

Taking small businesses seriously: a look at the Taiwanese experience



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This article looks at the legal and policy framework for promoting small and medium-sized enterprises (SMEs) in Taiwan over the last fifty years. As trade and investment relations between transitional economies in eastern Europe and Central Asia become closer, the Taiwanese experience may provide useful economic policy insights in SME-sector management for policy makers in transition countries.¹

The people of Taiwan have transformed their country from an isolated agrarian society in the 1950s into a vibrant, globalised, and industrialising economy with a strong high-tech sector at the beginning of the twenty-first century.² This island democracy has also managed to maintain equitable levels of income and wealth distribution. How were these results achieved? The promotion of SMEs has been a key component in Taiwan's success. The overwhelming majority of approximately one million companies in a country of 23 million citizens are SMEs, forming the *Mittelstand*³ or "middle class" of the Taiwanese economy. The Asia Pacific Economic Cooperation Forum (APEC) has acknowledged Taiwan's achievement in nurturing SMEs.⁴

A market-friendly legal system

The point of departure is the need for a market-friendly legal system, which effectively protects property rights and enforces contracts. Taiwan followed the European continental civil law tradition. Its Civil Code and commercial laws had been on the books in mainland China since the 1930s. Therefore, when the Nationalist government went to Taiwan in 1949, it brought a

well-established legal system to the island, a fact whose importance cannot be underestimated. Private entrepreneurs and SMEs would be more hurt by a deficient legal framework than well-connected corporate tycoons with access to political power.⁵

Throughout the last fifty years, courts in Taiwan have been able to effectively protect the property and contractual rights of business entities. There have been complaints about backlogs and delays in judicial proceedings, and Taiwan's judiciary has formally embarked on a path of judicial reform. Nevertheless, the codes and courts, as well as the property registration system, have laid the foundation necessary to resolve commercial disputes and attract foreign and domestic investment.

When societies evolve, legal systems should also evolve in order to meet new challenges and demands. The law against counterfeiting provides an example of this evolution. Even like many other industrialised countries, Taiwan is not free of piracy activities. Although the developing intellectual property regime has

Taiwan and the countries of eastern Europe and the CIS: a few comparative remarks

Unlike countries of the former Soviet block, Taiwan has virtually no natural resources. As a result, Taiwan has significantly focused its development on education. Taiwan also has essentially only one ethnicity in its demographic composition. This potentially simplifies internal transactions.

Whereas most of eastern Europe and the former Soviet Union were industrialised before World War II, Taiwan had an agrarian economy until the 1960s.

Another fundamental difference is that Taiwan has never lived under a socialist regime. There is a state sector, but its representation in the entire economy has been maintained at a manageable level, through privatisation and expansion of the private sector over time.

As with the countries of eastern Europe and the CIS, Taiwan has enjoyed abundant manpower during its economic takeoff phase. Eastern European economies also share the same Civil Law tradition with Taiwan

not matched the protection accorded to tangible rights, the situation started to change in the 1980s for two reasons.

First, Taiwan had to react to pressures from trading partners abroad by amending its IP laws and improving the enforcement mechanisms against infringements. The Fair Trade Law, which prohibits unfair competition, came into force in 1992 while courts and prosecutors began to interpret counterfeiting as a form of egregious economic crime.

The second and more important reason is that Taiwan began to foster the growth of the knowledge-based industry in the late 1970s, beginning with high-tech manufacturing and later focusing on higher value-added information technology products like printed circuit boards, chips, personal computers, and peripheral equipment. Taiwan could not have developed the high-tech sector without strengthening at the same time its intellectual property protection. In other words, Taiwan saw the wisdom of intellectual property laws and "internalised" the external pressure to protect those rights.

Why is this evolution in the legal and economic framework important to SMEs? The answer is simple - SMEs can become powerful companies later and should receive proper training while they are young and inexperienced. When Taiwan's economy began to transform in the late 1980s because of increasing labour and land costs, SMEs could not survive without adapting. One form of adaptation, discussed below, was start-up companies gaining access to venture capital and moving into the higher value-added sector. In this sense, intellectual property protection was not only desirable but essential for the expansion of Taiwanese SMEs.

Government support

As Taiwan's economy began to take off in the 1960s, its growth pattern was highly correlated with an increasing emphasis on the creation of a favourable climate for SMEs.

In 1966, the government of Taiwan set up the first task force to support SMEs. Foremost among its objectives was to establish financing and revolving credit facilities for SMEs. In 1981, the Ministry of Economic Affairs set up an SME department to formally carry out SME policy formulation and implementation. In 1993 the Statute for the Development of Small and Medium Enterprises was enacted, and in 1997 a constitutional amendment authorising the government to support start-up companies and protect their development was adopted.⁶

The time gap of more than a quarter of a century between forming the SME task force in 1966 and enacting the SME Statute in 1993 illustrates a common phenomenon in developing economies - informal directives issued by government agencies, rather than formal legislative enactments, played an important role

during this formative period.

Low entry and operating costs

The two most popular forms of business organisations under Taiwan's company law are a company limited by shares (equivalent of the German Aktiengesellschaft) and a company with a limited liability shareholder (equivalent of the German GmbH). Many SMEs in Taiwan opt to incorporate themselves as companies limited by shares for image, tax and future stock listing reasons.

As with other civil law countries, these companies must have a minimum amount of capital paid in by shareholders.⁷ Paid-in capital requirements fixed by the government can act as barriers to entry. Therefore, in recognition of entrepreneurial initiative and in an effort to foster economic development by encouraging investment, the Taiwanese government chose not to place the minimum capital requirements at high levels.

Instead of acting as a barrier, paid-in capital requirements in Taiwan have been used to offer tax incentives for certain manufacturing activities. This arrangement clearly reflects the government's industrial policy to encourage economies of scale for selected products and activities. In general, when such tax incentive programmes are being planned, the beneficiary industry has the opportunity to discuss with the Industrial Development Bureau the optimal eligibility rules, such as the corresponding minimum capital requirement.

In theory, the purpose of imposing a minimum paid-in capital requirement is to provide a protective cushion to creditors in the event of insolvency. In reality, however, the Ministry of Economic Affairs, which enforces the provisions of the company law, has not even made inflationary adjustments to the required minimum for the last two decades. In other words, in real monetary terms the Ministry of Economic Affairs has been continuously reducing the minimum capital requirement and hence the market entry barriers, thereby promoting SME growth and expansion.

Open and externally-orientated economy

Globalisation and an active World Trade Organisation have contributed to the opening up of national economies on a scale unknown in the early 1960s, when Taiwan began to promote its SMEs. However, Taiwan has persistently adhered to market-friendly policies of great importance to SMEs, such as facilitation of export financing, creation of export-processing zones and providing trade information and related support to exporters.

Because of this strong export promotion policy, Taiwan's SMEs became internationally competitive. Initially, Taiwan's SMEs could not compete with bigger domestic firms on the domestic market. However, export markets gave them the opportunity to globalise early on, although at the very low value-added end and only for

processing contracts. When the domestic market (including the importing regime) began to open up in the late 1980s, Taiwan's SMEs were well-positioned to expand rapidly.

It is impossible to empirically demonstrate what the impact of earlier domestic liberalisation on SMEs would have been. However, a fair guess would be that SMEs would have been even more competitive in the long run. The sooner a country opens up its domestic market and removes restrictive and sector-specific laws and rules that are anti-competitive, the easier it is for SMEs to adapt and expand in the future.

The banking system

Until the early 1990s, the government exerted tight control over the banking sector. Most deposits and loans outstanding were held by state-run banks. While a system organised by the state offered stability, this was at the expense of efficiency. SMEs found it difficult to obtain financing because state-run banks relied predominantly on asset-based lending. Collateral was preferably real estate (and stocks and bonds since the 1970s), as well as personal guarantees by directors of corporate borrowers, including SMEs. Therefore, SMEs often had to rely on the informal market to cover their financing needs.

In response, the government of Taiwan set up a credit guarantee fund for SMEs in order to alleviate their problems in gaining access to bank credit. The fund has suffered financial losses, which in practice can be viewed as subsidies to an SME lending pool. Currently, there is a plan to impose more discipline on SME borrowers, so that those receiving loans and credit guarantees from this fund will also receive technical consultation, a form of mandatory venture capital training.

In an effort to address, at least in part, the issue of the informal economy, a provision in Taiwan's company law requires companies with a certain level of paid-in capital (as set forth and updated by the Ministry of Economic Affairs) to retain external auditors to certify their financial statements.⁸ In addition, the financial accounting law requires businesses of a certain size to set up an accounting system that meets minimum integrity standards.⁹ Even though there is still much room for improving the corporate governance regime in Taiwan today, professionals, such as certified public accountants, have been designated as gatekeepers in a private-sector driven economy.

The most important measure, however, was the banking law reform in 1989 and the liberalisation of the banking system in the 1990s. Overall, service quality in the banking sector has improved, and there is now less need to rely on the informal sector as a source of financing.

Functioning and efficient capital markets

Taiwan began to develop its capital market in the early

1960s. However, due to concerns about speculations and the lack of capital market spirit in the population until the late 1980s this capital market was not efficient; few firms were listed, and liquidity was low. This situation started to change dramatically during the mid-to late 1980s, as more firms sought listing to gain access to public funds, and the banking sector began to witness the direct access of companies to capital markets.

There are now more than 1,000 firms listed on the Taiwan Stock Exchange and the GreTai Securities Market. Most of them trace their humble beginnings to an SME¹⁰. In 2002, Taiwan's listed companies raised substantial funds from abroad, attracting the heightened attention of the investment banking community in Asia. Taiwan's securities and exchange law has also evolved in the last three decades to meet the needs of firms raising funds.¹¹ Strengthening the corporate governance regime of family-controlled listed firms is the present challenge facing Taiwan's Securities and Futures Commission.¹²

Promoting high-tech start-ups and venture capital

In the early 1980s, Taiwan's government began to study and implement the venture capital experience of the United States. It then brought in venture capital (VC) firms like Hambrecht & Quist and Walden. The Chiao Tung Bank, the China Development Investment Corporation (now an industrial bank), and the Development Fund began to offer venture funding to scientists and engineers. Many of them were trained in the West and had worked for global companies such as IBM, Intel, HP, and Xerox but wanted to set up their own business, either in Silicon Valley or in Taiwan's Hsinchu Science Park.

These government efforts have spawned a vibrant VC industry in Taiwan, and the members of the Taiwan Venture Capital Association consider themselves to be representatives of the most active VC environment outside the United States, even though in dollar amounts Taiwanese VC firms may not be the best-funded ones. In essence, the VC industry was created because the government introduced specific rules to encourage VC funds to be set up (as companies limited by shares, for the reasons mentioned above). It also offered tax credits for investments in high-tech companies or VC funds.

The emergence of the capital market and the maturity of the Hsinchu Science Park, both of which occurred in the 1980s, provided a strong base (and an interesting exit alternative for founders) for start-ups and VC funds. The timing of these policies made good sense within the context of Taiwan's development model. In addition, even though Taiwan's corporate and securities laws are rigid, entrepreneurs and VC firms were able to use the low transaction cost and the cluster effect of locating start-up firms close to one another to draft flexible contracts. In this way, they were able to achieve an efficient vertical division of labour in the relevant

segment of the global high-tech industry.

Tax reform and alleviation of double taxation

Through its tax collection power, the government is an important stakeholder in SMEs. When Taiwan began its economic development, it was tempted to impose high import duties and domestic taxes. However, economists in Taiwan have long argued that such a policy would foster the informal sector and skew work incentives.¹³

In the mid-1980s, Taiwan amended its business tax law and implemented a value-added tax system that reduced double taxation in the consumption of goods and services. In 1998, Taiwan amended its income tax law and implemented an income tax integration plan. As a result, corporate income taxes will be used to offset individual income tax liabilities, and double taxation of income has been reduced. Generally speaking, these tax reforms are favourable to SMEs as they have decreased the overall tax cost of their business.

Labour mobility and incentives

One of the factors contributing to the success of Taiwan's SME sector is labour mobility. Until the mid-1980s, labour laws did not inhibit economic growth. It must be pointed out that martial law was enforced in Taiwan until 1987, and labour unrest was frowned upon. Economists in Taiwan have conducted empirical studies to demonstrate that over the decades wage levels in Taiwan have risen at a pace commensurate with economic development. Indeed, Taiwan's SMEs are renowned for the entrepreneurial spirit of their employees, who often see themselves as "big fish in a small pond" with the objective of setting up their own business one day.

Anecdotal evidence suggests that covenants "not to compete" were rarely imposed on former employees in the past and have received heightened judicial scrutiny since becoming more popular in the high-tech sector in recent years.

Taiwan's company law also requires that the articles of incorporation of each company set forth a voluntary percentage of net income after tax to be used as employee bonus.¹⁴ Such bonuses may be paid in stock, and this practice has become very popular with high-tech start-ups and listed companies. In addition, Taiwan's company law also requires the company to set aside at least 10 per cent of any cash offering for subscription by employees so that they can become owners.¹⁵

During the early years of Taiwan's economic development, these bonus and share offering schemes reflected a laudable desire to improve labour welfare. They were also intended to make employees minority shareholders in the firm as a remedy to the "agency cost" problem posed by the theory of the firm.¹⁶ On the other hand, these indigenous efforts also suggest that Taiwan's corporate law could not afford alternative tools

to achieve this goal. In recent years, the company law and the securities and exchange law have been amended to allow stock options and treasury shares, so that employee ownership can be achieved in ways that conform more closely to standard international practices.

On the other hand, the labour standards law, enacted in 1984 largely for the manufacturing sector and now applicable to essentially all businesses, is viewed as imposing too much rigidity on the employment market. Although the law creates pension fund and severance payment obligations on the part of the employer following a defined benefit plan model, many SMEs have underfunded their liabilities. Currently, Taiwan is considering proposals to switch to a defined contributions plan model and to allow pension portability.

Conclusions

By all accounts, Taiwan's economic development model has been a success, and SMEs constitute one of its integral elements. As this article highlights, laws, rules, agencies, and policies (constituting what some economic historians like Douglass North call "institutions")¹⁷ have to a large extent shaped the strengths and weaknesses of the SME sector in Taiwan. The more adventurous Taiwanese SMEs have become major investors in China and Southeast Asia. Taiwan's experience in promoting SMEs could be a useful tool for policy makers and private firms in eastern Europe and the former Soviet Union in their continuing efforts to encourage and develop their domestic SME sector.

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¹ At the same time, the differences in the local conditions need to be recognised and any comparison between post-communist economies and Asian models should be viewed as an approximation and subject to further studies. Regarding trade, although Taiwan's investment in eastern Europe and Central Asia is insignificant at present, bilateral trade has grown substantially. In 2002, Taiwan's trade with central and eastern Europe reached US\$1.214 billion, representing a 26 per cent increase from 2001. Similarly, trade with CIS countries for 2002 amounted to US\$1.620 billion, up by 38 per cent from 2001. For more information, see <http://www.cieca.org.tw>

² See K.T. Li, *The evolution of policy behind Taiwan's development success*, Yale University Press (1989).

³ This term is commonly used to refer to SMEs in Germany.

⁴ See "Strengthening an APEC entrepreneurial society", APEC SME Ministerial Statement (2003); "Expanding the benefits of cooperation for SMES", APEC SME Ministerial Statement (2002).

⁵ See Lawrence S. Liu and Tain-Jy Chen, "The role of law and legal institutions in Asia economic development: the case of

Taiwan, patterns of change in the legal system and socio-economic development" Harvard Institute of International Development, Working Paper No. 663 (1998).

⁶ Constitutional Amendment, art. 10 (3).

⁷ Company law of Taiwan, art. 156.

⁸ *Id.*, art. 20.

⁹ Art. 9, 79.

¹⁰ One example is Acer, Taiwan's premier information technology company founded in the early 1980s.

¹¹ Art. 22.

¹² See Lawrence S. Liu, "Law and political economy of capital market regulation in the Republic of China on Taiwan", *Journal of law and policy in international business*, Vol. 28 (3), pp. 813-856 (1997).

¹³ See, for example, Sho-chieh Tsiang, *Lessons from the economic development of Taiwan* (in Chinese), pp. 284-309, Commonwealth Publishing Co., Taipei, Taiwan (1985).

¹⁴ Art. 235.

¹⁵ Art. 267.

¹⁶ See, for example, E. Fama, "Agency problems and the theory of the firm," *Journal of political economy*, Vol. 88, pp. 288-307 (1980); M. Jensen and W. Meckling, "Theory of the firm: managerial behavior, agency costs, and ownership structure," *Journal of financial economics*, Vol. 3, pp. 305-360 (1976).

¹⁷ D.C. North, *Institutions, institutional change and economic performance*, Cambridge University Press (1990).