New Questions of Identity: How Taiwan Is Reimagining Itself

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Closer economic ties to China are reshaping the national debate in Taiwan and giving the opposition new issues to exploit.

Chen Tain-Jy
The key to reviving Taiwan’s economy lies in promoting its long-neglected services sector.

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Taiwan’s Middle-Income Trap: No Escaping Without Services
By Chen Tain-Jy

Taiwan’s economy, built on an export-oriented manufacturing sector, was once a powerhouse of Asia’s emerging economies. But over the past decade or so, growth in personal income has slowed considerably and the Taiwanese economic miracle has begun to fade. The key to reviving the economy lies in promoting Taiwan’s long neglected services sector, writes Tain-Jy Chen.

An examination of per capita income growth in Taiwan over the past several decades reveals troubling trends in its ability to adjust its economic growth model to accommodate changes in the global economy. Its per capita income reached US$8,339 (at current prices) in 1990, and by 2000 it had risen to $14,906, a benchmark for a middle-income country. Since then, the pace of economic growth has slowed. Despite its declining birth rate, Taiwan only managed by 2012 to bring its per capita income to $20,995. Over the period 1990-2000, then, income almost doubled (and the rate of growth was even higher in the pre-1990 period when Taiwan was among the ranks of the so-called “Asian Tigers” alongside South Korea, Singapore and Hong Kong). In the 12-year period since 2000, however, per capita income grew by only 41 percent, and today, Taiwan’s per capita income is the lowest among the four Asian Tigers. It would be harsh to regard Taiwan as falling into a middle-income trap, but it is obvious that Taiwan has encountered major bottlenecks in its economic growth path in the last decade and has been unable to overcome them. Perhaps we can view Taiwan as a victim of the high middle-income trap. Simply put, until now, Taiwan has not retooled its economic development model, which had been extremely successful before 2000. It continues to position itself as a low-cost manufacturer in the global production networks, although a large proportion of its manufacturing activities have already been relocated to China, not to mention that China too has just recently been quickly transformed itself into an innovative high-tech country with well-established global brands such as Samsung, LG and Hyundai. While Taiwan remains largely a contract manufacturer for global brands, Korean brands have come to dominate the world’s semiconductor and smart phone sectors, beating prestigious Japanese and American archivials.

In the last few years, Taiwanese manufacturers have begun to follow the Korean model in establishing global brands and have achieved some success. Brands in the ICT sector such as Acer, Asus and HTC have gained a foothold in the industry. They remain niche brands, however, and can hardly become flagship companies for Taiwan to drive the economic growth of the entire country in the same way that Samsung and LG have been doing for Korea. Taiwan’s economic vitality lies in its small and medium-sized enterprises, which do not fit the Korean model of chaebol-led growth. While branding is important to Taiwan’s manufacturing industry, if Taiwan wants to shed its role as a low-cost producer, it needs to pay more attention to its services industry, which has long been overlooked by policymakers.

In fact, in my opinion, it is the under-development of the services industry that explains the stagnancy of Taiwan’s economy since 2000. The services industry grew rapidly in the 1990s as it gained production resources from the manufacturing sector following the massive exodus of factories to other Asian countries. In terms of value-added, the services industry came to account for 67.5 percent of gross domestic product in 2000, surging from 57.0 percent in 1990. For that decade, Taiwan’s economic growth can be largely explained by resource reallocation across sectors, much like what happened in the 1960s when resources were transferred from the agricultural sector to the manufacturing sector. As low-productivity factory activities moved to overseas locations, production resources were redirected to the higher-productivity services sector. Resource reshuffling was accommodated by the opening-up of the services sector to multinational companies that brought new products and service models to Taiwan. However, by the end of the millennium, this process was roughly completed. Since then, there have been few productivity improvements in the services sector. The share of services output in GDP was 67.4 percent in 2012, almost unchanged from 2000. When two-thirds of economic activities are stagnant in terms of productivity, it is hard to expect rapid growth in personal income.

Three reasons account for the low productivity of Taiwan’s services sector: 1) a lack of investment; 2) a lack of innovation; and 3) a lack of exports.

1) Lack of investment in Services

Capital formation has been a major driver of Taiwan’s economic growth in the past, but investment has mostly occurred in the manufacturing sector. The amount of investment in the services sector has been relatively small. As opportunities to invest in the manufacturing sector became fewer, capital formation in Taiwan dwindled to a relatively low level and has never exceeded 23 percent of gross national product since 2001. Bricks and mortar are not so important for the services industry, but there are other types of capital goods that are essential to the improvement of services productivity. For example, ICT technology has been an important driver of productivity growth in the service sector in OECD countries since the 1990s. The introduction of ICT technology in the areas of distribution, retailing, logistics and professional services such as legal services, architecture, and accounting has significantly enhanced the labor productivity in these countries. Taiwan is a major manufacturer of the world’s ICT products, but it has fallen behind the advanced countries in employing ICT-related technologies. In the manufacturing sector, Taiwanese firms have sometimes been forced by their clients to introduce frontier ICT technologies just to remain compatible with the global production networks. In the services sector, such pressure does not exist because Taiwan’s services providers are essentially isolated local players, detached from the global networks.

In addition to sluggish private investment, government investment in the services sector is also lacking. Taiwan’s government has been active in
Taiwan is aware of the importance of innovation if the economy is to move away from a resource-based growth model. Tax laws have promoted spending on research and development since 1990. However, most research and development (R&D) expenditure has taken place in the manufacturing industry. In 2011, private sector spending on R&D was NT$300 billion (about US$10 billion) on R&D, of which NT$297 billion was in the manufacturing sector. In fact, before relevant tax laws were changed in 2011, only manufacturers were entitled to tax incentives for their R&D expenditures; services providers did not qualify. Government spending on R&D, the importance of which has been declining over time but still accounted for 27.3 percent of total R&D expenditure in 2011, was also concentrated on the manufacturing sector. Taiwan has one of the most successful public research institutions in the world, namely, the Industrial Technology Research Institute (ITRI). However, even today, only a very small fraction of ITRI’s budget is spent on service-related projects.

Because of the lack of local R&D spending, multinational firms that accounted for most of the innovation in Taiwan’s services sector. New service models in the retail sector, including mass merchandisers, convenience stores and chain stores, were introduced by multinational firms and later imitated by local firms. New technologies in construction, transportation and telecommunications were largely imported from foreign countries. Indigenous technologies in the services sector have been virtually non-existent. Even improvements in imported technologies have been rare.

Taiwan is an export-oriented economy. Although economic growth has slowed in recent years, exports remain vibrant. In 2012, Taiwan exported US$301.1 billion worth of goods to the rest of the world, amounting to 65 percent of its GDP. Despite the slowdown in economic growth, exports of goods have more than doubled in the last decade. In contrast, the volume of exports of services has been minuscule. In 2011, the most recent year for which data are available, Taiwan exported US$46 billion, worth of commercial services, equivalent to only 13 percent of its exports of goods the same year. In that year, Taiwan ranked 24th in the world in terms of services exports, compared to 18th in terms of goods.

A lack of exports of services has been accompanied by a corresponding lack of imports. Barriers to services imports remained high even after Taiwan joined the World Trade Organization in 2002. In fact, until the mid-1980s, foreign services providers were given very limited access to Taiwan’s domestic markets. The doors started to open in the mid-1980s, beginning with retailing, logistics and financial services. While more commitments to market access were made upon Taiwan’s entry into the WTO, domestic regulations have continued to impede import competition. Foreign services providers have complained about a host of Taiwan-specific regulations that were incompatible with international norms.

In essence, the services industry in Taiwan is still ruled by the old concept of “import substitution.” Ironically, in the manufacturing sector, Taiwan was among the world’s first countries to refute the concept of import substitution in the 1960s and prove it wrong with several decades of superlative economic performance through export expansion. But Taiwan’s commitment to the export-driven growth model did not apply to services. Because of its inward-looking stance, Taiwan’s services industry remains locally oriented and its service providers remain small in scale. Without export markets, economies of scale cannot be realized.

This situation has only begun to change slowly in recent years. Some Taiwanese services providers have successfully penetrated the Chinese market and become global players. These include firms in the retailing, food and distribution businesses. Because they set an example of the possibility of services exports and demonstrated the merits of economies of scale through exporting, many other firms were inspired to follow suit. The Taiwanese government has also recently launched a program to promote services exports.

Service Exports are Key

Among the three “locks,” the lack of exports is the core problem in Taiwan’s services industry. Without exporting, Taiwan’s services providers cannot obtain the scale needed to support R&D and to justify their investment in ICT technologies. The comparative advantage of trade in services is not determined by the cost of production, but rather by the quality of service. Unlike in the case of trade in manufactured goods, the low-wage countries do not necessarily have an advantage in services trade. On the contrary, it is normally the high-wage countries that dominate world trade in services because they offer high-quality services. Those services can only be created by innovation and applications of new technologies, such as ICT technologies. So there is a “Catch-22” problem. Nevertheless, Taiwan has to begin somewhere to promote its services exports. Fortunately, the emerging markets in China and Southeast Asia provide a good opportunity. Consumers in these countries are hungry for high-quality services.

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Unfortunately, young workers, particularly college graduates, prefer services jobs to manufacturing jobs. The creation of well-paying jobs in the services sector is the only way to bring down the unemployment rate, which has been hovering between 4 percent and 5 percent in recent years, and to increase the average income at the same time.

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