In Service of Growth

Legal Regimes, FDI and Taiwan's Economic Development

Research > China

Can laws and policies surrounding Foreign Direct Investment (FDI) sustain economic growth? Through an examination of the evolution and operation of Taiwan's FDI legal regime, I would like to suggest that the essence of Taiwan's success lies in its specific combination of liberalization and regulation. Well-considered policies can act as 'doorkeepers' to economic development and if the government maintains a legal regime consistent with public interest-oriented economic policy, it can promote Taiwan's development without risking its economic sovereignty.

By HO Ming-Yu

Taiwan in the 1960s turned to FDI to replace hitherto substantial aid from the United States. The government sought to combine FDI with the availability of cheap labour to achieve industrialization; import substitution, the promotion of exports and investment in labour-intensive industries became the objectives of Taiwan's economic policy. (Kuo, Ranis, and Fei 1981:73-74). In order to attract FDI to targeted industries, regulations were enacted to provide privileges and benefits – cheap credit and rebates on imported components and raw materials – to government approved initiatives. The strategy produced impressive results: instances of FDI to Taiwan shot up, pushing its value from USD 15 million in 1960 to USD 139 million in 1970.

In the 1970s the government adopted the Secondary Import and Export Substitution Policy. Retaining the economy's export orientation, it targeted for future growth capital, skilled labour, and technology-intensive manufacturing industries (Ranis and Schive 1985:93). The approach called for sloughing off industries that were deemed internationally uncompetitive, such as low-end textiles, electronics, and footwear, while increasing local and foreign investment in strategic industries, e.g. microelectronics and capital equipment (Gold 1988: 186-197). Results of the new policy included the construction of a high-technology industrial park and a new tier of import-substitution industries.

To promote FDI, the government simplified investment procedures. Through the 1970s the Statute for Encouragement of Investment (SEI) was revised nine times. Both the Statute for Investment by Foreign Nationals (SIFN) and Statute for Investment by Overseas Chinese (SIOC) were revised in 1979. Between 1970 and 1980 FDI increased by 700 per cent while FDI-funded enterprises accounted for 22 per cent of exports.

Taiwan's economic structure became problematic in the early 1980s. On the one hand, Taiwan faced competition from developing countries as rising domestic labour costs made exports less competitive on overseas markets. On the other hand, Taiwan still lacked sufficient capital and technology to develop capital and technology-intensive industries. From 1981, when oil prices stabilized and then declined, Taiwan's trade surpluses became increasingly and persistently large. This put upward pressure on the exchange rate and adversely affected domestic money supply while protectionist sentiment abroad forced Taiwan to open its markets (Lau, 1990: 184).

Faced with these dilemmas, the government redrafted its development strategy. Its 1984 policy of liberalization, internationalization, and institutionalization aimed to upgrade industry, adjust the country's economic structure, and build Taiwan into a science-and-technology island as well as a Asia-Pacific Regional Operations Centre (Yü 1995:257; Chiang 1995:170). Incentives to attract investment in high technology industries were introduced alongside the establishment of more science parks. As the latter hosted both domestic and foreign companies, this initiative was geared not only to attract FDI, but also to broaden the industrial base and upgrade domestic skills. Legal reforms of FDI regulations in the 1980s reflected government policy of fostering as many capital and technology-intensive investment projects as possible. The SEI enacted in 1960 was amended in 1984 and 1987. The 1980s also witnessed five revisions of the SIFN and four revisions of the SIOC.

Negative listing

In May 1988 the government announced its 'Negative Listing Policy' for FDI applications. Under the previous 'Positive Listing' industries open to foreign shareholding were exceptions to the rule. Over time the government broadened the range of permissible industries: with the 'Negative List' of 1989, all industries except those listed were deemed open to FDI. Total FDI inflows reached their peak of USD 2.418 billion in 1989, almost six times the figure for 1980.

Liberalization of FDI policy meanwhile continued apace. The Negative List was revised in 1990 and 1996, considerably reducing the number of industries restricted to investment by foreign nationals and overseas Chinese. In 1991, the Statute for Encouragement of Investment (SEI), which had targeted specific industries, was replaced by the Statute for Upgrading Industries (SUI), designed to encourage domestic and foreign investment across industries. Similarly, the statutes for investment by foreign nationals and overseas Chinese, SIFN and SIOC, were revised in 1997 to remove obstacles to and improve conditions for investors. Total FDI in the 1990s nearly tripled the figures for the previous decade.

The growth of high-tech industries is now the focus of economic development policy in Taiwan. As manufacture-oriented industries gradually transform into innovation-oriented ones, it is hoped that Taiwan's acquired advantage in high-tech manufacturing, along with its strategic geographical location, will continue to attract FDI into the 2000s. Taiwan's entry into the WTO in 2002 and opening of the domestic market have created further opportunities for FDI. The Negative List, reformed once more in 2003 to meet WTO rules, contains only 10 prohibited industries and 25 restricted industries for investment by foreign nationals and 8 and 22 such industries respectively for overseas Chinese. Most industries in the prohibited and restricted categories comply with the WTO's national treatment principles: giving others the same treatment as one's own nationals. Preferential tax measures – including credits for investment in R&D and five-year exemptions or shareholder investment credits for companies in important emerging industries – were extended until 2009.

Given Taiwan's strong position in high-tech, its entry into the WTO and pro-FDI legal reforms, one would have expected FDI flows to further increase. This was not to be: FDI to Taiwan dropped from USD 7.608 billion in 2000 to USD 3.272 billion in 2002. In part, this was due to the effect of global recession on investor confidence; the rise of China as an economic power also played a part.

Taiwan's future prospects are threatened by developing nations following closely on its heels. China – with its abundant labour force, market size, land costs and tax incentives – is catching up fast and attracting ample FDI. More recently, China has begun developing its high-technology industries, necessitating within Taiwan further upgrading and innovation. (Li 2002). Public and private inputs into R&D remain insufficient; Taiwan today does not exercise solid control over critical technologies. Having gone through labour-intensive, capital-intensive, and then technology-intensive phases, industry in Taiwan has to become knowledge-intensive. Failure to create higher added value will ensure loss of FDI to China and a slowdown of economic growth. The question of how to achieve these ambitious goals lies open to further research. <

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***Dr HO Ming-Yu** is Assistant Professor of Financial and Economic Law, Fu-Jen Catholic University, Taipei, Taiwan. She has a particular interest in the relationship between law and economic development.*
flaw0001@mails.fju.edu.tw

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The statistical data used, is based on *Taiwan Statistic Data Book*, Council for Economic Planning and Development (2002).