Specter of Inequality Haunts Taiwan

by Craig Meer and Jonathan Adams

Pan Da-wu has fallen on tough times. Ten years ago, during the go-go 1990s when Taiwan’s economy was still booming, he was a manager at a reshipment company, pulling in NT$90,000 ($2,745) a month. Now, to make ends meet, the 45-year-old father of one is driving a cab seven days a week, more than 12 hours a day, and barely manages to earn NT$30,000 a month.

Mr. Pan blames his lot on his lack of skills, and the flight of the island’s manufacturers to China. “If you are over 40 and don’t have any qualifications, you’re struggling,” said Mr. Pan, whose wife left him a few years ago. “In the past, older people could get jobs in factories, but most of those jobs are gone now—all the companies have left for China. To support a family these days, you need to make more than NT$50,000 a month, and most guys my age and with my qualifications find this nearly impossible.”

Mr. Pan’s case is hardly unusual in Taiwan these days—or for that matter, in other countries across Asia. In country after country, the gap between the richest and the poorest is growing sharply wider, and the middle class is getting squeezed. Once-comfortable families are seeing real incomes erode, and watching as their slice of the pie gets ever smaller.

The International Monetary Fund’s September Regional Economic Outlook for Asia notes that income inequality increased “dramatically” across Asia in the last decade. In that time, 13 out of 18 Asian countries posted increases in income inequality, as measured by the Gini coefficient. Ten out of 15 have a widening richest-poorest income gap, with South Korea posting the sharpest divergence. And a majority of countries are seeing a shrinking middle class, especially China and Sri Lanka.

Rising inequality is nothing new, but with the trend speeding up in recent years, the IMF and others are starting to sound an alarm about the dire implications for the region. “Economists have shown that countries that are more unequal are more likely to have social conflicts and ethnic tensions,” says the IMF’s Erik Lueth, a co-author of the chapter on inequality in the latest Regional Economic Outlook. Indeed, the two countries with the sharpest recent rise in inequality as measured by the Gini index—Sri Lanka and Nepal—are embroiled in a civil war and insurgency, and the number three country, China, is increasingly wracked with social unrest.

A widespread assumption is that the driving force behind growing inequality is globalization. But the IMF report challenges that view. It finds no link between trade...
openness and income inequality, and no effect on income inequality from net foreign direct investment flows. According to the IMF, technological change is a more likely cause for rising inequality across Asia. “Skill-biased technological progress represents a shift in the production technology that favors skilled over unskilled labor,” says the report. That process of technological advance would be happening regardless of the openness of a given country to foreign trade. In other words, says the IMF, don’t blame globalization.

Some dispute that conclusion, though. Political economist Robert Wade, from the London School of Economics, says the jury is still out on the link between more open trade and inequality. And he says the IMF has set up a false alternative of the cause of inequality (either more open trade, or technological progress), when the two may actually be linked. “Skill-biased technological change may itself be a result of greater openness,” says Mr. Wade. “I’m skeptical of the [IMF’s] explanation, because official agencies like the World Bank and the [International Monetary] Fund are always falling over backwards to deny that trade can have anything but benign consequences.” Moreover, the IMF’s finding conflicts with some other studies in the field. For example, while the IMF found that FDI did not worsen inequality, a study published in 2003 by economists Rafael Reuveny and Quan Li concluded that inbound FDI did.

Tired-out Tiger

Is the IMF right? To address that question, we turn to the case of Taiwan. Not so long ago, Taiwan was the poster child for equitable growth. From 1964 to 1980, it saw an export-led boom in which GDP expanded at an average of more than 10% per year and incomes actually became more equal—the Gini coefficient declined from 0.32 to 0.28 (a Gini coefficient of zero represents perfect equality and a coefficient of one represents perfect inequality). The island’s success in light manufacturing for export has often been cited by those singing the praises of globalization. Through trade, Taiwan’s pie got a lot bigger a lot faster, and everyone got a slice.

However since 1980 income inequality in Taiwan has gotten steadily worse. The Gini coefficient peaked at 0.35 when the tech bubble burst in 2000, and has only fallen slightly since, to 0.34. The richest 20% in Taiwan have seen their share of income rise from 36.8% in 1980 to 40.2% last year, while the share of the poorest 20% has fallen from 8.8% to 6.7%.

Ask economists and government officials what has driven Taiwan’s trend of growing inequality, and technological progress isn’t high on the list. Jack Hou, an economist at California State University, Long Beach, cites the narrative familiar to many on the island: As Taiwan’s manufacturing firms decamped to China in recent decades, less-skilled factory jobs went with them, pushing unskilled, middle-aged factory workers into jobs that paid less. The island’s skilled workers fared much better: A 2003 study by economists Lin Chun-hung and Peter Orazem, for example, found a persistent shift in demand toward skilled labor, with returns for a college education rising from 1978 to 1996 for all but the least experienced college graduates.
For Taiwan, to focus only on technology is to ignore the 800-pound gorilla next door: China, whose own boom has sent shock waves through the island’s economy. By shifting factories to China, with its lower costs for labor and raw materials, many of the island’s firms actually avoided the need to upgrade their technology to stay competitive. Some firms moved entire operations across the Strait, pulling major suppliers along with them. “China has given many firms a second life,” said Hung Jui-bin, from Taiwan’s Council for Economic Planning and Development. “The wage costs in Taiwan are too high for a lot of companies and if they stay here they will face financial problems. So they go to China and, because the costs are so much lower, they can continue doing the same business with the same equipment.”

That exodus to China was made possible by increasing capital mobility. In a 1995 case study of outbound FDI for the United Nations University, economist Nagesh Kumar noted that Taiwan relaxed previously rigid controls on outbound FDI in the late 1970s, and began to actively promote outbound FDI in the mid-1980s. At the same time, rising wages and a sharply appreciating New Taiwan dollar eroded the competitiveness of the island’s exports—leading factory owners to cast their eyes abroad, especially to Southeast Asia. The result was a torrent of money flows out of Taiwan, with the stock of official outbound FDI surging to $3 billion in 1990 from just $26 million in 1975. And that was just in the beginning. Taiwan began to approve official China-bound investment in 1991, and China itself became more open to foreign money later in the 1990s. By last year, approved outbound FDI stocks from Taiwan hit $91.7 billion, with more than half of that ($47.2 billion) going to China. And that last number is thought to vastly undercount real flows: This year the government guessed that Taiwanese had invested a staggering $150 billion in China since the 1980s, if unapproved and indirect flows are included.

That massive stream of money out of Taiwan mirrors the larger global rise of footloose capital and often volatile money flows. For political reasons, and to avoid overdependence on one market, the Taiwanese government has tried to stanch the flow of investment to China, but with scant success. Taiwanese firms have simply routed investment through shell companies in third locations such as the Cayman Islands and Hong Kong, doing an end-run around the island’s financial regulators.

Many in Taiwan—particularly those with pro-independence leanings—blame the flight of Taiwanese investment to China for a host of the island’s economic ills, including rising inequality. “The Taiwanese firms that invest in China are often not expanding into China, but leaving Taiwan and relocating completely,” said David Hong, president of the Taiwan Institute of Economic Research. “When they leave, they take important human capital with them and that is a net loss to the Taiwanese economy.”

However, Taiwan’s investment in China is just the most glaring example of a broader trend of huge outflows that began in the 1980s—at the same time that Taiwan began its two and a half decade trend toward greater inequality. Perhaps Taiwan’s unique
relationship and proximity to China make it a special case. But South Korea similarly relaxed outbound FDI controls in the mid to late 1980s, and saw rising inequality a few years later—a trend that spiked sharply after the capital flight of the 1997 East Asian Financial Crisis and has continued to increase rapidly.

Of course, two coincidental trends—higher FDI outflows and growing inequality—do not prove a causal link. And the IMF is not necessarily wrong to cite skill-biased technological progress as one cause of rising inequality across a broad swathe of Asian countries. But in the specific case of Taiwan, that explanation is at best too simple, and at worst misleading. For Taiwan, the circumstantial evidence is compelling: technology looks like just one piece of a puzzle, and likely a minor one at that, with the relaxation of capital controls and flight of corporate investment to China key factors behind a worsening income gap.

What Can Governments Do?

Governments who seek to reduce income inequality face a dearth of viable options: It is much easier to identify what doesn’t work than what does. Trade and capital controls are problematic, spending on retraining and education may only have limited impact, and more progressive taxation is often a political nonstarter. For economies like Taiwan’s, the best course of action may be to promote a more efficient and higher-quality services sector.

Absent any solid evidence that more trade leads to rising inequality, erecting trade barriers could be counterproductive and would likely only shrink a country’s GDP. Capital controls are more tempting, with some evidence that both inbound and outbound FDI may be linked to rising inequality. But after opening the floodgates in the 1980s, it’s unlikely that countries like Taiwan and South Korea would be able to dam up the flows now—and such moves would likely only hobble their firms’ international competitiveness. Taiwan’s China-specific controls, as already noted, have not been effective.

Although China-bound investment is officially capped at 40% of a firm’s net worth, companies get around this by establishing subsidiaries abroad. In fact, some economists and politicians—especially on the pro-unification side—argue that fewer controls on China-bound investment, along with direct cross-Strait transport and banking links, would actually encourage more Taiwanese money and talent to stay on the island.

With few experts willing to be seen as opposing globalization, the usual prescriptive mantra for fighting inequality is more education and training. From Thomas Friedman to Joseph Stiglitz to the IMF, the pundits are unanimous in suggesting that governments must help more of their citizens gain the high-end skills they need to survive in today’s globalized world. But bluntly put, for many less-skilled workers—particularly older ones—no amount of retraining and continued education is going to bump them into the highly-skilled, high income bracket. Taiwan has high education spending and a strong safety net that includes comprehensive national health care, which accounts in part for the
absence of extreme poverty on the island. But such benefits have not reversed the trend toward more inequality.

Progressive taxation is an often-proposed fix from the left, but redistributing funds from the rich for social programs may have only marginal returns. Moreover, in many countries such policies are becoming harder to sell politically.

For Taiwan, perhaps the best fix is to upgrade its services sector—which now accounts for more than 70% of GDP and most of the island’s jobs. The bitter irony of Taiwan’s restrictions on China-bound investment is that they lock critical sectors of the economy into a state of competitive immaturity. The banking sector is a case in point: The sector remains hopelessly inefficient, with too many banks employing too many people, and rigid government controls over domestic mergers and acquisitions. Taiwan bans its banks from opening branches on the mainland, which has blunted their ability to compete. Macquarie Research Equities wrote in a recent note: “Without access to China (or M&A) in the medium term, the banking sector is structurally moribund.” Making service sectors such as banking more competitive could be the key to raising wages for the middle and lower middle class—and that goes for countries at similar developmental stages, like South Korea.

**Rumblings of Discontent**

Clearly there are few realistic options for reversing inequality without blunting competitiveness. But the cost to governments of doing nothing is also high. In China, the growing divide between haves and have-not’s—which often breaks down as a divide between rich coastal areas and the poor hinterland—has spooked Beijing into action. The gap, compounded by widespread corruption among local Communist Party cadres, is seen as one of the driving forces behind the often-quoted “87,000 civil disturbances” that occurred last year. In the Philippines, inequality has helped feed a decades-long Islamist insurgency in the nation’s disadvantaged south—and the political dominance of a powerful landed elite has long blocked much-needed economic reforms. In South Korea, the IMF report quotes an official saying that “if the polarization problem is left unresolved, South Korea could be divided into two, resulting in three Koreas on the peninsula.”

In Taiwan, the political implications of rising inequality aren’t as obviously apparent—possibly because the problem in Taiwan (with a 0.34 Gini coefficient) is far less acute than in regional peers like the Philippines (0.46) and Malaysia (0.49). But one little-noted aspect of the recent street protests against President Chen Shui-bian is that they were in large part a middle-class revolt. “The wealth gap in Taiwan is very wide, and that was a key point for the protesters,” said Marion Wang, a political scientist at National Sun Yat-sen University in Kaohsiung. “Many in the middle class feel that their standard of living has been downgraded. Their incomes have decreased, but prices are rising.”

The protests drew most of their recruits from pro-opposition urbanites who have seen their salaries stagnate or drop, while Mr. Chen allegedly lavished diamond rings and
other goodies on his relatives with public funds. It’s unlikely that so many Taiwanese would have taken to the streets over Mr. Chen’s alleged misdeeds were it not for the widespread perception that he has failed to revive a flagging economy in which only the rich are getting ahead. “If you take a look at the protesters, a lot of them are middle-aged women,” said Mr. Pan, the cab driver. “They’re having trouble balancing the family budget because their husbands don’t make enough, and then they see this corruption on TV and it makes them furious.”

Unless they can find a way to tame rising inequality, Asian leaders are likely to see more of that fury—either at the ballot box, on the streets, or in a worst case scenario, through more violent forms.

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