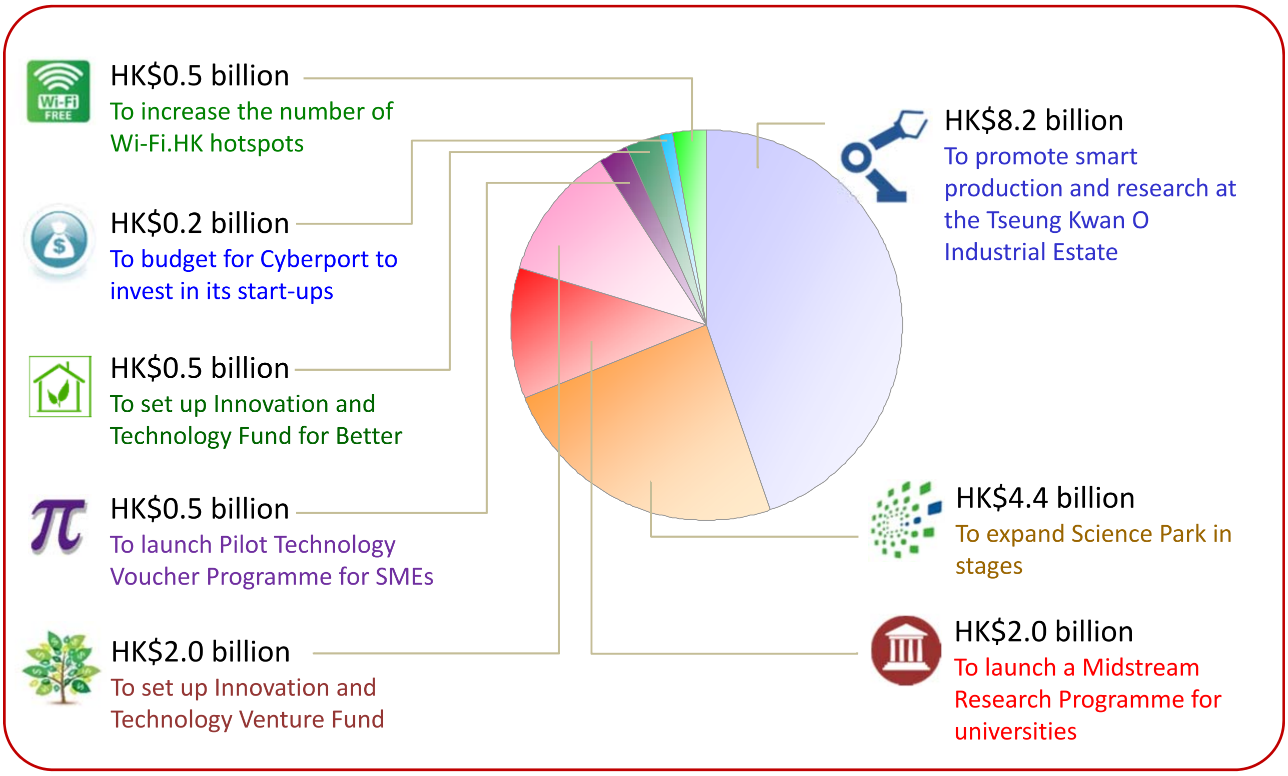
Data sources: Various sources including websites and press releases of relevant developers and entertainment companies.

4. Economic diversification

4.1 On the issue of economic development, another major theme identified in the 2016-2017 Budget is the emphasis on diversifying the economy and promoting new engines of growth. In this regard, the Financial Secretary has proposed various spending initiatives and/or programmes to (a) nurture innovation and technology ("I&T"), (b) support start-ups and small- and medium-sized enterprises ("SMEs"), (c) encourage the application of Fintech, (d) promote the development of creative industries, and (e) assist industries in finding new markets along the "Belt and Road" routes.

4.2 Among the various spending initiatives announced by the Financial Secretary, the I&T sector receives the most financial commitment from the Government which amounts to an estimated HK$18.3 billion (**Figure 6**).

Figure 6 – Financial commitment for the innovation and technology industry as announced in the 2016-2017 Budget



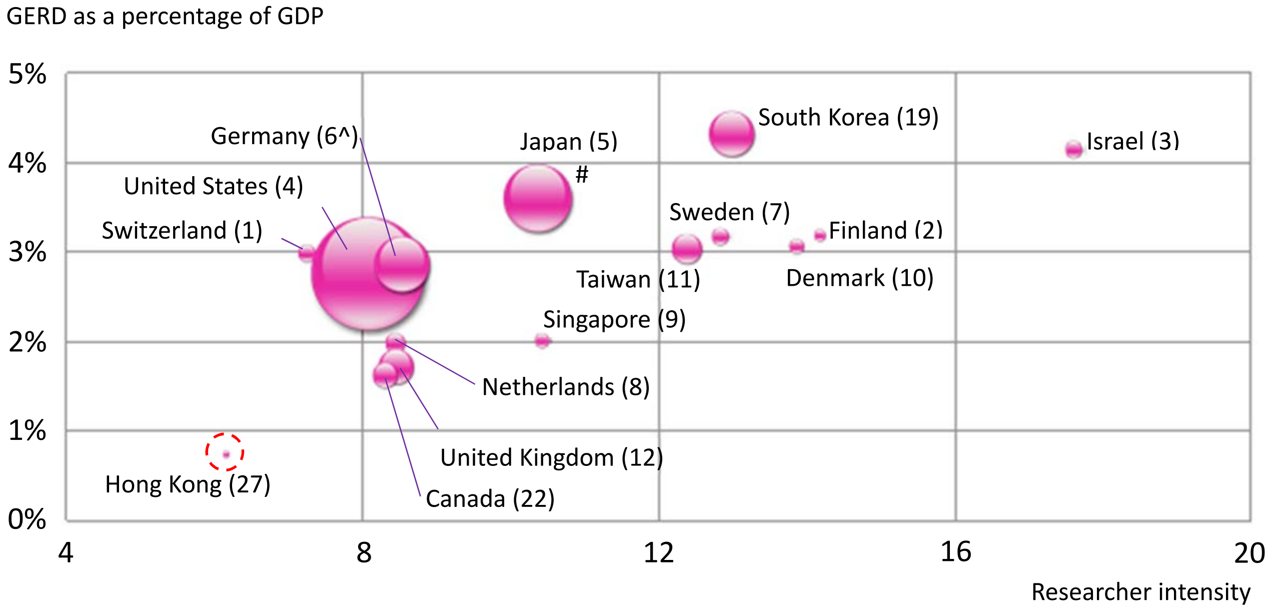
Data source: 2016-2017 Budget.

4.3 However, Hong Kong is a late starter in the I&T industry[12] and has a lot of ground to catch up with many other competing cities. Its gross expenditure on research and development ("GERD") as a percentage of GDP stood at a low of 0.74% in 2014 (**Figure 7**), lagging behind many other developed economies. Hong Kong also trails in researcher intensity[13], another indicator of strength of research and development ("R&D") activities. Its researcher intensity, at 6.15 in 2014, was among the lowest in developed economies.

12 See Central Policy Unit (2015).

13 Researcher intensity refers to the number of full-time equivalent number of researchers per 1 000 labour force.

Figure 7 – R&D investment and researcher intensity for selected economies (2014*)



Notes: (*) All are 2014 figures, except the figures for Switzerland (2012), Singapore (2013) and the United States (2013).
(^) The figure in the bracket represents the ranking in the Global Innovation Index published in the *Global Competitiveness Report 2015-2016*.
(#) Bubble size indicates the amount of GERD.

Data sources: Census and Statistics Department, Organisation for Economic Co-operation and Development and World Economic Forum.

4.4 In contrast, other Asian economies such as Singapore and South Korea have established firm footholds in the I&T industry.[14] Singapore started R&D efforts 25 years ago, and today it is in the top division of R&D-intensive countries.[15] For South Korea, its commitment to technological progress has made the country one of the fastest-growing Organisation for Economic Co-operation and Development ("OECD") economies over the past decade. It is also the world's most R&D-intensive country, with GERD at a high of 4.29% of GDP in 2014. Apart from the government's financial commitments, there are also other contributory factors as detailed below which propel Singapore and South Korea into the forefront of the technology hub in the region.

[14] Being another "Little Dragon", Taiwan has seen large technology companies losing ground in the global market in recent years due to its lack of new innovations to improve the quality and capabilities of their products. See Rosier (2016).

[15] See Organisation for Economic Co-operation and Development (2013).

Singapore

4.5 In Singapore, the government has invested heavily in state-of-the-art facilities and equipment and offered attractive salary packages to world-renowned scientists and engineers. This in turn drives up Singapore's researcher intensity to one of the highest levels in the world, which stood at 10.5 in 2013.[16]

4.6 The Singaporean government has also put in place specific tax incentives and grants for industries that are considered important or having high growth potential for the country. These include the Productivity and Innovation Credit to provide tax credits not only for actual innovations but also for other innovation-related activities such as training and the acquisition of intellectual property rights.[17] There is also the Capability Development Grant – Technology Innovation to support companies undertaking projects to develop innovative technology products or solutions.[18]

4.7 More importantly, Singapore has set out the Research, Innovation and Enterprise Plan ("RIE Plan") as a roadmap for supporting R&D efforts over the next five years. The first five-year technology plan was launched in 1991. This, together with the subsequent technology plans, has helped Singapore build a comprehensive R&D ecosystem comprising public sector research bodies, academic research institutes and corporate R&D laboratories. Reflecting this, private sector sales revenue from commercialized products/processes attributed to R&D performed in Singapore more than doubled from S$10.4 billion (HK$46.5 billion) in 2003 to S$22.3 billion (HK$138.3 billion) in 2013.

4.8 The latest RIE Plan 2020, unveiled in January 2016, will commit S$19 billion (HK$107 billion) to Singapore's R&D over 2016 to 2020.[19] This compares with a mere S$2 billion (HK$9.0 billion) budgeted for the first five-year technology plan in 1991. According to the Singaporean government,[20] the RIE Plan 2020 will contribute significantly to the economy, create opportunities and jobs, support Smart Nation[21], and help workers to thrive amid technological changes and globalization. Commercialization of technology is also another key focus of the RIE Plan 2020, aiming to help create value from existing R&D investments in both the economy and quality of life.

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16 The 2013 figure is the latest available figure from OECD.

17 Under the Scheme, eligible businesses can enjoy 400% tax deductions/allowances and/or 60% cash payout for investments made by them.

18 The Grant defrays up to 70% of qualifying project cost such as consultancy, training, certification and equipment costs.

19 The funding will focus on four core technological domains in which Singapore has a competitive advantage or meet national needs. These are (a) advanced manufacturing and engineering, (b) health and biomedical sciences, (c) services and digital economy, and (d) urban solutions and sustainability.

20 See Prime Minister's Office (2016).

21 Smart Nation is Singapore's national vision of using latest technology to benefit the country in terms of making life better for the people and improving business environments. It takes its name and inspiration from the concept of a smart city taken to a countrywide scale.

South Korea

4.9 In South Korea, innovation relies not only on investment in R&D but also on education and knowledge-based capital. As such, the country has invested beyond R&D in assets such as firm-specific skills. According to OECD, workers in South Korea benefit from on-the-job training to a similar extent as in some Scandinavian countries.[22]

4.10 In addition, the South Korean government provides direct R&D support such as subsidies for employing R&D personnel and grants for conducting creative basic research. It also incentivizes firms' R&D through tax relief measures. As a result, South Korea's total government support to firms' R&D was the highest of all OECD countries in 2013, at 6,147 billion won (HK$43.6 billion) or 0.43% of GDP.

4.11 In June 2013, South Korea announced the Third Basic Plan for Science and Technology to set out the government's strategy to support R&D activities between 2013 and 2017. The US$79 billion (HK$612 billion) plan focuses on the following five areas: (a) expanding government investment in R&D, (b) developing national strategic technologies, (c) nurturing creative talents by providing more funding for basic research, (d) strengthening technological assistance for SMEs, and (e) creating more I&T jobs. The Third Plan aims to (a) increase the contribution of R&D to economic growth from 35% to 40%, (b) position South Korea among the world's top seven in capacity for innovation in science and technology, and (c) create 640 000 jobs in science and engineering.

4.12 The I&T development in Hong Kong, Singapore and South Korea is recapitulated in **Figure 8** below.

22 See Organisation for Economic Co-operation and Development (2015).

Figure 8 – Innovation and technology development in Hong Kong, Singapore and South Korea

GERD as a percentage of GDP

- Hong Kong: 0.74% (2014)
- Singapore: 2.0% (2013)
- South Korea: 4.29% (2014)

Researcher intensity

- Hong Kong: 6.15 (2014)
- Singapore: 10.46 (2013)
- South Korea: 13.02 (2014)

Financial commitments for I&T activities

Hong Kong: The 2016-2017 Budget:
- HK$18.3 billion

Singapore: The RIE Plan 2020:
- HK$107 billion during 2016-2020

South Korea: The Third Basic Plan for Science and Technology:
- HK$612 billion during 2013-2017

Expected benefits to the economy

- Hong Kong: To diversify the economy and promote new engines of growth as stated in the 2016-2017 Budget.
- Singapore: Objectives of the RIE Plan 2020 are to boost the Singapore economy, create opportunities and jobs, support Smart Nation, help workers to thrive amid technological changes and globalization, and promote commercialization of technology.
- South Korea: Key targets set for the Third Basic Plan for Science and Technology:
  (a) increasing R&D's contribution to economic growth from 35% to 40%;
  (b) positioning South Korea among the world's top seven in capacity for innovation in science and technology; and
  (c) creating 640 000 jobs in science and engineering.

Data sources: 2016-2017 Budget, Census and Statistics Department, National Research Foundation, National Science and Technology Council, and Organisation for Economic Co-operation and Development.

5. Observations

5.1 The following observations are made based on the findings above:

(a) the 2016-2017 Budget continues the trend seen in the previous budgets with the reliance of government revenue on profits and salaries taxes, land premium and stamp duties. Revenue from these sources varies with the state of the economy. Over the years, increased economic integration between Hong Kong and the Mainland has rendered the "China factor" as a major determinant of the contributions of various major revenue items to the Government's coffers;

(b) looking ahead, the deepening Hong Kong-Mainland economic relations and the Mainland's "One Belt One Road" Initiative should reinforce the importance of the "China factor" to the Government's coffers. Indeed, finding new markets along the "Belt and Road" routes has been identified as a future growth driver in the 2016-2017 Budget;

(c) with government revenue growing broadly in line with GDP since FY1997-1998, economic development is another factor affecting the contributions of various major revenue items to the Government's coffers. In the 2016-2017 Budget, the focus is on fostering new growth areas and exploring new markets for the pillar industries;

(d) on the spending initiatives for the pillar industries, the 2016-2017 Budget only sets out targeted relief measures for the tourism industry. While the weakening tourism industry should benefit from the short-term relief measures, the competitiveness of Hong Kong's tourist attractions remains an area of concern. Hong Kong has seen very few well-received new tourist spots coming on stream after the opening of the Hong Kong Disneyland in 2005. Yet, there is a rush of theme park construction across Asia. New theme parks are scheduled to open from China, Japan and South Korea to Singapore and Malaysia over the coming years. This will add to the concern over the competitiveness of Hong Kong's tourist attractions;

(e) on the issue of economic development, another major theme identified in the 2016-2017 Budget is the emphasis on diversifying the economy and promoting new engines of growth. Among the various spending initiatives announced by the Financial Secretary, the I&T sector receives the most financial commitment from the Government. In this regard, Hong Kong is a late starter and compares less favourably with R&D-intensive economies such as Singapore and South Korea in terms of both GERD/GDP ratio and researcher intensity;

(f) Singapore provides specific tax incentives and grants to promote its I&T industry, whereas South Korea features substantial government support (including tax incentives and grants) to foster firms' R&D activities. Yet, Hong Kong offers limited financial incentives for the I&T industry[23]. Singapore and South Korea also contrast with Hong Kong in setting out a medium-term strategic plan as a roadmap for supporting the R&D activities over the next five years; and

(g) in Singapore, private sector sales revenue from commercialized products/processes attributed to R&D performed in the country has more than doubled during 2003-2013. While strong in basic research capacity, Hong Kong has a lot of catching up to do when it comes to the commercialization of local R&D results.[24] This might be due to the under-investment in applied research[25] as reflected in Hong Kong's relatively low GERD/GDP ratio.

Research Office
Information Services Division
Legislative Council Secretariat
30 March 2016
Tel: 2871 2110

[23] See Ernst & Young (2014a).

[24] See Commission on Strategic Development (2015).

[25] According to Our Hong Kong Foundation (2016), "the ratio in the US between basic and applied research is close to 1:1 in the last decade.... According to the 2014 Budget Speech…. government annual investments on the Innovation and Technology Fund (ITF), which has a strong focus on business-related, downstream 'applied' research, is around HK$533 million. Compared to the annual RGC [Research Grants Council] budget of around HK$1.1 billion, which has a stronger focus on upstream, primarily basic research, investing on applied (including midstream and downstream) research has even more catching up to do."

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