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Challenges and Responses : An Analysis of Economic Development Among Some East Asian Newly Industrializing Countries (NICs) or Areas; The Effect of Their Using Tax Incentive Systems to Attract Foreign Investment with Lessons From Taiwan's Tax Incentive System as an Illustration

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For My Mother

Yeh-Herne Lin

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ABSTRACT

Challenges and Responses: An Analysis of Economic Development Among Some East Asian Newly Industrializing Countries (NICs) or Areas; The Effect of Their Using Tax Incentive Systems to Attract Foreign Investment with Lessons from Taiwan's Tax Incentive System as an Illustration

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Sustained economic development since World War II was the phenomenon of the "East Asian Miracle," although the glory was tainted by the impact of the 1997 Asian financial crisis. South Korea, Taiwan, Singapore, and Hong Kong were among the East Asian Newly Industrializing Countries (NICs) who shared the phenomena but each had unique circumstances with which to deal. China, on the other hand, stagnated before the 1978 opening to the world but has improved spectacularly economically since, and retains its momentum going into the new millennium. The motive and dynamics of the East Asian economic phenomena have been studied thoroughly, and China seems to share some common bonds with its East Asian predecessors. This thesis analyzes the post-WWII economic progress of Taiwan, Singapore, and Hong Kong, as they were overseas Chinese societies to which China has given special treatment to entice investment, and which China has emulated since 1978. Economic planning or industrial policy was one of the common bonds of these East Asian NICs in achieving their economic development. Using Taiwan's tax incentive system as an illustration, this thesis analyzes Taiwan's system with a focus on how such a system evolves over time. Timely and effective responses in the face of challenges surely are the key to economic progress. Taiwan has managed to achieve certain progress even with its imperfect policy-making system. At this post-1997 crisis period, a close study of the Taiwan

story may offer lessons for Taiwan, China, or any other developing countries in their ambition to achieve prosperity.

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Chapter 1 Introduction

1.1 Introduction

Once having been nicknamed the "four tigers"—South Korea, Taiwan and the city-states of Hong Kong and Singapore--so called because of their similarity in achieving sustained rapid economic development after World War II, were later named Newly Industrializing Countries (NICs) by the Organization for Economic Co-operation and Development. These East Asian NICs' economic development has been lackluster and in fact, they have been struggling to come out of the economic slowdown as the specter of the 1997 Asian financial crisis continues to loom larger. (Wade, 1998) Currently, China seems among the few countries in Asia boasting of economic growth. (Walden Country Reports)

With China's huge 1.2 billion people as a potential market to attract investment from all over the world, these East Asian NICs' success stories must naturally be the objects of emulation to facilitate China's transition from a closed communist society to a more or less market-oriented society. (Jia, 1987: 4) In fact, history is strewn with examples of China's learning from outsiders—earlier, learning from the old Soviet Union and some old Eastern Europe Bloc countries such as Yugoslavia before the opening and later, these market-oriented East Asian countries or areas. (Chin, 1959: 44, 66-7)

From 1950s to early 1990s, these East Asian NICs succeeded in creating economic progress by using industrial policies to shape their desired development. (Wang, 2001: 2-3) Their success was also attributed to their adopting measures such as administrative reforms and liberalized fiscal and financial regimes. These measures helped to make their environment more amenable to international standards and able to attract desired foreign investment. (Cable and Persaud, 1987: 1-17) Researchers also point out a number of similarities among these East Asia countries: all are densely populated, deficient in raw materials, and all have emphasized exports of manufactured goods. All are raised under the "Confucius" cultural influence. (Berger: 1986) They all are linked economically by extensive webs of trade and investment and all enjoyed huge trade surpluses with the U.S. (Noble, 1988: 1-2)

For a better learning curve, China has no reason to forgo learning from these East Asian countries, which made decades of sustained economic progress while China stagnated technologically and economically under Mao Tse-Tung's closed China policy and the cultural revolution. In fact, since it opened to the outside world in 1978, China has more or less emulated the economic measures—so-called East Asian model of economic development and industrial policy of these economic predecessors, including their tax incentive systems--and reaped bountiful rewards. For example, scholars have concluded that China's Special Economic Zones (SEZs) were based on China's close study and understanding of Taiwan's successful Export Processing Zones (EPZs). (Vogel, 1989: 127; Osborne, 1986) In only a quarter of a century, China has made inroads into all aspects of export markets and literally replaced its predecessors. China has become the world's third largest trading partner with the U.S. in the new millennium. (Walden Country Report: China)

1.2 The Objectives of the Thesis

This thesis is based on the assumption that the way toward prosperity is universal: those administrative reforms, export-oriented industrial policy and more liberal fiscal and financial measures instrumental to those East Asian NICs' success also may be helpful with other developing countries such as China. To achieve the intended goal of sustained economic prosperity, a continuing open and democratic society where the government lets go of control by sharing resources with private sectors seems to be necessary. (Friedman and Friedman, 1980: 57) Also, political stability plays an integral role in economic progress. This latter assumption is based on another observation that not all emerging countries succeed in achieving sustained economic progress. For example, except Singapore, the rest of the five original members of the Association of South East Asian Nations (ASEAN), namely, the Philippines, Malaysia, Indonesia and Thailand are viewed as "second generation" or near NICs—they started economic developing with the East Asian NICs almost at the same time, that is, after WWII, but these countries lagged behind; their political instability was perhaps one of the major hindrances. (Hughes and Dorrance, 1987: 65, note 1; Lindblad, 1999: 259-72) Also, for the more recent cases, Latin American countries did not achieve sustained economic progress after some initial economic progress. (Banuri, 1991: 14) Scholars have also attributed this comparative inferior performance to the degree of openness of economy. (Hughes and Singh, 1991: 60-97).

This thesis thus briefly reviews the economic development of Taiwan, Singapore and

Hong Kong with an emphasis on how they became what they have become today. They are chosen because they are among the aforementioned four East Asian NICs or areas and they are the "overseas Chinese societies" that China has formally given special investment treatment and from which China learned. (Lu, 1956: 63-8) For example, in 1985, China promulgated laws providing preferential treatment for investments made by overseas Chinese. See, 1985 Regulations on Preferences for Overseas Chinese Investment. By analyzing the East Asian NICs and China's economic development, this thesis argues that China does resemble these "overseas Chinese societies" in terms of its preparedness in gaining sustained economic progress—it is densely populated, it has emphasized exports of manufactured goods, and it is now linked economically by extensive webs of trade and investment (for example, the bilateral trade between Taiwan and China has increased sharply since the opening up) with these societies (with Hong Kong returned to China as Hong Kong Special Administrative Region, HKSAR, since 1997) and has enjoyed huge trade surpluses with the U.S, and with minor disruption, China is politically stable and China keeps opening up its door. (Hsing, 1998: 1-39)

This thesis then focuses on a close study of one fiscal system these countries all use—the tax incentive system. This thesis uses Taiwan's system as a sample representative of the East Asian NICs' systems to illustrate how the system evolves to facilitate the adopting country's economic progress—in essence, a history of challenges and responses. As foregoing, this thesis is based on the assumption that emulation of systems among all these successful NICs and China is inevitable and that China's learning was also supported by empirical data. In the context of timelines, tax incentive systems have almost finished their mission in these East Asian NICs, while China's system continues to evolve. The difference is in the stages of economic development and also in the kinds of industries each country intends to entice. For example, tax incentive systems are deemed to be more efficacious in export oriented manufacturing industries (Guisinger, 1983), which contribute greatly to China's current continued economic progress, but they are of lesser importance now in the East Asian NICs because their targeted industries have been upgraded to high-tech industries or because the East Asian NICs are aiming to become regional financial centers. This analysis will pinpoint that Taiwan's tax incentive system was tailored to its specific needs as the society evolved. Rather than being strictly centrally planned, Taiwan's system developed on an *ad hoc* basis. Although criticized as ill-coordinated and fragmented, Taiwan's decision making system actually functioned to face varying external and internal impacts as Taiwan evolved. (Noble, 1988: 41-2, 385) In the case of Taiwan, paradoxically, the ill-coordinated situation lessens or disadvantages the government's power to intervene too much. This leads to an observation that as a fiscal tool, flexibility maybe is the single important constant in the face of ever-changing tides and waves of impacts. With this, the thesis concludes that China, or other developing countries that aim to achieve sustained economic progress with similar attendant circumstances, should be flexible in the face of changes. This echoes a fundamental principle of tax policies in developing countries; that is, developing countries' tax policies should be practical and accommodate the particular circumstances of the country in question. (Bird, 1992; Li, 1988)

Chapter 2 Post WWII Economic Development

2.1 Overview of Economic Progress in Three East Asian NICs and China—From 1950s to 1990s

2.1.1 The Initial Stage—From 1950s to 1978: Stagnation versus Growth

Economic development was one of the most important motivations for China's opening to the western world. During the 1970s, China, on the one hand, started to remedy the negative impact, both socially and economically, of the "paranoid idealism" of the Cultural Revolution. On the other hand, when China's new political leaders rushed to raise China's economic and technological levels, their unpreparedness and ideological bias led to ineffective policies, such as purchasing expensive foreign equipment and machinery without concomitant ability to install and use it. These mistakes deepened China's economic impasse. Against this backdrop, the opening policy was conceived in 1978 and went into full force after Deng Xiaoping's 1984 announcement reiterating China's resolution to open up. (Jiang, 1998: 559-62; Jia, 1994: 4; Easson and Li, 1989: 2-5)

By contrast, ethnic Chinese societies outside China, notably three East Asian NICs, Hong Kong, Singapore and Taiwan, created sustained economic growth during the same period and were on their way to becoming rich. Benefiting from ordered British governance, including a rule of law society, efficient administrative systems and a laissez-faire economic tradition, Hong

Kong was adept at adjusting its role to cope with the changing global climate. Variable factors contributing to Hong Kong's economic success include: an efficient civil service, minimal government regulation, and independent judiciary, neutral enforcement of laws and regulations, and the entrepreneurial spirit of the Hong Kong populace. (Han, 1988: 333) Hong Kong was among the first in Asia to have established the anti-corruption agency, the Independent Commission Against Corruption (ICAC), in defiance of the deep-rooted governmental official corruption issues related to Chinese societies. Through ICAC, Hong Kong established its image of efficiency and no red-tape. (Chan, 1997: 101) Starting from the 1950s, Hong Kong discovered that export-oriented business was more suited for its society than import substituting industries, because of Hong Kong's limited domestic customer base, small size, and few natural resources.

Since its founding in 1965, the tiny city-state of Singapore, facing political and economic challenges from imposing neighbors such as Malaysia, Indonesia, and Thailand, strove to define its identity in the world. Thanks to an autocratic polity that enforced its policies with powers akin to those of a police state, Singapore moved fast to implement an export-oriented policy and attract multinational companies. Singapore successfully made its human and physical infrastructures more amenable to international standards by undergoing complete social and administrative reforms and, with foreign help, investing heavily in physical construction. Attracted by a conducive business climate and an extremely honest, efficient administrative system, foreign direct investment swarmed to take advantage of Singapore's low-cost labor. As a result, Singapore enjoyed a double-digit growth rate during the 1970s along with the formation of its regional manufacturing center. Singapore has developed into a major manufacturing center for textiles, clothing, pharmaceuticals, and computer components. It also has become a major center for shipbuilding and oil refining in Southeast Asia. Multinational corporations, which have established the manufacturing facilities and regional headquarters in Singapore, have helped create Singapore's rapid economic development. Singapore has achieved this mainly by giving preferential treatment including tax incentives and by making low-cost labor available, although the latter factor declined in the 1980s. (Bennett, 1993: 3-6)

By high fines and even prison terms, Singapore has raised its general civilian levels rapidly and became a reputed clean, civilized, and orderly society. These social reform measures could involve detailed civilian life such as following the traffic signs, no scattering garbage, courtesy, no spitting, and no public urinating. The administrative reforms also were strictly implemented to reach all aspects of a public servant's life: anticorruption measures and service efficiency improvement were relentlessly pursued by the government. In achieving these goals in a short period of time, the scope of government interests invoked and enjoyed by the Singapore government that infringed on individual privacy far exceeded western standards. For example, Bennett points out that despite being known for its advanced communications and information processing infrastructure, the Singaporean government exercises a remarkable degree of control over the dissemination of information, including not allowing individual Singaporeans to own satellite dishes because they could use the dishes to receive unauthorized broadcasts, and a closely monitored and controlled circulation of magazines and newspapers. (Bennett, 1993: 23-4) Also, influential politicians state that Singapore recognizes no first amendment right to freedom of the press and Singapore does not aim to approximate U.S. practice. (Kelly and London, 1989:

364) To this day, Singapore maintains its competitiveness by the appeal of its uncorrupt and extremely efficient administrative systems despite its generally viewed strict legal system. (Chan, 1997: 101; Norton, 1998: 226)

Taiwan, helped by the generous U.S. financial aid during the Korean War and the ensuing decade, shed the negative image of a defeated former Japanese colony by becoming an export phenomenon during the 1970s. Note that, however, some scholars attributed Taiwan's post-WWII economic success to the Japanese colonial legacy. (Barnett and Whyte, 1982: 1,065-89) At one time, Taiwan's economy languished along with shrinking diplomatic relationships with the world because of an inflexible political claim to mainland China, which culminated in withdrawal from the United Nations. In the early 1970s, the political setback, in addition to the oil crisis gravely impacted Taiwan's burgeoning economy. Taiwan's economic debacle was further aggravated by late-started infrastructural improvement as the Nationalist government did not plan to stay in Taiwan until into the 1970s. The first major infrastructure construction in Taiwan started with the Ten Construction project, which included building the first south-north highway, construction of seaports, dams, freeways, railways and airports in 1973, some 28 years after the Japanese's retrocession from Taiwan. This project aimed to repair the war-damaged Japanese infrastructures and the whole project finished in 1979. (Li, 1988: 49-51)

The economic planning in Taiwan was prompted by the prospect of an eventual cutoff in American support and the evident exhaustion of primary import substitution. (Noble, 1988: 36; Li, 1988: 25-6) Unlike its authoritarian political system, the economic planning bureaucracy was ill-coordinated and fragmented. (Noble, 1988: 385) The bureaucracy enjoyed freedom of creating policy because of the absence of party and legislative oversight since top leaders and the government policy-making technocrats were all Nationalist Party members. However, the administrative structure was "a profusion of independent cabinet-level agencies," whose complexity and fluidity counterbalanced the policy-making. (Noble, 1988: 41-2) Nonetheless, Taiwan's economy managed to take off when it nimbly used economic techniques such as export processing zones, tax incentive systems, and double-rate (interest and currency) controls to implement an export-oriented industrial policy as well as a partially liberalized fiscal and financial policy. Taiwan's post-war economic growth was generally characterized as occurring in three stages: in the 1960s, an expansion toward manufacturing exports; the import-substitution industrialization in the 1970s, and the industrial upgrading toward high-tech industries in the 1980s (Gereffi, 1990; 3-31).

In conclusion, at the time when China opened up in 1978, there was a great gap in terms of economic situations between the three East Asian NICs and China. The successful experiences of these East Asian NICs, however, attest that a Chinese (or Chinese majority) society can learn and benefit from the Western systems as opposed to being devoured by the Western machines. This deep-rooted xenophobia of Western things comes from historical experience—the economic relationship between China and Western countries was forced upon China by the Western powers, notably Britain, through the Opium War in the late nineteenth century. The resulting establishment of the treaty-port system and trading by the Western powers gave birth to economic and political imperialism in China. (Fairbank, 1978: 491-542) As far back as in the late Qing (Ch'ing) dynasty (1616-1911 A.D.), the concept "make foreign things serve China" started. This argument has since proved to be an indispensable part of the Chinese cultural heritage (Jia, 1994: 2-4). The whole political-economic struggle of China since the late Qing dynasty has been a history of whether a Chinese society can use the Western system or be used by it. This fear about the power of Western systems, and a sense of xenophobia about foreign participation in Chinese economic life that lingers in politics, has shown up in a form of conservatism and caution about using foreign capital, technology, and investment throughout modern Chinese history. These East Asian NICs' successes awoke for China a sense of empowering in terms of dealing with the Western systems. Thus, in the late 1970s, emulating the economic achievement of these overseas Chinese societies by adopting foreign economic measures, capital, technology, and investment was a logically acceptable compromise for an autarchic and xenophobic China. (Jia, 1994: 3-4) Also note that this new learning and assistance from East Asian NICs and later Western countries was viewed differently from China's prior experience of getting assistance from the Soviet Union and Eastern European countries. Before the opening-up, Western help was viewed as a taboo of getting help from "imperialist" and "capitalist" nations; whereas aid from the former Soviet Union and the former Eastern European Bloc were viewed as based on equality and mutual respect of sovereignty. (Chin, 1959: 44)

2.1.2 "Chapter Two"—From the 1980s on: Challenges and Responses

The three East Asian NICs continued to grow and transform from the 1980s on, only to see signs of slowdown in the end of the 1990s. China meanwhile has improved sharply its economic progress, some of which has been accomplished by replacing one by one many labor-intensive industries or export oriented manufacturing industries of the three East Asian NICs.

2.1.2 (a) From 1980s to 1990s: Growth and Transformation

Hong Kong became a light manufacturing center in the 1970s by utilizing its geographical and transportation advantages: Hong Kong is situated at the southern edge of Asia where waterways converge and it has a good deep-water port. Hong Kong further adopted a fully deregulated trade and financial regime during the 1980s and became the foremost financial center of Southeast Asia. By 1997 before the Chinese takeover, Hong Kong established itself as the eighth largest trading power in the world. Hong Kong was the fifth largest banking center for external financial transactions, the fifth largest foreign exchange market, and the seventh largest stock market. Hong Kong has the world's largest container port. (Financial Secretary's Office, Hong Kong: 1997)

In the 1980s, consolidating its status as a primary center for foreign equity investment, Singapore transformed its labor-intensive industries into high-tech and service sectors as the labor market matured and the low-wage work force grew to be well-educated, largely English-speaking professionals. (Fong, 1987: 84-100) Singapore also maintained its competitiveness with one of the largest and most efficient container port facilities in Southeast Asia as well as one of Asia's best infrastructures. (Walden Country Report: Singapore)

Going into the 1980s, heeding the tidings of the times, Taiwan revamped its tax incentive system to attract high-tech and service industries to replace traditional light manufacturing industries. Environmental concerns also played a role in pushing Taiwan to change from labor-intensive industries to current secondary high-tech based industries—such as original equipment manufacture ("OEM") for advanced countries and computer chip foundries. (Li: 1988; Wang: 2001)

2.1.2 (b) Into the New Century

The new millennium brings in a new chapter for each of these four societies. Hong Kong Special Administrative Region (HKSAR), the new Hong Kong, with ambivalent feelings, has returned to China on condition that China allow Hong Kong to retain its autonomy for the next 50 years. Hong Kong's doubt about its continuous prosperity manifested during and after the pre-takeover Sino-British negotiation was not without merit: In 1999, China overturned a Hong Kong high court's decision, putting into doubt China's keeping its promise of letting Hong Kong enjoy a 50 year autonomy; the lack of or postponement of infrastructural investment and long-term planning during a decade of the Sino-British negotiation and following started taking a toll on Hong Kong. Instead of continuing growing into a better global financial center or China's financial window to the world given its pre-turnover strength in both financial infrastructure and human resources, Hong Kong faces competing threats from cities such as Shenzhen and Shanghai. The former now grabbed Hong Kong's container business by competitive pricing. The latter possessed time-honored better strategic geographic and transportation location and thus, human resources, goods and wealth all gravitated toward this historically-proven city, not to mention China's policy emphasis on Shanghai. (Wu and Wong, 1997) The anxiety and insecurity about Hong Kong's future led to series of mass demonstrations recently.

After having benefited from an efficient autocratic polity and the British legacy of an ordered civil government system, Singapore's ambition to seize the chance of Hong Kong handover to be the regional financial center was disrupted by its hubris--the less noticeable downside of being an autocratic government—that is, maintaining a more or less rigid legal system and allowing limited information flow. The Singapore government has been by far the dominant player in the city-state's economic development. The government maintains the primary role in all aspects of economic policy-making and for the most part has not incorporated the private sector into the process. (Lim, 1983) Although this tight regulation contributed to Singapore's earlier success, the rigid governmental control may dampen Singapore's leap to upgrade itself. Bennett argues that the heavy-handed regulatory environment of Singapore threatened Singapore's aspirations to become a world-class financial center, in the face of numerous neighboring countries posed to replace Singapore's then labor-intensive industries. (Bennett, 1993) Others criticized Singapore's rigid legal system, while conceding its other strength such as an extremely uncorrupted system. (Norton, 1998: 226)

Taiwan, functioning from the limited freedom granted by its hybrid, overlapping policy making cabinet-level administrative machines, demonstrated its economic resilience to have survived international economic crises, competition and even overcome the crippling diplomatic deadlock occasioned by its stiff political claims. In the meantime, except the early success of the export-oriented industrial policy, Taiwan's emphasized industries have failed one by one—from the capital- or tech-intensive industries such as heavy-machinery, basic metal, petro-chemical and vessel construction industries, the national defense industry, and super ICs industry such as DRAM makers. Into the 1990s, Taiwan has succeeded only in becoming the center of a semiconductor chip foundry. The latter's success was attributed to the government's cooperation with private sectors after its initiation, rather than adopting a centrally-planned position. (Wang, 2001: 167-9)

China remains the only economically growing country among the areas compared. However, cautions are to be heeded for such areas as ideological controversies, together with the resulting policy instability, inflation, and old burdens such as inefficient state enterprises. (Jia, 1994: 169-75) As recently as 1996 in the wake of ideological disputes, China abruptly stopped most new economic measures, with the tax incentive system amongst them. This could be a sign of political power struggle; or, more precisely, a reaction to a political vacuum as a new generation of leaders replaced the old guard. Ostentatiously, the discontinuation of the tax incentive system was a response to a World Bank article arguing against the utility of such system in helping China get desired foreign capital and technology. (Jiang, 1998: 553) In another development, China also asked foreign law firms in China to disclose certain client information. This move put China's sincerity to comply with international standards seriously in doubt. In 2001, China discouraged internet development, for fear that this modern gadget would promote information flow to an extent that China cannot police. In addition, China has yet to learn to cope with some main side effects of economic development—inflation and the gradually expanding wealth gaps between areas and between people. According to one scholar's recommendation, China may shorten its learning curve by absorbing the rich experiences from the newly returned Hong Kong. (Norton, 1998: 215-6)

2.2 The Future--Danger or Opportunity?

As economic development is a dynamic process that needs constant new inputs to renew and rejuvenate, no societies are spared to live in yesterday's glory. Fortunately, these four societies do not seem to cease to face and cope with new challenges. Just as the Chinese equivalent of the word "crisis" is of dual nature—danger and opportunity, the current plateau each of these four societies faces may well represent both possibilities. China has finished and even excelled in many aspects through economic emulation. Feeling blessed or not, China's quarter-of-a-century old economic experiment has brought with it a qualitative change to the fundamentals. As population moves to where the job market is and where the economic development is, China's society-maintenance systems such as food rationing and travel controls have been hard to maintain. For example, reports on the so-called "blind population flow to the cities" were numerous. This happened against the backdrop of China's population control tools—the neighbor-spying system. Whether these changes represent danger or opportunity depends on how China views them. China can always go backward to the longstanding autarchic and xenophobic tradition, but China can also choose to stick it out with the opening, bearing predictable growing pains. With disproportionate size, natural endowment and other factors, the three (with Hong Kong became HKSAR, technically not an "overseas Chinese society" after its turnover) East Asian overseas Chinese societies' experiences may not be exemplary enough for China. However, the experiences of Hong Kong, Singapore, and Taiwan all attest to the importance of a more open and free society —including a more liberal economic policy, an ordered civil governance provided by rule of law, freedom of information exchanges--in creating sustained economic development. (Norton, 1998; Bennett, 1993; Li, 1988; Han, 1998) Of these three Asian societies, Hong Kong had all of the three elements and won the economic race, if any, in becoming the primary regional center. The task now is whether China can allow the Hong

Kong Special Administrative Region to continue grow stronger and better. Singapore had achieved one of the most accelerated economic development thanks to its roughly having the first two elements; its drawbacks of selected adherence to the rule of law principle and limited information freedom only showed in latter advanced development. Taiwan, with its tripartite origin of influences—China, Japan and the U.S., achieved a middle-of-the-road result since it had all these three elements but more or less discounted; Taiwan's latest development, for example, the recent years since its lifting the Martial Law, saw a burst-out new vigor and confirmed further the importance of the direction of a more open and freer society. The lifting of the Martial Law in 1987 created a series of social, political, and economic reforms including administrative efficiency improvements, tax law and investment overhauls. However, after becoming the "most democratic Asian society" (Wall Street Journal, March 18, 2000) by voting for a non-Nationalist President, Taiwan's new social vigor was partially cooled off by the lingering economic slowdown.

Who is going to write a better sentence for their next chapter depends on how each of these societies deal and cope with the dual nature of crisis—danger or opportunity in the new century.

Chapter 3 Tax Incentive System

3.1 An Analysis of a Fiscal System Used by the East Asian NICs or Areas—Lessons from Taiwan's Tax Incentive System as an Illustration for the East Asian NICs' Adapting to the Ever-Changing Times and Tides of the World

3.1.1 Economic Planning and Economic Development of the East Asian NICs

Scholars have pointed out common bonds such as cultural heritage, dense population, and a deficiency of resources as motives for the economic development of the East Asian NICs. They also argue about the impact of industrial policy upon the structural transformation and upgrading of the economy for the East Asian economic phenomena. (Noble, 1988: 2-3) Scholars argue that some of the success of East Asian NICs lies in their governments' using industrial policy to guide firms and industries toward economic activities with long-term benefits for their economies. These East Asian NICs use tax breaks, provision of financing, protection of infant industries, promotion of economies of scale, and assistance in the acquisition and dissemination of foreign technology to create comparative advantages in various industries critical for long-term growth. (Johnson, 1982; Johnson, 1981: 9; Wade, 1990: 23-61) Others argue that the free market structure is better than governmental industrial planning (Clinger, 1984: 3-5). This includes Schultze's attribution of Japan's post-WWII economic success mainly to the huge savings rate, aggressive business leaders and modern technology rather than to the government's industrial policy. (Schultze, 1984: 12) The argument goes on that the government is not able to identify the right industrial structure in carrying out an industrial policy; and government does not have clear criteria to decide which industries to protect or restructure in governing a systematic government policy (Schultze, 1984: 15, 17). Note that even in an advanced country such as the U.S., which boasts of no industrial policy, government intervention or spending has contributed to the protection of infant industry and later technology-sensitive industries. For example, Branscomb argues that U.S. government spending on defense-related R&D and on the development of military technologies in fact has had the effect of an industrial or technology policy. (Branscomb, 1992: 2, 4) Farrell and Mandel point out that U.S. government funds have helped protect many infant industries, such as airlines and electronics; they also argue that the Reagan Administration's providing huge tax breaks for the real estate industry and funding high-tech industries like biotechnology had the effect of an *ad hoc* industrial policy. (Farrell and Mandel, 1992)

3.1.2 Industrial Policy—Economic Planning

The active use of industrial policy to achieve the goals of advancing from developing countries to developed countries can be exemplified by the case of Taiwan. A scholar and one of the main planners for the shaping of Taiwan's industrial policy and economic development, Kuo-Ting Li, points out that because of Taiwan's limited resources in both human and physical capital as well as lack of natural resources, the Taiwan government had to plan carefully to utilize the limited available means to achieve goals when Taiwan started to develop after WWII. (Li, 1988: 216) Li notes that the Taiwan government has established six guiding principles in shaping its industrial policy and economic development. These are: (1) An evolutionary approach to technological advancement; (2) A balance between industry and agriculture; (3) International cooperation and an investment climate conducive to self-help; (4) heavy educational investment; (5) Overseas feedback for planning and review; and (6) Fiscal conservatism and a balanced budget. (Li, 1988: 217-22) However, Li also points out that despite the existence of a well thought-out plan, unexpected developments will occur and cause constant revision, and that co-ordination, follow-up, and evaluation of the economic development planning are important. (Li, 1988: 37)

3.1.3 Policy Option--Tax incentive system

Debates linger about the efficacy of tax incentive systems. For example, Surrey argues that direct expenditures are a better method of implementing social policy, and that tax expenditures are generally wasteful, inefficient, and inequitable. (Surrey, 1973: 126-54) Zelinsky argues against the inefficiency, stating that tax incentive systems can be efficient; for example, tax incentive systems may be more efficient for a government's program because of lower transaction costs. (Zelinsky, 1986) Yelpaala argues that tax incentive systems are inefficient in the context of foreign direct investment. (Yelpaala, 1985) Scholarly debates aside, country studies have shown that the right kind of tax regimes and incentives may, indeed, be important, especially when pursuing export-oriented investment. (Guisinger, 1983) Scholars point out that fiscal incentives may be important but they need be looked at in the context of corporate tax levels as a whole and the needs of particular types of investors. This refers to the empirical studies that show that export-oriented investment and large-scale investments do require incentives. Also, for businessmen, tax incentives are viewed as secondary because the post-tax profitability of new investments is of limited significance if there are not enough markets or the costs of production are high. A further conclusion is that a tax incentive system can be viewed from the reverse side: although the efficacy of the tax incentive system is debatable, the lack of it may create an adverse impression for a developing country as it is viewed as though the country does not want to compete in enticing foreign investment. (Cable and Persaud, 1987: 11-2)

A tax incentive system is a fiscal system using tax holidays, reduced tax rates, tax credits, reductions, investment refunds, accelerated depreciation allowances and investment allowances or subsidies, carry-over loss and other tax burden reducing measures to gear foreign investment toward the adopting country or to favor the specific industries the adopting country desires to develop. (Jiang, 1998: 550; Cable and Persaud, 1987: 11) As with industrial policy, the three East Asian NICs and other developing countries have actively adopted tax incentive systems to attract and shape the direction of the foreign capital. (Cable and Persaud, 1987) Scholars indicate that, "for most governments, taxation is perhaps the most readily available instrument of industrial policy." (Okimoto, 1989: 86)

3.1.4 Policy Option—Free Trade Zone

Often, free trade zones are used together with tax incentive schemes, especially when the developing countries seek to attract export-oriented investment but the domestic costs are high due to government protection. Within the zones, investment can enjoy long tax holidays and thus lower cost for investors to facilitate export-oriented industries. Thus, the developing country can achieve its goal of attracting export-oriented industries and also maintain its import barriers to protect its fragile domestic market. (Cable and Persaud, 1987: 12-3)

3.1.5 Policy Option—Exchange Rate Control

Currency rate control is another tool developing countries use. Developing countries use exchange rate control to maintain a country's balance of payments while basically recognizing the freedom of investors to repatriate their capital and profits. Various forms of exchange control usually affect the importation of goods for production, the ease and extent of repatriation of capital, and local currency borrowing. This factor is viewed as a negative factor to attract foreign investment. However, it is also essential to keep the export-oriented countries from massive capital flight. (Cable and Persaud, 1987: 13)

3.2 An Analysis of The Tax Incentive System in Taiwan

3.2.1 Starting out—the Intertwined U.S.-Japanese Influence

Most economic measures that Taiwan adopted, such as export processing zones, a VAT tax system and a tax incentive system, owed their origins to Japan, whose tax systems and other economic development policies were in turn modernized during the American occupation after the WWII thanks to contribution from American experts during General Douglas MacArthur's regime. For example, Carl S. Shoup held a six economist team (known as the Shoup Mission) to have contributed to the modernization of Japan's tax system. (New York Times, March 16, 2000) U.S. Aid during the Korean War not only introduced the economic planning concept into Taiwan, but also catalyzed the starting of economic planning with U.S. Aid's departure. (Li, 1988: 36)

As a tiny island country with few natural resources, Taiwan's economy has traditionally relied on international trade—trade with mainland China in the Qing Dynasty, trade with Japan during the Japanese governance of Taiwan, and trade globally after the WWII, with the U.S. as the main trading partner. (DeGlopper, 1995) As a result, Taiwan was open to learning and adapting to new things. While China failed to learn from western culture and technology, Japan had prospered by learning western social, political, and technological systems since the Meiji reformation (1868-1912 A.D.). Japan's more modernized economic and financial systems had been assimilated into Taiwan society during Japan's fifty-year (1895-1945 A.D.) governance. (Numazaki, 1992: 51-67) In the historic tragedy, the "228 event" in 1947, and the subsequent "White Horror Era," the Nationalist government systematically massacred Taiwanese elite under the guise of exterminating either Japanese or Communist influences. The result was an immediate brain drain and longstanding hatred between local Taiwanese people and the mainlanders. (Noble, 1988: 36) Nonetheless, when the Nationalist government realized that it needed to plan for a permanent stay in Taiwan, it found out that, resented or not, the Japanese systems were deeply imbedded in Taiwan and superior to comparable systems since Japanese society was more advanced than Taiwan. Thus, when Taiwan started serious economic planning in the wake of the withdrawal of the U.S. financial aid, the Japanese legacy and some of its economic model became the natural basis of emulation. Subsequently, Japan, South Korea, Singapore and the UK have influenced Taiwan's tax incentive system as Taiwan continuously integrated and revised its laws.

3.2.2 Challenges and Responses--The Evolution of Taiwan's Tax Incentive System

Taiwan's tax incentive system is part of its economic planning started by an agency formed to handle U.S. Aid. The economic planning machinery was formalized when the U.S. Aid departed in 1965. (Li, 1988: 26) As a fiscal policy tool, Taiwan's tax incentive system evolved when Taiwan's society and economic development changed.

In 1960, the Statute for Encouragement of Investment (the "SEI"), Taiwan's first tax incentive law, went into effect. This law aimed to attract foreign investment to develop Taiwan's export-oriented industries in replacement of the prior import-substituting industries. The tax incentive system underwent an overhaul in 1970 to fit Taiwan's increased pace of economic development, and thus the Second Stage of the SEI took effect. In 1980, the tax incentive system was further upgraded to be the Third Stage of the SEI. This overhaul was to gear foreign investment toward the high value-added industries and the importation of anti-pollution equipment and facilities as Taiwan transformed from the export-oriented labor-intensive industries to a new stage. In 1990, The Statute for Upgrading Industries (the "SUI") replaced the SEIs, to suit the direction of establishing high-tech based industries, mainly the semiconductor chip industries.

3.2.3 The Initial Effort--the First Stage of the Statute for Encouragement of Investment (the "SEI") (1960-1970)

Taiwan's post-WWII industrial development began with import substitution in the 1950s by the Economic Stabilization Board (ESB). Under this policy, the economic stage focused on the production of consumer goods and agricultural products while importing raw materials, machinery, and equipment. The departure of U.S. Aid prompted the setting up of a cabinet level economic planning agency. First, the Council for US Aid was reorganized to the Council for International Economic Co-operation and Development (CIECD). In 1965 when U.S. aid phased out, the head of the Council became the Minister of Economic Affairs, which formalized the economic planning organization. (Li, 1988: 25-6)

In the 1960s, export-oriented industries development gradually replaced the earlier emphasis on import substitution. The policy change was to resolve the basic condition of raw material shortage, especially in light of U.S. Aid withdrawal. This policy was also to take advantage of the excessive agricultural workforce and turn the deficits in the balance of payments into surplus. (Li: 1988: 13-4)

3.2.3 (a) The Establishment of The First Stage of the SEI-1960

In 1960, the Statute for Encouragement of Investment (the "SEI"), Taiwan's first tax incentive law, took effect. However, due to a residual policy of building import-substituting industries, this law had little effect until the withdrawal of the U.S. financial aid became imminent in 1965 when the speed of moving toward export-oriented industry increased. New incentive provisions were added to tailor the SEI to suit the needs of the export-oriented policy.

The tax preferences of the SEI included tax holidays, reduced tax rate, tax exemption and tax reduction. Later, accelerated depreciation, tax deduction, and deduction carry-over were added during the different stages of the SEI. Enterprises in productive industries were to enjoy the tax preferences.

Article 5 of the SEI provided a five-year tax holiday for "productive enterprise" which is defined in Article 3 as a company conducting any of the following operations: manufacturing, handicraft, mining, agriculture, forestry, fishery, animal husbandry, transportation, warehousing and public utility. The tax holiday started from the date of starting sales of goods/rendering services or employment. Article 10 provided a reduced 18% maximum income tax rate, including all surcharges, after the five-year tax holiday, as opposed to the 32.5% maximum income tax rate for ordinary for-profit enterprises. Article 12 provided a tax exemption for reinvested profits. Articles 28 and 29 provided a tax exemption or reduction of the stamp tax. Those transactions applicable for this tax benefit included: 1) Agreements for loans, mortgages, or pledges, and written acknowledgment of debts and debentures; 2) Discount contracts, acceptance contracts, promissory notes, and bank drafts or bills of exchange; 3) Contracts for future delivery of goods or services; and 4) Certain Invoices.

Table 1 Basic Scheme of the First Stage SEI—1960

Scheme	Scope	Comparison with enterprises not applicable to SEI
Tax Holiday	1. Starting Date: date of sales of goods or employment 2. Duration: 5 years 3. Applicable: 10 Productive Industries—manufacturing, handicraft, mining agriculture, forestry, fishery, animal husbandry, transportation, warehousing and public utility.	N/A
Income Tax Rate	Up to 18%; applicable after 5 year tax holiday for Productive Industries	Up to 32.5% for For-Profit Enterprises;
Tax Exemption	Reinvested Profits	N/A
Exemption or Reduction of Stamp Tax	1. loan agreement, mortgage, pledge, debt note; 2. discount contracts, acceptance contracts, promissory note, bank drafts or bills of exchange; 3. contracts for delivery of goods or services; 4. certain invoices.	N/A

3.2.3 (b) The 1965 Revision of the First Stage SEI

In 1965, in light of the implementation of the export-oriented policy, additional tax incentives were added—installment payments for tax and import duty exemption to encourage development of export-oriented industries.

Article 23 provided for installment payments of tax, and import duty exemptions to encourage both local people and foreigners to import foreign machines, equipment, or parts for the use of productive enterprises. At this stage, Taiwan had only basic agriculture-related industries; the goal of the SEI was to attract manufacturing or labor-intensive industries that

Taiwan lacked. The burden of proving that these imports or investments were new was on the investors (Article 3). Only newly established productive industries were eligible for the beneficial tax system. Those who qualified for the tax preferential treatment had to be limited corporations organized under the Corporation Law for local people, or foreign equivalents who apply to invest in Taiwan and get government approval pursuant to the Statute for Investment by Foreign Nationals, promulgated on July 14, 1954 and as amended on December 14, 1959.

Table 2 New Tax Incentive Schemes Added at the 1965 Revision of the First Stage SEI

Scheme	Scope	Comparison with prior law
Installment Payment of Tax	Corporations organized by local people and foreigners	N/A
Import Duty Exemption	Corporations organized by local people and foreigners	N/A
Burden of Proof –New Productive Industries	Investors must prove their enterprises are in new productive industries	N/A

3.2.3 (c) The 1967 Revision of the First Stage SEI

As the movement to an export-oriented policy became clearer, a revision in 1967 expanded the scope of productive enterprises to reflect such policy. By adding four additional industries as qualified industries, this revision extended the definition of a productive enterprise to include 14 industries, ranging from mostly export-oriented assembly or processing operations to some domestic infrastructural construction related industries. These qualified industries included: 1) Manufacturing industry: enterprises based on labor or machines which manufacture, assemble or process products; 2) Handicraft industry: enterprises based on handicrafts which manufacture, assemble or process products; 3) Mining industry: enterprises engaged in exploration, mining and ancillary flotation and refining; 4) Agricultural industry: enterprises which utilize land and machines in farming and the ancillary product processing industry; 5) Forestry industry: enterprises which utilize forest land and equipment for planting or replanting forests and logging to produce wood-related products and their by-products; 6) Fishery industry: enterprises which catch and cultivate marine animals and plants by fishing boats, cultivating ponds, or equipment; and their ancillary processing, transportation and marketing industries; 7) Animal Husbandry: enterprises which utilize ranches, farms, or equipment for raising and breeding livestock and their ancillary product processing industry; 8) Transportation industry: enterprises with power-driven facilities and capacity sufficient to undertake transportation of passengers and/or cargo by water, land, or air; 9) Warehousing: enterprises which lease their specific self-constructed warehouses for storage of goods; 10) Public Utilities Industry: enterprises which provide the public with municipal transportation, telecommunications, health, irrigation, faucet water, electricity, or gaseous fuel; 11) Public Housing Construction Industry: enterprises which invest in construction of modern public housing units; 12) Technical Service Industry: enterprises which furnish technical know-how or patent rights to assist the manufacture of products which have not been produced domestically; 13) Hotel Industry: enterprises running international tourist hotels, domestic tourist hotels, or public hotels within a forestry entertainment area or scenic area whose construction and facilities conform to the government-prescribed criteria; and 14) Heavy-duty Machinery Construction Industry: enterprises which engage in civil engineering construction with heavy-duty machinery.

Table 3 Changes Made at the 1968 Revision of the First Stage SEI

Scheme	Scope	Comparison with prior law
Expansion of applicable productive industries	1. Adding 4 industries: public housing construction, technical service, hotel and heavy-duty machinery construction industries.	1. N/A 2. 10 industries as productive industries eligible for tax incentive schemes

3.2.4 Growing and Coping--The Second Stage of the SEI (1970 - 1980)

From 1961 to 1972, Taiwan's economic development accelerated, which made the First Stage SEI insufficient to meet the needs of the time. Thus, a major overhaul of the system took place in 1970 to make clear the applicable scope and ushered in the Second Stage of the SEI ("Second Stage SEI"). The government also started developing a securities market; the Second Stage SEI thus included several provisions for promoting development of the securities market. Subsequent crises Taiwan faced, such as the two oil embargos, brought several revisions to the Second Stage SEI in order to meet the challenges. Also, this law contained a sunset provision, Article 82. The provision provided that the statute would expire on December 31, 1980--reflecting Taiwan's ambivalence toward incentive schemes.

The main changes in the Second Stage SEI included simplified administrative procedures and new incentives such as accelerated depreciation (Articles 6 to 8). This law also provided incentives to promote securities markets, as part of efforts to strengthen capital markets as an avenue for corporate finance. Also, tax exemptions on certain land use provisions were added to help investors securing land to facilitate the development of Export Processing Zones (EPZs). Other additions included: provisions facilitating privatization of public enterprises and provisions adding the arms-length transaction concept in dealing with transfer pricing issues.

Reflecting the ever-changing environments in Taiwan's highly developed stage during the 1970s, the Second Stage SEI underwent seven subsequent changes to cope with the changing times and tides.

3.2.4 (a) The Creation of The Second Stage of the SEI—1970

From late 1960s to 1970s, Taiwan's export-oriented industries bloomed due to the movement of many low-wage laborers from the countryside into industrial areas. The measures and incentives under the export oriented policy included the expansion of scope and adding new schemes in the tax incentive system and setting up export-processing zones. (Liang and Liang, 1986: 106; Li, 1988: 138)

On the other hand, the rapid economic progress since the late 1960s created problems that Taiwan had to face. These included stagnation of the farm sector and inflation. As part of Taiwan's transformation from an agricultural society to an industrial society, country population dwindled as people flooded to the city for jobs in the labor-intensive industries. In addition, the global economic crises of the oil embargos in 1973 adversely affected Taiwan. (Li, 1988: 30-2)

As new capital and technology were scarce during the early years of the Nationalist government's reign, Taiwan's industries remained under heavy Japanese influence as the private sector continued to operate the Japanese-era facilities or to depend on Japanese indirect investment using local people as nominal business owners to circumvent the anti-Japanese legislation. Taiwanese industries during the 1950s and 1960s were owned mainly by private investors who used the former Japanese facilities and know-how to continue manufacturing since there was a strong anti-Japanese atmosphere. The import-substituting policy helped the re-entry of Japanese money and technology, through avenues allowed for entrepreneurs in the import-substituting industries, since the Taiwanese industries needed the Japanese to supply the innovative technology that Taiwan lacked. During the 1960s, the ability to provide EPZs with Japanese-speaking staff was important in Taiwan. (Hughes & Dorrance, 1987: 63). This need dwindled in the 1970s as Taiwan utilized more liberalized trade, fiscal systems, and economic policies to attract broader foreign investment from Europe and the United States. However, Japan's more advanced technology and economic development, its proximity and Taiwan's old ties with Japan all contributed to Japan's maintenance as Taiwan's second largest trading partner after the U.S. for decades. Unlike Taiwan's trade surplus with the U.S., Taiwan's trade with Japan was in deficits for years. (Li, 1988: 23-4)

Besides the administrative streamlining, the Second Stage SEI added the additional tax incentive of accelerated depreciation (Article 6). Under the law, a productive enterprise may select either accelerated depreciation, or a five year tax holiday starting from the date of starting sale of goods, rendering services or employment. With accelerated depreciation, productive industries would enjoy shortened useful life of machinery or equipment up to half of that permitted other industries. Under the method, if the original useful life of the machinery or equipment is ten or more years, the shortened useful life shall be five years. If the original useful life is less than ten years, it may be accelerated by half. As to buildings, constructions, and facilities, communication and transportation facilities, their useful life may be shortened by one third. These benefits applied to newly established productive enterprises, as well as to the expansion (Article 2) and renovation (Article 8) of existing productive enterprises.

The Second Stage SEI also increased the maximum income tax rate for a productive enterprise to 25%, from the previous 18% (Article 10). Certain capital- or technology-intensive productive enterprises received a 22% rate. These included basic metal manufacturing industries, heavy-duty machinery industries, petro-chemical industries and vessel manufacturing industries.

To encourage reinvestment for productive industries, the Statute provided a tax deferral for shareholders' undistributed profits when they were reinvested in the manufacturing (Article 12) to encourage reinvestment for productive industries. The new shares were distributed to the shareholders in the form of capital increase in reinvesting in machinery, equipment, and communication or transportation facilities for production of goods, rendition of services, or for research and development. They were excludible from the shareholders' consolidated income, or for-profit enterprise income of the taxable year for taxation. But when such shares were thereafter transferred, bestowed, or distributed as legacy, the total amount of the price of the shares would be taxable income.

Further, in an initial attempt to develop capital markets, the Second Stage SEI allowed tax exemptions on long term capital gains (held one year or longer) for registered stocks and bonds. Article 15 of the Second Stage SEI prescribed that: Where a person sells registered share certificates or corporate bonds publicly issued and listed on the market by for-profit enterprises, or government bonds or development bonds issued by the government at various levels or by an industrial bank, which he previously purchased or otherwise acquired and which he has held for one year or more, the gain realized from such a sale above the cost may be excludible from his taxable income. However, if losses were incurred as a result of the sale, such losses are not deductible from person's taxable income for the taxable year.

Further, the Second Stage SEI raised the withholding tax rate for nonresidents' taxable income to 30%, from the previous 15%. The law also reiterated that only Taiwan-source income would be taxable (Article 17). In addition, the revision prescribed detailed rules to ease productive enterprises' securing land as a continuing effort to facilitate the establishment of the Export Processing Zones (EPZs). Articles 36 to 73 extensively regulated methods to acquire or lease land for manufacturing, and defined the scope of tax exemptions or deferrals for purchasing or leasing industrial use land. The revision also added provisions, Articles 74 to 79, regulating the privatization of state-run enterprises and setting up a development fund (for economic development) to help finance such privatization. This amendment also added the arms-length concept in dealing with transfer-pricing issue (Article 7).

Table 4 Basic Scheme of the Second Stage SEI--1970

Scheme	Scope	Comparison
Accelerated Depreciation	1. productive enterprises choose either tax holiday or accelerated depreciation 2. shortened useful life of fixed assets: i) machinery/equipment: 10 years to become 5 years; lesser than 10 years to become half of that useful life; ii) buildings/ facilities/ transportation and communication facilities: accelerated by one third of useful life. 3. applicable: i) new investors; ii) expansion and renovation of existing productive enterprises	N/A
Maximum Income Tax Rate	Increased to 25%; some capital- or tech-intensive productive industries limited to 22%.	Previously, 18%;
Tax Exemption of Reinvested Profits	Not taxable income when distributed; but transfer, bestowed as a legacy shall be taxable income.	N/A
Tax Exemption of Capital Gain by Stocks and Bonds Held for One Year or More	But no loss deduction for stock or bonds transfer or sales;	
Increased Withholding Tax Rate	1. 30% for Taiwan-source income; 2. applicable: nonresidents;	Previously, 15%.
Tax Exemptions or Deferrals for Purchasing or Leasing Industrial Use Land		N/A
Measures Encourage Privatization of State Enterprises		N/A
Measures Encouraged Development Fund		N/A
Added Arms-Length Transaction Concept in Transfer Pricing		N/A

3.2.4 (b) The 1972 Revision of the Second Stage SEI

During the decade of the Second Stage SEI, Taiwan revised the law frequently--seven revisions happened during the life of the Second Stage SEI. These were in 1972, 1973, 1974, 1977, 1978, respectively, and two times in 1979.

The constant changes of laws, on the one hand, showed Taiwan's flexibility and willingness to cope with ever-changing internal and external economic impacts; on the other hand, certain excessive changes exposed the structural defects of Taiwan's lacking a check-and-balance system, and demonstrate the ill-coordination and overlapping functions of Taiwan's economic planning policy-making machine. (Noble, 1988: 41-2) For example, Taiwan tightened its tax incentive law in 1973, which effect was mostly reversed by the revision less than a year later in 1974. (See, *infra*, sections on 1973 and 1974 revisions).

Table 5 Comparisons of Certain Changes Made During the Life of the Second Stage SEI

	Maximum Income Tax Rate	Tax Exemption of Reinvested Profits	Withholding Tax Rate
Second Stage SEI—1970	25% (22%)*	Yes	30%
1972 Revision	25% (22%)*	Yes	30%
1973 Revision	**35% (30%)***	**No**	**35%**
1974 Revision	**30% (25%)***	**Yes**	**35%**
1977 Revision	25% (22%)*	Yes	35%
1978 Revision	25% (22%)*	Yes	35%
Two Revisions in 1979	25%(22%)*	Yes	35%

*( ): rate in the parentheses is for certain capital- or tech-intensive productive industries.

The 1972 revision aimed to solve the side effects of industrialization--stagnation of the agricultural sector including low income of farmers, a shortage of farm labor resulting from the urbanization of population, and rising labor cost and prices of agricultural materials. Moreover, because Taiwan's average farming area per farmer was too small to make machine farming feasible, there was a need for a farm production service industry that leased farming machines. The 1972 revision made the farm production service industry eligible for tax exemption and accelerated depreciation. In the Second Stage SEI, the tax holiday provision was Article 6, replacing the First Stage SEI's Article 5. This revision extended the tax holiday to for-profit enterprises as well as unincorporated enterprises that engage in supplying farmers with agricultural productive service and have been registered with the agricultural authorities.

Table 6 Changes Made at the 1972 Revision of the Second Stage SEI

Scheme	Scope	Comparison with prior law
Expand Applicable Productive Industry	Added Farm production service industry	N/A
Extension of Tax Holiday to Unincorporated Enterprises	Such enterprises shall engage in supplying agricultural productive service	N/A

3.2.4 (c) The 1973 Revision of the Second Stage SEI.

The 1973 revision was in response to the government's decision to raise the tax to finance the long overdue major repair and building of the debilitated Japanese Era infrastructure as the government resolved to stay in Taiwan. The first of its kind for the Nationalist government since its arrival in Taiwan, the Ten Major Development Projects were launched in 1973 and finished in

1979. The infrastructure development involved repairing and building ports, airports, highways, railways and dams. (Li, 1988: 15) Also, the revision removed loopholes that had existed in the prior law.

The 1973 revision included increasing the maximum income tax rate for a productive enterprise from 25% to 35% (Article 10). The rate applicable to certain capital- or technological-advanced enterprises was raised to 30%, as opposed to previous 22% (Article 10). The revision abolished tax exemption of shareholders' reinvested profits (Article 12). The law changed the tax deferral of long-term capital gain (held for one year or longer) of stocks and bonds purchases (Article 10) to either tax-exemption if the purchase was before 1974, or taxable for half of the income from the sale of registered stocks or bonds that were purchased during or after 1974. The revision raised the withholding rate for nonresidents to 35%, from previous 30% (Article 17). Individuals and for-profit enterprises could apply for a tax refund with proof of taxes paid in their domicile; however, the refund could not exceed their withholding tax on Taiwan-source income.

Table 7 Changes Made at the 1973 Revision of the Second Stage SEI

Scheme	Scope	Comparison with prior law
Increased Maximum Income Tax Rate	1. Up to 35%; 2. Some capital- or tech-intensive new industries up to 30%	1. Previously 25% 2. Previously 22%
Abolished Tax Exemption of Reinvested Profits		1. Previously, tax exemption.
Changed Tax Deferral of Capital Gain for Stock and Bond Held for One Year or More	1. Tax exemption if purchased before 1974; 2. Half of the sale income if purchased in or after 1974	1. Previously, not taxable.
Increased Withholding Tax Rate	1. up to 35%	1. Previously 30%;

3.2.4 (d) The 1974 Revision of the Second Stage SEI

The worldwide economic recession caused by the 1973 OPEC oil embargo proved that this tightened tax incentive law was badly-timed; it decreased Taiwan's economic resilience. In 1974, Taiwan revised the Second Stage SEI again, mainly to undo the stifling effect of the previous revision and to tackle the worsening economy. These changes included lowering the maximum income tax rate for productive enterprises to 30% (Article 10) as compared to the 35% ceiling in the previous revision. The revision lowered the maximum income tax rate to 25% as opposed to previous 30%, for capital-intensive and technology-intensive enterprises or those productive enterprises issuing stocks publicly where the issuance involved only registered stocks. Also, Article 12 was revived to allow retroactive tax exemptions for shareholders' undistributed profits.

Table 8 Changes Made at the 1974 Revision of the Second Stage SEI

Scheme	Scope	Comparison with 1973 law
Reduced Maximum Income Tax Rate	1. Up to 30% 2. Some capital- or technology-intensive enterprises or publicly traded productive enterprises—up to 25%	1. Previously 35% 2. Previously 30%
Revived Tax Exemptions for Reinvested Profits	1. Applied retroactively to resume the tax free regime of reinvested profits;	1. Reinvested Profits were taxable.

3.2.4 (e) The 1977 Revision of the Second Stage SEI

In 1977, Taiwan revised the Second Stage SEI a fourth time to respond to fierce competition from South Korea and Singapore. Taiwan's new policy was to promote the modernization of traditional labor-intensive industries, and to encourage the development of capital- or technology-intensive industries—including basic metal manufacturing industries, heavy-duty machinery industries, petro-chemical industries and vessel manufacturing industries.

The tax holiday was extended to up to 9 years from the original 5 years. Many provisions provided incentives for upgrading industries and R&D. These incentives included import duty exemption, and classifying R&D expenditures as expenses. A tax holiday was applicable for purchase of machinery and equipment and whole plant transfers. Other developments included further regulations on securing land for industrial use, securities market regulation, and continuing the Development Fund for Facilitating Taiwan's Economic Development

The 1977 revisions extended tax holidays for four more years (Article 6), in addition to the initial five years to accommodate the latent profit-making nature of capital- or technology-intensive industries. This was achieved by delaying the starting date of the tax holiday for one to four years after the date of sales of goods or employment. Previously, the starting date of the tax holiday was the date of starting sale of goods or employment. In order to encourage plant modernization, the revision extended tax holidays to new equipment and facilities. Previously, only the establishment of new productive enterprises enjoyed this tax incentive. This provision was to encourage productive enterprises to raise their productivity by expansion and renovation (Article 6). The revision allowed nonqualified productive enterprises to enjoy the remainder of the tax holiday when they purchased whole factory equipment from qualified productive enterprises (Articles 2 and 3) moving to new facilities.

Articles 36 to 73 provided provisions encouraging R & D. For example, the Detailed

Implementation Law of the Second Stage SEI allowed enterprises to allocate their research and experiment expenditures as expense. Also, an import duty exemption on apparatuses and equipment to be used for R & D purposes was granted.

The revision encouraged stock market growth by raising the maximum tax exempt dividends from NT $2,000 to 8,000 (Article 16). This revision also reduced the tax rate for limited corporations that issued their stock publicly from 25% to 10%, and abolished withholding taxes on undistributed profits.

The law encouraged merger and acquisition by offering tax exemption or deferral on the incident stamp tax, deed tax and land related capital gain tax for purchases and sales of equipment, facilities, factories and land (Articles 33 to 35). The revision also expanded the scope of persons qualified to purchase industrial use land to include prior land owners whose lands were condemned by the government.

Article 76 also extended the funding sources of the Development Fund for Facilitating Taiwan's Economic Development from income of recently privatized public enterprises to the National Coffer appropriation. The provision also expanded the use of this fund beyond helping to fund technology-intensive productive enterprises for the Ten Major Infrastructural Construction Project to funding for purchases of machines and equipment.

Article 10 reduced the maximum income tax rate and surcharges of productive enterprises to 25% from the earlier 30%. The revision decreased the preferred tax rate for basic metal manufacturing industries, heavy-duty machinery industries, petro-chemical industries or other encouraged capital- or technology-intensive industries to 22% from the previous 25%. The change also allowed enterprises to write off 1% of their export loss reserves in order to encourage export--this move was modeled after Japan's and South Korea's similar measures.

Table 9 Changes Made at the 1977 Revision of the Second Stage SEI

Scheme	Scope	Comparison with 1974 law
Expanded Tax Holiday Duration and Applicable Range	1. Duration: Up to 9 years tax holiday; certain capital- or tech-intensive industries may start tax holiday one to four years after date of starting sales of goods/ rendering services or employment; 2. Expanded to : new equipment/facilities purchases;	1. Previously 5 years
Increased Maximum Tax Exempt Dividends	1. Up to NT$8,000	1. Previously $2,000
Reduced Corporate Income Tax Rate For Publicly Traded Corporation	1. Up to 10%	1. Previously 25%
Abolished Withholding Tax on Reinvested Profits		
Tax Exemption of Stamp Tax, Deed Tax and Land-Related Capital Gain Tax	1. Applicable for: purchase and sale of equipment, facilities, factories and land;	N/A
Allowed R & D Expenditures as Expenses		N/A
Import Duty Exemption on equipment/facilities for R & D		N/A
Measures Encouraged Purchase of Industrial Use Land	1. Extended qualified persons to landowners whose land was condemned;	
Extended Development Fund Funding Source	1. Included the National Coffer Appropriation	1. Previously the funding source was the proceeds from Sales of public enterprises
Extended Development Fund's Use	1. to funding for purchases of machines and equipment	1. Previously funding for productive industries for the Major Economic Infrastructure Construction Plan
Extended Tax Holiday to Whole Plant Transfer	1. Whole plant purchaser would enjoy the remainder of the tax holiday of the productive industry plant seller	N/A
Reduced Maximum Income Tax Rate	1. Up to 25% 2. Capital- or Tech-intensive productive industries—22%	1. Previously 35% 2. Returned to the rate of 1970
Allowed Loss Write-Off	1. 1% of export loss reserves	N/A

3.2.4 (f) The 1978 Revision of the Second Stage SEI

One half year later, the Second Stage SEI was amended again. The change was modeled after similar provisions of Singapore and the UK. This revision added two sections regulating the taxation of nonresidents, allowing foreign investors to apply withholding tax for their profits whether they stayed in Taiwan for longer than 183 days (Article 17, sections 1 and 2). This was a change from Article 7 of the Individual Income Tax Law, which prescribed that foreigners who stayed in Taiwan for 183 days or longer were taxed at the same progressive rates as residents. Foreigners who stayed in Taiwan for less than 183 days were charged with withholding tax of 35% for their Taiwan-source income. This addition also gave foreign employees of a foreign investors beneficial tax treatment: for those who stayed in Taiwan for longer than 90 days but less than 183 days, their income was not deemed as taxable Taiwan-source income.

Table 10 Changes Made at The 1978 Revision of the Second Stage SEI

Scheme	Scope	Comparison with prior law
Extended Withholding Tax Applicability to Foreigners Even if Staying Longer than 183 Days		1. Previously, foreigners staying for longer than 183 days shall be levied same progressive tax rates as residents;
Beneficial Tax Treatment for Foreign Employees of a Foreign Investor	1. Income from Taiwan not deemed as Taiwan-source income; 2. Applicable to: foreign employees who stay longer than 90 days but shorter than 183 days;	N/A

3.2.4 (g) The Two Revisions in 1979—Second Stage SEI

In 1979, Taiwan's diplomatic relationships with the world seriously shrank in the wake of the U.S.'s breaking ties with Taiwan. Two more revisions of the tax incentive scheme were under way to reflect a new policy emphasis of developing national defense industries and a continuing effort to redress oil price crises.

The scope of productive industries was expanded to include the technical service industry and national defense industry. Tax exemption was accorded to enterprises in the national defense industry as well as importers of natural resources.

These revisions included an expansion of scope of productive industries to include the technical service industry as an encouraged industry (Article 3), in order to develop a precision technology industry. The changes also added capital- or technology-intensive productive enterprises engaging in the national defense industry as an encouraged industry (Article 10). Tax exemption from the income tax and stamp tax was extended to enterprises engaging in the national defense industry (Article 22). The changes extended tax exemption to enterprises that imported foreign natural resources into Taiwan (Article 5).

Other developments included changes of tax base, increasing tax exempt dividend and regulations on M&A. The tax base was revised to "annual taxable income," instead of the previous "annual income" to rectify the anomaly that some enterprises were prevented from enjoying tax exemption accorded them (Article 10). The changes increased the tax-exempt dividends from NT $8,000 to NT $12,000 (Article 16). Article 34 repealed the requirement of minimum export amount for enterprises to enjoy tax preferences accorded to merger and acquisition.

Table 11 Changes Made by the Two Revisions of the Second Stage SEI in 1979

Scheme	Scope	Comparison with prior law
Expanded Productive Industry	1. Added technical service industry; 2. Added national defense industry as encouraged industry	1. N/A 2. N/A
Extended Tax Exemption to Importation of Foreign Natural Resources		N/A
Changed Tax Base	1. "annual taxable income"	1. Previously, "annual income"
Tax Exemption of Income Tax and Stamp Tax	1. Applicable to national defense industry enterprises;	
Increased Tax Exempt Dividends	1. Increased to NT$12,000	1. Previously, NT$8,000
Repealed Minimum Export Amount for Qualifying for Tax Preferences in Merger and Acquisition		

3.2.5 Transformation—The Third Stage of the SEI (1980-1990)

Going into the 1980s, Taiwan's economic growth slowed down because other developing countries replaced Taiwan in the traditional labor-intensive industries as Taiwan's competitive advantage of low-cost labor gradually disappeared. Out of prudence, Taiwan chose to continue using tax incentive schemes in shaping its industrial direction when the Second Stage SEI expired in the end of 1980. The Third Stage of the SEI (the "Third Stage SEI") aimed to attract high-tech, high-value added product industries. Environmental concerns were part of the picture as Taiwan suffered from serious pollution due to previous industrial development.

3.2.5 (a) The Creation of the Third Stage of the SEI—1980

The Third Stage SEI expanded the Second Stage SEI's 82 provisions into 89 provisions. The basic scheme was retained, but the direction was sharply different. The expanded tax incentive scheme of the Third Stage SEI was mainly in encouragement of R&D, upgrading of industries, and anti-pollution purchases, whereas the basic scheme of the Second Stage SEI reflected the formation of a tax incentive system with an emphasis on manufacturing.

The Third Stage SEI included a tax deduction and tax deferral for equipment investment and profits reinvestment on equipment, a tax deferral for importation of foreign natural resources, and extending tax holiday or accelerated depreciation for R&D investment. Installment payments of tax and import duty exemption were extended to importation of parts and materials, and tax exemptions were conferred for anti-pollution purposes.

Article 10 provided that productive enterprises could deduct 10 to 15 percent of equipment investment and the deduction could be carried over for the next four years when the deduction exceeded the taxable income. Article 8 provided a tax deferral of up to four years on enterprises importing foreign natural resources. Previous law conferred tax exemption to such enterprises without prescribing the applicable duration. Article 35 extended a tax holiday or accelerated depreciation to qualified enterprises spending a certain percentage of investment on research and development. Articles 23 to 38 provided further tax incentive measures to encourage the continued development of capital markets. Article 12 provided accelerated depreciation of 50% reduction of useful life on enterprises upgrading production equipment. A tax deferral on shareholder's newly issued registered stocks was conferred when enterprises reinvested the undistributed profits in equipment or machinery upgrading (Article 13).

Article 46 added a 2-year accelerated depreciation for for-profit enterprises' purchases of energy-saving equipment and machinery. This article also conferred the same treatment on for-profit enterprises purchasing anti-pollution equipment and machinery. Installment payments of tax and exemptions of import duty were granted on the importation of parts and materials for manufacturing machines and equipment (Article 21). Such incentives were also applicable to importation of apparatuses and equipment for quality testing purposes. The same incentives were accorded to merger and acquisition (Article 38) of productive enterprises forced to relocate by reason of affecting public interests such as pollution (Article 39). Besides installment tax payment and import duty exemption, productive enterprises received exemptions from income tax, stamp tax, and deed tax resulting from relocation.

Other amendments involved a streamlining and consolidation effort, such as repealing provisions redundant to other laws. For example, article 13 of the Second Stage SEI regarding tax exemptions for reinvested profits for non-qualified limited corporations was eliminated because of a repetition with article 42 of the Income Tax Law.

Table 12 Comparison of the Basic Scheme between the Second Stage SEI and the Third Stage SEI

Scheme	Third Stage SEI-1980	Second Stage SEI-1970
Tax Deduction for Equipment Investment	1. deduct 10-15% of equipment investment; carried over for next 4 years if deduction exceeded taxable income;	N/A
Tax Deferral of Importation of Natural Resources	1. up to 4 years;	N/A
Tax Holiday or Accelerated Depreciation for R & D Investment		N/A
Measures Encouraged Capital Markets		1. Tax Exemption of Long Term Capital Gains by Purchases of Stocks or Bonds
Accelerated Depreciation	1. for Upgrading Equipment and Facilities Reduction of up to 50% of useful life;	1. N/A 2. Productive enterprises choose either tax holiday or accelerated depreciation 3. Shortened useful life of fixed assets: i) machinery/equipment: 10 years to become 5 years; lesser than 10 years to become half of that useful life; ii) buildings/ facilities/ transportation and communication facilities: accelerated by one third of useful life. 3. Applicable: i) new investors; ii) expansion and renovation of existing productive enterprises
Tax Deferral on Reinvested Profits for Upgrading Equipment and Facilities	1. Yes	1. N/A 2. For profits reinvestment in manufacturing;
2-Year Accelerated Depreciation	1. for purchases of energy-saving equipment and machinery; 2 for purchases of anti-pollution equipment and machinery	1. N/A 2. N/A
Installment Payments of Tax and Import Duty Exemption	1. for importation of parts and materials 2 for importation of apparatuses and equipment for quality testing purposes;	1. N/A 2. N/A 3. For Establishment of Productive Enterprises;
Exemptions of Income Tax, Stamp Tax and Deed Tax	1 for M & A purposes; 2. for forced relocation of plant due to pollution;	1. N/A 2. N/A 3. For purchasing or leasing industrial use land;

3.2.5 (b) The 1982 Revision of the Third Stage SEI

In 1982, in view of Taiwan's economic slowdown, Taiwan revised the Third Stage SEI, in concert with other financial and administrative improvements. Provisions also included tax incentive schemes to facilitate the construction of the Taipei World Trade Center and favorable tax treatment for trading conglomerates as Taiwan aimed to keep up with the standards of world financial centers.

The revision included further defining the duration of tax holiday for capital- or tech-intensive industries and extending beneficial tax treatment to skyscraper construction investors. This revision also extended tax incentive schemes to trading conglomerates.

For capital- or technological-intensive industries, Article 7 extended the starting date of tax exemption from one year after starting sale of goods or employment to two years after such date. Tax exemptions and accelerated depreciation were extended to investors for construction of skyscrapers pursuant to the World Trade Center plan, which was a new infrastructure investment plan to enhance Taiwan's status as regional financial center (Article 8, Section 1). A reduced 25% income rate was to apply to trading conglomerates, whose qualifying criteria were promulgated by the Executive Yuan (Article 15). Article 41 raised the permissible undistributed profits to two times of the paid-in capital for publicly traded companies and encouraged industries.

Table 13 Changes Made at the 1982 Revision of the Third Stage SEI

Scheme	Scope	Comparison with prior law
Extended Starting Date of Tax Holiday	1. extended from 1 to 2 years after date of starting sales of goods or employment for capital- or technological-intensive industries;	Previously, tax holiday started from date of starting sales of goods or employment; some capital- or tech-intensive industries started tax holiday from one to four years after date of sales of goods or employment
Expanded Tax Exemption or Accelerated Depreciation	1. Extended to investors in construction of skyscraper industry	
Reduced Maximum Income Tax Rate to Trading Conglomerates	1. extended the 25% beneficial tax rate to trading conglomerates;	
Raised the Upper Limit of Undistributed Profits	1. to two times of the paid-in capital for publicly traded companies and productive industries;	1. Previously 100% of the paid-in capital;

3.2.5 (c) The 1984 Revision of the Third Stage SEI

In 1984, in light of growing trade protectionism from the formation of more trading blocs, amendments were under way. Revisions included further expansion of encouraged productive industries; extending tax preferences to importation of finished products and technology transfer; changes of tax deduction rate and carried-over years for equipment investment; beneficial tax rate conferred on venture capital industry; and tax deduction for R&D expenditures.

These amendments added the public facility construction industry to the encouraged industries (Article 3). Tax preferences were conferred on importation of finished products from overseas investment, as well as on technology transfers (Article 8). The tax deduction rate for equipment investment was changed to range between 5% and 20%, as opposed to the previous 10% to 15% (Article 10). Such tax deductions could not exceed 50% of taxable income. Article 10 also extended the applicable deduction carried-over years to five years from the previous four years. Article 34 provided a tax deduction of up to 20 percent of the research and development expenses exceeding highest levels of past five years, but the amount deductible could not exceed 50% of taxable income and the amount exceeding would be carried over for the following five years. Article 15 conferred the reduced 25% income tax rate on the venture capital industry; and tax exemptions for dividends from that industry were provided in Article 16.

Article 39 expanded the scope of encouraged treatment for plant relocation by reason of pubic interests such as pollution and zoning. Article 41 expanded the permissible amount of reserved profits--this move was to encourage capital reinvestment of high-tech industries. Articles 54, 71, 72 and 80 provided incentives to facilitate deregulating industrial use land. Another addition included a proviso in Article 29 providing mutuality for tax-exemption on airlines to protest countries such as Thailand and the Philippines that levied a business tax on Taiwan's airlines.

Table 14 Changes Made at the 1984 Revision of the Third Stage SEI

Scheme	Scope	Comparison with prior law
Expanded Productive Industries	1. added the public facility construction industry to productive industries	1. Previously, investors in constructing skyscrapers were accorded tax incentives as productive industries
Extended Tax Incentives as Accorded to Productive Industries to Importation of Finished Products and Technology Transfers;	1. to importation of finished products from overseas investment; 2. technology transfers;	N/A
Tax Deduction Rate and Carried-Over Duration for Equipment Investment and R&D Expenses	1. deduct 5% -20% of equipment investment; 2. carried over for next 5 years if deduction exceeded taxable income; 3. R&D Expenses are deductible up to 20% of highest amount in the past five years; with the deductible amount not exceeding 50% of taxable income; the amount exceeding 50% of taxable income would be carried over for the next 5 years;	1. Previously, 10% to 15% 2. Carried over for next 4 years; 3. N/A previously.
Extended Beneficial Income Tax Rate and Tax Exemptions for Dividends	1. to venture capital industry;	N/A

3.2.5 (d) The 1987 Revision of the Third Stage SEI

In 1987, the Third Stage SEI was revised again to facilitate Taiwan's further industrial transformation from labor intensive industries to capital-intensive or high value added industries. The revision was to encourage formation and reorganization of foreign branches. The strategically encouraged industry expanded to Super IC/DRAM industry. Venture capital industry was further accorded beneficial tax treatment.

Changes at this revision included extending encouraged treatment to foreign branches other than subsidiaries (Article 3). But Article 13 provided that foreign branches' undistributed profits was treated the same as those of foreign subsidiaries. That is to say, no preferential tax treatment was conferred. The same tax exemption accorded to M & A under Article 38 was applicable to the reorganization of subsidiaries into branches. That is to say, tax exemption was conferred on income tax, stamp tax, and deed tax when purchasing or leasing land. But an additional 20% tax was levied on foreign branches for their profits repatriating to foreign parent in order to equalize the tax burden of branches and subsidiaries (Article 15).

Article 15 reduced maximum income tax rate for trading conglomerates to 22%, as opposed to the previous 25%. A tax deduction of up to 30% was accorded to specifically-encouraged high-tech industries such as Super IC/DRAM industry (Article 20).

The venture capital industry was accorded a 20% tax deduction of the investment amount; a reduced tax rate of 20% was levied on the venture capital industry (Article 15); this was a further reduction from the previous 25%. Article 16 provided a tax exemption of up to 80% of income for the venture capital industry.

Other revisions involved consolidation with other tax laws, for example, Articles 11, 29, 30, 33 and 45 were repealed because they were redundant with the new Business Income Tax Law. These provisions were about export income, national defense armament sales, and industrial use land regulation.

Table 15 Changes Made at the 1987 Revision of the Third Stage SEI

Scheme	Scope	Comparison with prior law
Tax Incentives Extended to Foreign Branch	1. applicable to productive industries' foreign branches, not including subsidiaries 2. but foreign branches' undistributed profits accorded the same treatment as foreign subsidiaries' undistributed profits; 3. but 20% tax rate was applicable to foreign branches' repatriating profits to their foreign parents;	N/A
Exemptions of Income Tax, Stamp Tax and Deed Tax	1. the same tax benefits accorded to M&A were applicable to reorganization of subsidiaries into branches;	
Reduced Maximum Income Tax Rate	1. up to 22% on trading conglomerates;	1. previously, 25%
Tax Deduction to Specifically Encouraged Industries—Super IC/DRAM Industry and Venture Capital Industry	1. up to 30% of investment for Super IC industry; 2. up to 20% of investment for venture capital industry	1. N/A, previously 2. Previously, 25%
Tax Exemption on Income	1. Up to 80% of income 2. Applicable: venture capital industry;	Previously, venture capital industry enjoyed beneficial income tax rate and tax exemptions for dividends

3.2.6 Consolidation--The Statute for Upgrading Industries (the "SUI")

After thirty years of a patchwork of continuous revisions, the SEI law created a tax regime too piecemeal and complex for tax administration. Redundancy or even language problems either canceled the intended effects or created unintended results. For example, one of the revisions in 1979 changed the language of Article 10, from "annual income" to "annual taxable income." Also Taiwan's basic tax incentive schemes were to grant tax exemption starting from the first year of starting sale of goods or employment. This created an inherent fallacy that some enterprises would never enjoy the entitled tax holiday since by nature the benefit was applicable only to those enterprises that enjoyed profits for taxable years. This problem triggered one of the major revisions in the Second Stage SEI: productive enterprises were to choose between either enjoying an income tax holiday or accelerated depreciation. Later, in the 1977 revision, Taiwan allowed capital-or technology-intensive industries to postpone the inception of the tax holiday.

Also, through a trial and error process, Taiwan's industrial policy changed from export-oriented labor-intensive industries, to capital- or technological intensive industries (i.e., heavy-machinery, basic metal, petro-chemical and vessel construction industries), to super ICs industries to high-tech OEM and computer chip foundries. This series of policy changes and industrial transformations made the SEIs obsolete. Taiwan thus decided to let the Third Stage SEI expire and replaced it with the Statute for Upgrading Industries (the "SUI") in 1990.

3.2.6 (a) The Creation of the Statute for Upgrading Industries (the "SUI")—1990

The SUI consolidated and streamlined the SEIs' tax incentive schemes, with a main directional change toward facilitating the establishment of high-tech based industries and upgrading all industries in Taiwan. To begin with, 44 provisions replaced the Third Stage SEI's 89 provisions. Productive industries were the applicable industries for the tax incentive system. The law had all the main features of the prior laws; that is, tax holidays, tax exemption, tax rate reduction, tax reduction, deduction carryover, and accelerated appreciation. But instead of prior laws' choice between tax holidays and accelerated depreciation, this law allowed the strategically important industries the choice between tax holidays and tax deductions and carryover for stocks as the basic structure. The encouraged industries included technological-, capital-intensive and venture capital industries. The tax incentive scheme was also extended to tech-based equipment and machinery and anti-pollution facilities purchases.

As its name suggests, this law aimed to provide incentives to upgrade all industries, including agriculture, manufacturing, and service sectors to make their transformation into technological-based industries possible (Article 1). Accelerated depreciation was accorded to companies' fixed assets (Article 2). Prior laws offered extensive accelerated deprecation incentives as manufacturing industries were the mainstay.

Tax deductions of up to 50% of income were conferred on investment in automated equipment and technology, waste management, resource recycling, R& D, and energy-saving equipment (Article 3). The deductible amount ranged from 5 % to 20 % of the investment. A four-year carryover was allowed when the deduction exceeded taxable income. The 50% income deduction was not applicable in the last year of the carryover. Prior laws had allowed the deductible amount to range between 10% to 15%, and four-year carryover (and once changed to five year carryover). Article 7 provided tax deductions of up to 20% of investment for investment in lagging areas. The deduction was to be carried over for four years. Similar tax deductions were accorded to stocks held for two and more years by investors of important technological-, capital-intensive and the venture capital industries (Article 8). These encouraged industries would choose between tax exemption of income tax or tax deductions of stocks (Article 8).

In the case of tax holidays, the measure was the same as in the SEIs; that is, a five year tax holiday starting from date of starting sale of goods/ providing services or employment. Enterprises were to choose postponement of starting date of tax holiday within two years of date of starting sale of goods/providing services or employment.

A 20% withholding tax was levied for nonresidents (Article 11). Prior laws had a 35% withholding tax rate. Income of foreign employees of an encouraged enterprise who stayed less than 183 days in Taiwan was deemed not derived from Taiwan (Article 12). This was the same as prior laws.

Article 13 continued the SEIs' incentive schemes for merger and acquisition, such as stamp tax and deed tax exemptions. Other measures such as forced plant relocation by reason of pollution (Article 14), increased amount of undistributed profits (Article 15), tax exemption of newly issued stocks by virtue of reinvestment and estate and gift tax consequences of such stocks (Article 16) were similar to the SEIs. The SUI also continued the SEIs' regulation of the development fund. The SEIs' extensive regulation of industrial use land was consolidated into a section devoted to regulating industrial complexes (Articles 23 to 42).

Table 16 Comparisons between the Basic Schemes of the SUI and the Third Stage SEI

Scheme	The SUI-1990	The Third Stage SEI-1980
Accelerated Depreciation	1. Fixed assets	1. Same 2. 2-year accelerated depreciation for energy-saving and anti-pollution equipment and machinery; 3. for upgrading equipment and facilities; reduction of up to 50% of useful life;
Tax Deduction	1. for investment up to 50% of taxable income; 2. deduction ranged 5-20% of investment; 3. 4 year carryover for deduction exceeding taxable income; 4. applicable to: automatic equipment and technology, waste management, resource recycling, R&D, energy-saving equipment; 5. deduction of 20% of investment for investment in lagging areas; carryover for 4 years;	1. Same; 2. Deduct 10-15% of equipment investment; 3. Carried over for next 4 years if deduction exceeded taxable income (later 5 years); 4. N/A to automatic equipment and technology, waste management, resource recycling; but applicable to R&D, energy-saving equipment; 5. N/A
Tax Holiday or Tax Deduction of Stocks	1. Deduction of 20% of value of stocks held two years or longer by investors of important tech-, capital-intensive industries and venture capital industry; 4 year carryover period; can choose between tax deduction and income tax exemption; 2. Starting date: a five year tax holiday started from date of starting sales of goods or employment; 3. Enterprises were to choose postponement of stating date within two years of date of starting sales of goods or employment;	1. N/A; Choice between tax holiday or accelerated depreciation; 2. Same; 3. N/A
Withholding Tax for Nonresidents	1. 20%	1. 35%
Taiwan-source income	1. Income of Foreign Employees of an Encouraged Enterprise who stayed less than 183 days was deemed not Taiwan-source income	1. Same
Exemption from Stamp Tax, Deed Tax	1. for M&A purposes; 2. applicable to forced relocation because of pollution;	1. Same 2. Same

Up to Two Times Paid-in Capital for Allowed Undistributed Profits	1. same	1. same
Tax Exemption of Reinvested Profits; But Estate and Gift Tax Consequences	1. Yes	1. same
Regulation of Development Fund	1. Yes	1. Yes
Regulation of Land Use	1. consolidated into sections regulating industrial complexes for high-tech industries;	1. regulated industrial use land;

Chapter 4 Conclusion

As with other East Asian NICs, Taiwan's tax incentive systems acted as a fiscal policy tool to facilitate Taiwan's leap into the success of sustained economic progress. Taiwan's system was created, revised and recreated again as the society changed over time. The system helped Taiwan grow from the 1950s-1960s' import substitution policy, 1970s' export oriented industries policy, 1980s' capital or technology intensive industries to 1990s' high-tech semiconductor chip manufacturing industries. Each period had its unique problems with which the Taiwan economic planning team responded. The responses to the challenges of the time thus reshaped the system time and again.

The system also benefited from learning from other NICs or advanced countries as long as the learning would benefit Taiwan. Such learning included the recent learning from Singapore, Japan, South Korea and UK. Broadly speaking, the financial aid from the U.S. acted as a catalyst for the creation of Taiwan's economic planning bureau and left an indelible mark in Taiwan's economic success story. Historically, the Japanese colonial legacy, including the physical and system infrastructures such as modern economic and financial systems, paved the road for Taiwan's later development.

The open and willing emulation of other societies' better systems played an important role in Taiwan's excellence in the economic competition. As a tiny island state where trading naturally prevailed, Taiwan had been accustomed to interaction with outsiders. Taiwan's trading and learning from more advanced countries at that time was historically inevitable—in Qing (Ch'ing) dynasty, trading and learning from mainland China, in Japanese era, trading and learning from Japan, during the Korean War and later, trading and learning from the U.S., and later, Taiwan's trading foothold set in every continent.

Taiwan's openness and learning contrasted with China's closed-door policy historically and before the 1978 opening. China has been plagued with ambivalence toward western systems ever since Britain treacherously forced China to open its port cities by the Opium War. Later in the Mao's Communist reign, self dependence (autarchy) and xenophobia, along with its communist ideology, prevented China from catching up with the times.

As a fiscal policy tool, tax incentive systems were not without criticism. Contrarians focused on the efficacy of the system from the angles of alternatives (Surrey) and context (Yelpaala). Others argued the system may be efficient from the points of cost (Zelinsky) and readiness to use (Okimoto). Country studies have shown that tax incentive systems may be secondary in investment considerations, but they may be important for certain types of industries such as export-oriented industries and large scale industries, not to mention that the lack of these systems may be perceived adversely by others as to the developing country's amenability to international standards and its willingness to improve the investment environment for foreigners.

Common bonds such as dense population, deficient natural resources, cultural common lineage, interlinked economic and trading activities were cited as motives and sources for the economic success of these East Asian NICs. Also, Taiwan, Singapore, Hong Kong, and other East Asian NICs all underwent administrative reforms, adopted export-oriented industrial policy at the outset, and liberalized fiscal and financial measures gradually. Each society at the same time faced its unique problems and circumstances and their solutions over the challenges must naturally be unique.

Using the evolution of Taiwan's tax incentive systems as an illustration, this thesis aimed to show how an East Asian NIC became what it has become today. Taiwan's unique solutions to the challenges of the time in the context of tax incentive systems showed responsiveness and flexibility in its economic planning. Note that the economic planning mechanism itself was not without criticism—scholars criticized this system as "ill-coordinated and fragmented." The team evolved from an agency handling the U.S. financial aid and was formalized when the U.S. aid left. The economic planning system consisted of technocrats who worked in multitudes of cabinet level decisionmaking environments—"a profusion of independent cabinet-level agencies." This system was criticized as lacking party and legislative supervision. Thus, the freedom of technocrats' decision making power in Taiwan was actually large, although somewhat counterbalanced by the complexity and fluidity of the administrative structure.

By analyzing the evolution of Taiwan's tax incentive system as part of Taiwan's economic planning measures, this thesis concludes that the freedom to respond and flexibility in the face of challenges may have been one of the crucial elements for the success of Taiwan's economic planning. This conclusion also coincides with one of the basic principles of tax policy in developing countries; that is, developing countries' tax policies should be practical and should accommodate the particular circumstances of the country in question.

In essence, Taiwan's system was more of a product of a trial and error process--dealing with the impacts more on an *ad hoc* case by case basis than through a forward-looking thought-out planning. As aforementioned, this character corresponded with that of Taiwan's economic planning machines—the policy-making process has been piecemeal and full of improvisation due to the ever shifting power center without party supervision. This character, however, created a freedom for the policy-making machines to react much unlike the comparable policy-making structures of a check-and-balance system such as those of the U.S. system. Paradoxically, this unintended freedom increased the policy-making machines' flexibility and capability, in contrast to Taiwan's relatively inflexible political machines and the policies. This freedom helped Taiwan rise to the occasion in the face of the ever-changing internal and international needs, impacts and the diplomatic impasse.

At this post -1997 Asian financial crisis era, the East Asian NICs' economic progress has slowed down and their economic decisionmaking has been in doubt. Numerous arguments have been advanced for the reasons of this "Great Asian Slump." Taiwan has actually fared relatively well. According to Wade, this is because Taiwan came out of similar crisis in early 1990s, thus survived relatively unscathed. (Wade, 1998: 698) Wang pointed out that the Taiwan government's lesser interventionist approach was behind the smoother path. (Wang, 2001: 2-3)

By examining the evolution of Taiwan's tax incentive system, this thesis concludes that Taiwan's flexible economic planning helped the shaping of Taiwan's economy today. An implication from this study is that this system may stand further testing if the pinpointed freedom of making decision and flexibility remain intact. At this juncture, reexamining the process Taiwan has gone through and remembering its lessons may be crucial for Taiwan's survival and prosperity in the new century. This study may also provide China, or other developing countries precious lessons in their common drive to reach prosperity facing the dilemma of danger and opportunity along the way.

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