

# Democratization and Financial Reform in Taiwan

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## **Abstract**

On surface, Taiwan's successful political democratization seems to materialize at a price of economic downturn. However, this paper argues that after an initial negative relationship between democratization and economic development, Taiwan is likely to embrace both achievements. The major cause of the initial tradeoff between democratization and economic development was due to the incorrect strategic choices made by former President Lee Teng-hui that undermined both democracy and economic development. He inaugurated the vicious crony capitalism, composed of the state, the KMT, protected conglomerates, and local factions, in order to consolidate his presidential power. The presidential turnover of 2000 largely broke up the old crony capitalism. But continued democratic reforms are needed in order to prevent the emergence of new crony capitalism. This paper uses a case study of financial reform to elaborate these arguments.

## I. Introduction

March 18, 2000 marked a watershed in Taiwan's political history: the island celebrated the first party turnover of the presidency since the Kuomintang (KMT) government moved to Taiwan in 1949. The Democratic Progressive Party (DPP) candidate Chen Shui-bian defeated both KMT candidate Lien Chan and People First Party (PFP) candidate James Soong, and became the tenth President of the Republic of China on Taiwan. This "democratic miracle" started in 1987 when the Taiwanese government lifted the 48-year martial law. Afterwards, Taiwan experienced a transitional phase of constitutional amendments, occasional legislative fist-fights, and somewhat chaotic street demonstrations. But the party turnover of the presidency was a very smooth process without major constitutional changes, military coups, and violent street demonstrations that often accompanied government turnovers in other developing countries.

However, escorting this "democratic miracle" has been Taiwan's economic slowdown since 1987. Taiwan's economic growth rates have continually declined from 11.64% in 1986 to 6.68% in 1997 and to -2.18% in 2001. This opposite development seems to lend support to the thesis that there is a necessary tradeoff between political democratization and economic growth. The financial sector is particularly hard hit. Even before the 1997 Asian financial crisis, many large Taiwanese conglomerates had reported serious problems with their financial structure and suspended loan payments. The government reported that non-performing loan (NPL) ratios were on the rise and reached a historical height of 8.78% in the first quarter of 2002.

Is political democratization to be blamed for the economic downturn in the past sixteen years? Or is it due to the lack of democratic institution-building that has caused the downturn? Using the case of financial reform, we argue that the lack of democratic institution-building, which would provide transparency and accountability to economic agents, has been the major cause for the growth of "crony capitalism" before the 2000 presidential turnover. However, after the presidential turnover in 2000, institutional relationships among the major financial actors of the crony capitalism have broken down and been transformed. Democratization seems to finally bear economic fruits after a transitional adverse impact. But whether the economic fruits can be sustained still hinges on the continued democratic reform.

The next section of this paper summarizes Taiwan's democratic progress, economic digress, and financial instability over the past sixteen years. Building upon the literature of neo-modernization school and state-institutionalism, the third section

briefly explains the theoretical arguments of this paper. The fourth section studies financial crony capitalism prior to 2000. The fifth section examines the transformation of crony capitalism after 2000. Based on these analyses, the final section submits proposals for future financial reforms.

## **II. Democratic Progress, Economic Digress, and Financial Instability**

Parallel to its well-known “economic miracle” generated during the 1960s and 1970s, Taiwan’s remarkable progress in democratization since the lifting of martial law has also earned herself a new title of “political miracle”. In 1997, Freedom House awarded Taiwan’s improvement in civil liberties and political rights by promoting her to the rank of liberal or electoral democracies, on par with other Western democracies. Translated into academic jargons, Taiwan’s democratic system has fulfilled Robert Dahl’s seven criteria of democracy (or seven “institutions of polyarchy”): elected officials in control of government decisions, free and fair elections, inclusive suffrage, the right to run for office, freedom of expression, alternative information, and associational autonomy.<sup>1</sup>

In addition, Taiwan has experienced turnovers in both the executive and legislative branches of government without military coups or major incidences of violence in the streets. The passing of mainlander President Chiang Ching-kuo in 1988 and the succession of native Taiwanese Vice President Lee Teng-hui was not only accepted by the mainlander-dominated ruling party KMT. The succession was also enthusiastically embraced by many members of the opposition party DPP.

A more critical test came on March 18, 2000, when the DPP presidential candidate Chen Shui-bian defeated the two candidates from the newly split KMT by a small margin. While Chen received 39% of the total votes, Lien Chan of the KMT and James Soong of the PFP garnered about 23% and 37% respectively. It was a crucial moment in Taiwan’s democratic history, not only because it was the first time an opposition party assumed power, but also because the military, which had declared the DPP as nothing but a conspiracy group, acquiesced to the new leadership. A small-scale street demonstration orchestrated by some grudging KMT members

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<sup>1</sup> Robert Dahl, *Polyarchy: Participation and Opposition* (New Haven: Yale University Press, 1971). For more detailed discussion of Taiwan meeting these seven criteria, see Chengtian Kuo, “Taiwan’s Distorted Democracy in Comparative Perspective”, *Journal of Asian and African Studies*, Vol. 35, No.1, (2000), pp.85-111.

occurred at the night of the election. The demonstration appeal, however, was targeted not at the new ruling party, but at the former President Lee Teng-hui (also chairman of the KMT), who allegedly withdrew his support of the weak KMT candidate in the last minute in order to prevent mainlander James Soong from winning the presidential race.

Although the DPP became the ruling party, it remained the minority party in the legislature, which had been dominated by the KMT since 1949. This resulted in a number of legislative deadlocks over high-profile issues such as the construction of the fourth nuclear power plant and over the constitutional revision. However, the political balance shifted to the DPP's favor after the legislative election of December 2001. It harvested 87 of the total 225 seats, making it the largest party in the legislature. The KMT finally conceded that it would play the responsible role of a loyal opposition party, even though a coalition of the KMT (68 seats) and the PFP (46 seats) would ensure a slight majority in the legislature.

As the Taiwanese celebrated their democratic miracle, their economic miracle was receding from the scene. The Taiwanese economy performed well after the second oil crisis in 1979. It continued to grow with a remarkable speed, reaching a peak of 12.7% in 1987 (see Table 1). Since then, however, economic growth has rapidly reversed its course. Even before the DPP took over the presidency, the economy still registered a modest growth rate of 5.4% in 1999. Did the presidential turnover bring out economic recovery? Not immediately. In fact, the 1<sup>st</sup> quarter of 2000, before the election, still reported a seasonal recovery of 7.9% growth, but immediately dropped to 3.7% in the 4<sup>th</sup> quarter. In the following year, the Taiwanese economy experienced its first negative growth in its 56 years of otherwise glorious history.<sup>2</sup>

[Table 1 about here.]

With some time lag between economic decline and the rise of unemployment, Taiwan's unemployment rates tell a similar story. When the Taiwanese economy began its decline in 1987, the unemployment fell from 1.97% in 1987 to 1.45% in 1993. Afterwards, the unemployment rate began to follow the pace of the general economic decline. It climbed up from 2.6% in 1996 to 3.0% in 2000 and to 4.6% in

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<sup>2</sup> <http://140.129.146.80/dgbas03/bs8/world/gnprate.htm>, accessed on October 6, 2003.

2001. In 2002, it broke another record and reached the historical height of 5.20%.<sup>3</sup>

The financial sector exhibits a similar pattern. Hurt by the 1997 Asian financial crisis, many of Taiwan's large conglomerates, including Tun Lung Metal Company, Kuangsan Group, Xin Ju Qun Group, Kuo Yang Construction, Chinese Automobile, and An Feng Steel, reported serious problems in their financial condition and caused serious repercussion in the financial market. Taiwan's NPL ratio reached a historical level of 8.78% in the 1<sup>st</sup> quarter of 2002.<sup>4</sup> Although this figure was below that of other Asian countries when the 1997 crisis broke out (some Asian countries reported more than 10%), the sharp and continued rise of NPLs created an unprecedented confidence crisis in the financial sector.

The deterioration of the financial market resulted in even more serious problems at the local level. According to the recent statistics published by the Ministry of Finance (MOF), NPL ratios of Taiwan's local financial institutions, including farmers' associations, fishermen's associations, and credit unions, increased from 4.02% in 1995 to 8.53% in 1997 and to 15.37% in 2002. In addition, bank-runs have occurred more frequently and more seriously after 1994 than ever before. According to Bao-An Lin's research, in the period of 1991 to 2001, uncertainty in the credit institutions led to eighty-three bank-runs at national banks and local credit institutions, with sixty-three occurred between 1995-1997.<sup>5</sup> The rising NPL ratios and the expanding bank-runs prior to the 1997 Asian financial crisis meant that the structural weakness of the financial market was caused not only by exogenous shocks but probably more by domestic factors.

How do we explain the negative relationship between democratic progress on the one hand and economic decline as well as financial instability on the other hand in Taiwan? The next section introduces the theoretical arguments of this paper.

### **III. Theoretical Arguments in Brief**

Scholarly debate on the relationships between democratization and economic development has gone through three stages. The modernization theory of the 1950s and early 1960s proposed a positive relationship between democratization and

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<sup>3</sup> <http://www.moea.gov.tw/~meco/stat/four/a-13.htm>, accessed on October 6, 2003.

<sup>4</sup> <http://www.boma.gov.tw/files/sta/index-10.xls>, accessed on October 17, 2003.

<sup>5</sup> Bao-an Lin, "Taiwan 1990 Niandai De Jinrong Jidui, Hebing Yu Jingrong Zhixu" [The Bank-runs, Merges, and Financial Orders of Taiwan in 1990s], papered presented at the annual meeting of Taiwanese Sociological Association, Taichung: Thunghai University, December 14-15, 2002, pp.7-8.

economic development. European democracies of the First Wave of Democratization were employed to support this thesis. But in the late 1960s and 1970s, many of the Second Wave democracies in the Third World broke down. The dependency school explained that the rise of “bureaucratic-authoritarian regimes” lead to a negative relationship between democratization and economic development.<sup>6</sup> Finally, the Third Wave of Democratization in Asia, Latin America, and Eastern Europe during the 1980s inspired the neo-modernization school, which rebuilt the positive relationship between democratization and economic development.

The neo-modernization school, however, has softened the deterministic tone of the old modernization arguments in several ways. First, economic development is now regarded as a contributing factor rather than a deterministic factor to democratization. Foreign relations, political parties, political cultures, the military’s attitude, and elite strategies may jointly influence the process of democratization. Secondly, economic development has a positive impact on the progress of democratization but its influence on the establishment of democratic regimes is uncertain. Whether or when a democratic regime is installed in a particular country is often influenced by short-term factors, such as political and economic crises as well as strategic interactions among power elites. By contrast, economic development affects the level and magnitude of democratic qualities. Thirdly, and most relevant for this paper, the relationship between the two is suggested to be curvilinear (for instance, N-shape) rather than linear.<sup>7</sup>

Lipset et al. suggest a N-shape relationship between economic development and democratization by combining the empirical findings of the old modernization theory and the bureaucratic-authoritarian theory.<sup>8</sup> However, they did not elaborate on the theoretical reasons why there exists a short-term negative relationship following a new democracy is established. In this paper, we borrow arguments from state-institutionalism to fill in the theoretical gap of the neo-modernization arguments.

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<sup>6</sup> Seymour Martin Lipset, “Some Social Requisites of Democracy”, *American Political Science Review*, Vol. 53, No. 1 (March 1959), pp.69-105; Guillermo O’Donnell, Philippe C. Schmitter, and Laurence Whitehead, eds., *Transitions from Authoritarian Rule: Prospects for Democracy* (Baltimore, MD: Johns Hopkins University Press, 1986).

<sup>7</sup> Adam Przeworski, and Fernando Limongi, “Modernization: Theories and Facts.” *World Politics*, Vol. 49, No. 2 (January 1997), pp. 155-183.

<sup>8</sup> Seymour Martin Lipset, Kyoung-Ryung Seong, and John Charles Torres, “A Comparative Analysis of the Social Requisites of Democracy”, *International Social Science Journal*, Vol. 45, No. 2 (May 1993), pp.155-75.

The state-institutionalists argue that, in the short run, voters in new democracies might tolerate the poor economic performance of democratic governments. In the long run, however, new democratic governments have to improve their governing capability in order to prevent the erosion of the legitimacy of democratic institutions, as evidenced by the breakdown of Second Wave democracies. The state-institutionalists improve on the liberal democratic theories, which emphasized the importance of setting up democratic constitutions and electoral systems, by pointing out the importance of the establishment of complex democratic institutions within the government. Particularly important are those democratic institutions that provide for checks and balances of governmental branches, an independent judiciary, law enforcement agencies, congressional reform, anti-corruption agencies, and citizen participation. The purpose of these fine-tuned reforms is to strengthen the accountability, transparency, and the long-term legitimacy of the democratic government.<sup>9</sup>

New democracies often face tremendous redistribution and patronage pressure due to the installment of electoral institutions. The resultant government deficit and corruption are likely to impede economic development. If the new democratic government fails to establish other democratic institutions that could strengthen the state's accountability and transparency, a systemic legitimacy crisis will generate a large window of opportunity for military coups or foreign interference. Therefore, short-term factors, such as the ruling elites' strategic decisions to develop democratic institutions and to consolidate their power, significantly influence the short-term relationship between democratization and economic development.

Following the neo-modernization school, we suggest that the Taiwanese case may reflect the downward part of the N-shape relationship between democratization and economic development. The cause of the economic downturn, as the state-institutionalists have argued, is due to the lack of accountability and transparency in economic and democratic institutions. However, our arguments differ from the neo-modernization school, which tends to focus on social factors, and the state-institutional school, which dwells on state factors, in that we turn our attention to the institutional linkages between social and state actors. This new research focus will strengthen the neo-modernization argument by explaining both the social and

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<sup>9</sup> Larry Diamond, *Developing Democracy: Toward Consolidation* (Baltimore, MD: Johns Hopkins University Press, 1999); Jorge I. Domínguez, and Abraham F. Lowenthal, *Constructing Democratic Governance: Latin America and the Caribbean in the 1990s - Themes and Issues* (Baltimore, MD: Johns Hopkins University Press, 1996); Adam Przeworski, Susan C. Stokes, and Bernard Manin, eds., *Democracy, Accountability, and Representation* (New York: Cambridge University Press, 1999).

state institutional causes of the N-shape relationship between democratization and economic development. It also strengthens the state-institutional argument by explaining why states institutional reforms are difficult to initiate (as in the case of Central Asia) or reforms of state institutions may not automatically lead to higher levels of accountability and transparency (as in the case of Japan and the Philippines).

By applying the new-institutionalist approach, our research foci and major arguments concentrate on those formal and informal institutional relationships among major actors in Taiwan's financial system, namely, the ruling party, the state (including both bureaucracy and the legislature), conglomerates, and local factions. Formal institutional relationships include relevant constitutional provisions, laws, executive orders, and organizational structures, while informal ones consist of norms, habits, and mutual expectations.<sup>10</sup> Using the financial reform case in Taiwan, this paper demonstrates that the new democratic leadership forged strong institutional links among the ruling party, the state, conglomerates, and local factions in order to override the challenge from both within and outside the ruling party. But these institutional developments were detrimental to financial development. The 2000 presidential election broke up these institutional developments and could provide a window of opportunity to bring back the positive relationship between democratization and economic development.

## **VI. The Growth of Crony Capitalism before 2000**

### **The Ruling Party**

The KMT was a major player in Taiwan's financial market. The ultimate organizational goal of the KMT was to maintain its status and privileges as the ruling

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<sup>10</sup> Sue E.S. Crawford, and Elinor Ostrom, "A Grammar of Institutions", *American Political Science Review*, Vol. 89, No.3 (September 1995), pp. 582-600; Michel Crozier, *The Bureaucratic Phenomenon* (Chicago: University of Chicago Press, 1964); Douglas C. North, *Structure and Change in Economic History* (New York: W.W. Norton, 1981); Douglas C. North, *Institutions, Institutional Change and Economic Performance* (Cambridge: Cambridge University Press, 1990); Herbert A. Simon, *Administrative Behavior: A Study of Decision-making Processes in Administrative Organization*, fourth edition, (New York: Macmillan, 1997); Arthur L. Stinchcombe, *Information and Organizations* (Berkeley, CA: University of California Press, 1990); Oliver E. Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications* (New York: The Free Press, 1975); Oliver E. Williamson, *The Economic Institutions of Capitalism* (New York: The Free Press, 1985).

party. However, in Taiwan's peculiar electoral history, rules, and culture, this meant that the KMT had to pump in a massive amount of money to engage in legal (e.g., propaganda) and illegal (e.g., bribing voters and vote-collectors) mobilization activities.<sup>11</sup> Where did the money come from? During authoritarian rule, the KMT maintained a convenient access to the state's coffers as a means of supporting party machinery and its astronomical campaign expenses. With the pace of democratization proceeding rapidly during the 1980s, the KMT was forced to find alternative sources of campaign financing. Thus, the KMT expanded its party enterprises during the 1980s and entered the banking and investment industries.<sup>12</sup>

The KMT's financial center was the Business Management Committee (BMC, *Dangying Shiye Guanli Weiyuanhui*), which was established in August 1993 in order to coordinate the expanded party enterprises. By 1994, the KMT had invested in 104 firms across ten sectors of businesses through seven holding companies.<sup>13</sup> By the end of 1998, the KMT enterprises' total assets amounted to US\$20 billion, ranking it twelfth among Taiwan's 100 largest conglomerates. Through these holding companies the KMT was able to control and manage four banks.<sup>14</sup> In 1999, the China Development Industrial Bank, which was the financial center of KMT enterprises, ranked first among Taiwan's 150 financial institutions in terms of both gross profit rate and return on assets.<sup>15</sup> Thus, the KMT was not only one of the largest banking

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<sup>11</sup> Central to Taiwan's electoral history, rules, and culture is the single-nontransferable-vote rule (SNTV). The island is divided into many medium-sized electoral districts. Each district can elect one or more representatives, depending on the size of the district. The SNTV system encourages the formation of local factions for vote mobilization. Vote-collectors (*zhuangjiao*) are those local vote-mobilizers who, through their networks of relatives and friends, can deliver a guaranteed amount of votes for candidates.

<sup>12</sup> See Ganlin Xu, "Zhenzhi Zhipei Huo Shishang Luoji—Dangying Shiye Gainian Di Zaijiantao" [The Logic of Political Domination or the Logic of Market?-- Rethinking "Party-Owned Enterprise"] *Taiwan Shehui Yanjiu Jikan* Vol. 28 (December, 1997), pp. 175-208.

<sup>13</sup> These holding companies are Central Investment Holding Company, Guang Hua Investment Holding Company, Qi Sheng Investment Holding Company, Jian Hua Investment Holding Company, Jing De Investment Holding Company, Yue Sheng Chang Investment Holding Company, and Hua Xia Investment Holding Company, see Lizhen Qiu, *Kuomingtang Dangying Jingji Shiye Fazhan Lishi Zhi Yanjiu: 1945-1996* [The Analysis of History of the KMT-owned Enterprises' Development: 1945-1996] (MA Thesis, National Taiwan University, 1997).

<sup>14</sup> They were Bank SinoPac, Kaohsiung Business Bank, China Development Industrial Bank, and Pan Asia Bank, see *Shangye Zhoukan*, no.605 (1999), pp.84-111.

<sup>15</sup> *Shangye Zhoukan*, no.603 (1999), pp.76-131.

institutions in Taiwan, but also among the most profitable ones.

## The State

During the martial law period, the state bureaucracy dominated the legislature in economic policymaking process. However, by the end of authoritarian rule, the legislature began to assert its control over the bureaucracy. The bureaucracy was increasingly subject to the political influence of legislators and was forced to tolerate, and even collaborate with, the distortions of the financial markets. The financial administration lost its political autonomy in the later period of KMT rule. Several incidences exemplified the shift in the power from the bureaucracy to the legislature.

First, in 1979 the Central Bank changed its institutional affiliation from the Presidency to the Executive Yuan, which was subject to legislative supervision and political influence. Although this institutional change happened before democratization, it laid the foundation for institutional erosion afterwards. Secondly, during the episode of licensing new private banks in the late 1980s and early 1990s, the Central Bank did not participate in the policymaking and implementation process. It was the MOF, particularly the Bureau of Monetary Affairs of the MOF, that orchestrated the entire process. Thirdly, the composition of the Central Bank board of directors changed dramatically during the democratization process. It brought in more government officials, who were directly subject to political pressure, and representatives of private banks. Together, they outnumbered state-owned bank officials and scholars on the board.<sup>16</sup> Fourthly, the Central Bank's presidency also saw three turnovers during the 1990s,<sup>17</sup> as compared to two in the previous twenty-eight years (1961 to 1989).<sup>18</sup> Finally, the financial administration lost political autonomy to the legislature through various revisions of the banking law. The legislature either initiated these revisions or modified the bills proposed by the financial administration against the latter's wishes.

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<sup>16</sup> Central Bank, *Zhonghua Mingguo Zhongyang Yinhang Zhidu Yu Gongnen* [Institutions and Functions of the ROC Central Bank] (Taipei: Central Bank, 1991), pp.152-65.

<sup>17</sup> There were four president served in the 1990s, they were Samuel Shieh (1989-1994), Liang Kuo-shu (1994-1995), Xu Yuan-dong (1995-1998), and Peng Huai-nan (1998 to present). Xu Yuan-dong died in airplane crash.

<sup>18</sup> Shangmao Chen, *Taiwan Yinhang Zhengce De Zengzhi Jinji Fenxi* [The Political Economy of Taiwan's Banking Policies] (MA. Thesis, National Chengchi University, 1998).

Before the 1980s, banking law revisions were minor,<sup>19</sup> infrequent, and primarily initiated by the financial administration; the legislature usually rubber-stamped the bills. Most of the legislators were elected in China before 1949 and had been dependent upon the administration's protection of their perks. However, since the mid-1980s, new legislators were elected in Taiwan and asserted their political power by revising critical articles in the administration's bills or by submitting their own reform bills. In 1985, the legislature revised four of the twenty-five articles proposed by the administration. In the 1989 banking reform, the administration proposed seventeen articles, where sixteen were revised. In the 1995 banking reform, the legislature proposed and passed two important items on banking reform, against the wishes of the Ministry of Finance. A major revision in April 1997 downgraded the Central Bank as an equal, if not subordinate, partner of the Ministry of Finance.<sup>20</sup>

In other words, legislators preferred to work with and expand the power of the Ministry of Finance, which was subject to legislative influence, than with the Central Bank, which had a tradition of political autonomy. Why would the legislature assert its political power? It was due to the election of a large number of legislators who were closely associated with the banking industry through directorship, shareholding, or loan relationships. Furthermore, legislators competed fiercely for a seat in the legislature's Finance Committee, which had authority over banking policies. For instance, when new banks applied for business license in the late 1980s, nine legislators were shareholders of ten applicant banks. During the administration's evaluation process, these legislators frequently voiced their concerns and made specific proposals to protect the interests of their banking clients.<sup>21</sup>

In sum, during the late authoritarian rule and the early period of democratization, the bureaucracy was captured by the legislature. Meanwhile, KMT legislators who had maintained close relationship with the banking community helped to legalize financial market distortions.

## **Conglomerates**

Taiwan's conglomerates grew rapidly in the mid-1980s and became major

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<sup>19</sup> The only exception during this period was the 1975 banking reform, whose purpose was to overhaul the 30-year-old banking law.

<sup>20</sup> Shangmao Chen, *Taiwan Yinhang Zhengce De Zengzhi Jinji Fenxi*, p.149.

<sup>21</sup> Junyi Li, *Choulou De Lifayuan* [The Ugly Legislature] (Taipei: Formosa, 1995), p.158.

players in Taiwan's policymaking process until 2000.<sup>22</sup> Those conglomerates, whose profits were based upon market protection or government licensing, became actively involved in politics. In order to protect or expand their established interests, they influenced policymaking through campaign contributions to friendly legislators, or by sending their own representatives to the legislative bodies at various levels. These representatives then controlled the relevant legislative committees, assuming the roles of both umpire and player. In addition, these representatives took advantage of the supervisory role of the legislature over the bureaucracy as a means to influencing the implementation of specific laws. As there was no effective norm or law governing the conflict of interests at various levels of representative bodies, the political and economic influence of conglomerates grew continually in Taiwan's political economy.

The distorting influence of conglomerates has been most prominent in financial markets. KMT-related conglomerates dominated the financial market prior to 2000. When the government opened the banking market to domestic applicants, Taiwan's conglomerates submitted nineteen applications. Among them, fifteen applicants had important political figures on these banks' boards of directors or as their shareholders.<sup>23</sup> Their political connections helped them to get business licenses, while the remaining four, which did not have political patrons, lost their bids. Approximately half of the fifteen new banks, however, immediately adopted very lenient loan policies toward their subsidiary enterprises and toward political patrons.<sup>24</sup>

### **Local Factions**

During authoritarian rule, Taiwan's local factions played a critical role in local elections (at the provincial, county, city, and town levels).<sup>25</sup> In order to maintain its legitimacy, the KMT had formed patron-client relationships with local factions. With democratization proceeding rapidly in the 1980s and 1990s, the political influence of local factions expanded as well, spilling over to the local financial markets, such as credit cooperatives and the credit departments of farmers' and fishermen's

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<sup>22</sup> For a succinct history of Taiwan's conglomerates, see Chenpu Duan, ed., *Taiwan Zhanho Jingji* [Taiwan's Postwar Economy] (Taipei: Renjian, 1994).

<sup>23</sup> Shangmao Chen, *Taiwan Yinhang Zhengce De Zengzhi Jinji Fenxi*, pp.89-95.

<sup>24</sup> Although banking regulations prohibit these new banks from lending money to their directors, some banks circumvent regulations by lending money to each other's directors, with tacit agreements of such transactions reached under the table.

<sup>25</sup> For the classic text on Taiwan's factions, see Mingtong Chen, *Paixi Zhengzhi Yu Taiwan Zhengzhi Bianqian* [Factional Politics and Taiwan's Political Development] (Taipei: Yuedan, 1995).

associations. However, they had only very limited or indirect influence over the national financial markets.

The patron-client relationship was based upon the local factions' mobilization of relatives and friends to support KMT candidates (usually factional leaders) in order to confer legitimacy on the immigrant political party from China. In exchange, the KMT granted licenses to factions to operate oligopoly businesses, such as liquor, cigarettes, schools, credit cooperatives, farmers' and fishermen's associations (including their credit departments), and transportation companies.<sup>26</sup> Local factions used these oligopoly rents to consolidate their factional cohesion and to buy votes in elections.

The DPP made large gains at various levels of election during the 1980s through ethnic appeals to Taiwanese voters. Pressure from the DPP and the SNTV voting system made KMT candidates even more dependent on factions for support. As competition among candidates increased, the price of vote buying rose as well.<sup>27</sup> The campaign money usually came from local credit institutions, which were not subject to close supervision by the central government. Prior to each election, candidates would submit loan applications to local credit institutions with over-valued collateral. After elections, credit institutions would continue to provide loans to winners and their campaign contributors. As a result, non-performing loans and bad loans accumulated.

The status of local factions was further elevated during the power consolidation process of former President Lee Teng-hui (1988-2000). Born a Taiwanese with little political support from the mainland-dominant party, bureaucracy, and military, Lee rapidly promoted local factional leaders to the central government and the party central. Patronage systems were thus elevated and expanded from the local level to national scale, particularly in the construction, real estate, and banking sectors.

In sum, the political democratization process, particularly after the lifting of martial law in 1987, seemed to have a negative impact on Taiwan's financial development. This negative relationship in the financial sector corresponded well to that of the national economic development and democratization.

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<sup>26</sup> Mingtong Chen, and Yunhan Chu, *Quyuxing Lianhe Duzhan Jingji Difang Paixi Yu Shengyiyuan Xuanju* [Regional Oligopolistic Economy, Local Factions, and Provincial Assembly Elections] (National Science Council Report, 1992), p.89.

<sup>27</sup> The first book recording in detail the KMT's vote-buying machinery is Bixia Zhan, *Maipiao Canhuilu* [Confession of Vote-Buying] (Taipei: Shangzhou, 1999).

## V. The Transformation of Crony Capitalism after 2000

### The Ruling Party

After the KMT lost the presidential election in 2000 and the legislative election in 2001, the KMT's financial empire began to crumble. The KMT's main coffer Central Investment Holding Company, for the first time in its history, reported a loss of approximately US\$1 billion in the year 2001. Among the KMT's other six holding companies, only the Kuang-Hwa Investment Holding Company reported profits.<sup>28</sup> Adding insult to injury, the DPP government brought legal actions to seize KMT assets that were acquired through dubious legal procedures during authoritarian rule.

Banks began to discontinue the practice of automatic rolling over KMT loans, and requested the KMT to provide supplementary collateral for those loans that were approved for political reasons. They also downgraded the credit of KMT assets. Due to overextended loans lent to political clients through careless credit-checking procedures, financial crises broke out in many of KMT-owned financial institutions.<sup>29</sup>

Has the DPP replaced the status of the KMT in the financial sector since 2000? Not yet. For one thing, the DPP is not a centralized party as the KMT is. Internal factionalism based on policy and ideological differences have long prevented the emergence of a strong party leadership in the DPP.<sup>30</sup> Secondly, the DPP did not own any party enterprise. It did not hold major interests in the banking business, it maintained a weak institutional relationship with financial institutions prior to 2000, and has been slow to establish strong links with banks since. Therefore, the DPP has not assumed the influential role as the KMT did in the financial market. As explained below, the "greening" (*liuhua*)<sup>31</sup> of state-owned banks or enterprises (replacing their pro-KMT managers with pro-DPP individuals) was completed by President Chen through his personal networks, rather than through the DPP party machinery.

### The State

The financial administration regained its autonomy. Due to the looming crisis in

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<sup>28</sup> *United Daily News*, May 1, 2002, p.22.

<sup>29</sup> *United Daily News*, February 14, 2001, p.3.

<sup>30</sup> The major factions in the DPP consisted of the President Chen's Justice faction, the New Tide faction, the Welfare State faction, and other constantly re-aligned factions.

<sup>31</sup> The color of the KMT party flag is blue, while the DPP's is green.

Taiwan's financial market, President Chen announced that the year 2001 would usher in a new era of financial reform. Without much legislative resistance, the Ministry of Finance also pushed through a series of banking reform bills. These include the Banking Law reforms in October 2000, the Law Governing the Merger of Financial Institutions in November 2000, six important financial laws in June 2001,<sup>32</sup> and the Financial Supervisory Board Law in July 2003.

The fact that the state regained its long-lost autonomy has had both positive and negative consequences. President Chen has gradually replaced the KMT's dominant positions in state-owned enterprises and state-owned banks,<sup>33</sup> as well as in some private banks in which the state or state enterprises were major stockowners. For instance, the pro-DPP businessman Chin-tsai Kuo is now the head of China Petroleum Company; Wen-yuan Lin, who handled campaign financing for President Chen in the 2000 presidential election, is now chairman of China Steel; former DPP lawmaker Pao-ching Cheng is chairman of the Taiwan Salt Industrial Corporation; and former DPP secretary-general Nai-jen Wu has taken over Taiwan Sugar Company. Most of these replacements have strong personal connection with the President.

These political appointments are also prevalent in the banking industry. Among the seventeen state-owned banks where the state was the majority shareholder, sixteen changed their management. Among the 184 directors representing the state in these banks, seventy-eight were replaced. President Chen's supporters constituted more than 70% of these new comers.<sup>34</sup> Since many of the state-owned banks also held stocks in private banks, President Chen was able to extend his influence to the management of private banks as well.<sup>35</sup>

In addition to banks, President Chen cast his shadow over newly formed financial holding companies. The ex-chairman of the First Financial Holding Company, Jerome Chen, one of President Chen's major campaign contributors, was appointed chairman of the company in October 2000. The Ministry of Finance made Shen-chih Cheng the chairman of the Mega Financial Holding Company. Cheng had

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<sup>32</sup> The six financial laws are the Financial Holding Company Law, the Business Tax Law Amendments, the Deposit Insurance Law Amendments, the Statute for the Establishment and Management of the Financial Reconstruction Fund, the Insurance Law Amendments, and the Securities Finance Management Law.

<sup>33</sup> "State-owned banks" include those banks that the state's shares are less than 50% but more than any other shareholder's.

<sup>34</sup> *United Daily News*, March 12, 2001, p.3.

<sup>35</sup> [http://magazines.sina.com.tw/businessweekly/contents/710/710-005\\_1.html](http://magazines.sina.com.tw/businessweekly/contents/710/710-005_1.html), March 22, 2002.

been the vice president of the Evergreen Conglomerate, which enthusiastically endorsed President Chen in the 2000 election.

The new relationships among the state, political party, and banks differ from the old ones in two aspects. In the old regime, the KMT took control of the banking system through its centralized party system. By contrast, President Chen has conducted the “greening” of state-owned banks or private banks through his personal networks without going through the formal DPP machinery. Another difference seems to be that conglomerates have lost overwhelming influence over banking policies because their past political connections have broken down and new connections are not yet consolidated.

Furthermore, the distorting influence of the legislature was reduced. Before the 2000 presidential turnover, the bureaucracy was captured by the legislature. The conflict between the bureaucracy and the legislature was mainly due to different institutional interests. After 2000, the partisan dimension entered and made the relationship more complicated. Because the 2001 legislative election did not produce a single majority party, all major political parties had to negotiate with one another as well as to make compromise with the administration in order to have their bills passed. Transparency and accountability increased in the policymaking process. In fact, despite the otherwise very vicious political saliva exchanged daily between the ruling party and the opposition parties, the legislature since 2000 has passed more bills than it did before 2000.<sup>36</sup> This positive development is well illustrated by the process of licensing the new financial holding company as discussed below.

## **Conglomerates**

The political influence of conglomerates has undergone several changes in the post-KMT regime. Those conglomerates that had close connections with the KMT could no longer exercise their political influence in the financial market. These conglomerates include many high-profile cases, such as the Hongguo Group (construction and real estate), Tuntex Group (construction and real estate), An Feng Group (steel), the Wang family of Kaoshiung (electric wires, banking), Taiwan Pineapple Group (agricultural processing), and Ever-Fortune Group (real estate,

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<sup>36</sup> Wan-ying Yang. “Party Cooperation and Conflict under Divided Government: the Fourth Term Legislative Yuan,” *Soochow Journal of Political Science*, Vol. 16 (March, 2003), pp. 47-93.  
<http://npl.ly.gov.tw/www./law/law5.jsp>, accessed on November 6, 2003.

electricity, and transportation).<sup>37</sup> Most of them are in the businesses of highly protected or regulated sectors, and all have suffered from serious financial problems.

There have also emerged *nouveau riches*, such as the Continental Engineering Corporation (construction, transportation), Evergreen Group (international shipping and airline), Chi Mei Group (petrochemical exports), I-Mei Foods Corporation (food processing), Pacific Electronic Group (communication), Linyuan-Fubon Group (insurance, banking), Acer ( semiconductors, computers), and United Microelectronics Corporation (semiconductors). Presidents of these conglomerates have received positions in the Presidency as National Policy Advisors, Presidential Advisors, or other advisory positions.<sup>38</sup> Most of these conglomerates differ from the old KMT-affiliated conglomerates in that they do not dependent upon government's protection to earn profits. Most of these conglomerates are exporters. They side with the DPP government mostly for ideological reasons, that is, Taiwan independence and free market. KMT connections today serve counterproductive purposes, while new DPP connections are not yet consolidated.

All conglomerates are now forced to compete in a relatively undistorted free market. The most representative case, as compared to the establishment of new banks described before, is the establishment of financial holding companies. In mid-2001, the legislature passed the Law on Financial Holding Companies in order to encourage the mergers of financial institutions. Unlike the establishment of new banks, the government did not limit the number of new holding companies. Therefore, it greatly reduced the incentives for applicants to utilize their political connections, and for legislators to lobby and affect the licensing process.

Two months after the Law took effect, the Ministry of Finance granted six of the eleven applications, while continuing to assist the other five to complete their application qualifications. Currently, there are fourteen financial holding companies. Mass media did not report instances of lobbying on the part of conglomerates as they did in the establishment of new private banks. After all, there is a new government in town. Therefore, the financial administration receives a long-lost political autonomy in this episode.

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<sup>37</sup> *Xinxinwen*, no.705, pp.22-44.

<sup>38</sup> Businessmen constituted about a quarter of the President's close advisors. Among the eighty-eight National Policy Advisors, twenty-one were businessmen; among the thirty Presidential Advisors, eight were businessmen. [http://www.president.gov.tw/1\\_structure/index.html](http://www.president.gov.tw/1_structure/index.html), accessed on March 23, 2002.

## Local Factions

The presidential turnover further weakened the linkage between the KMT and local factions.<sup>39</sup> After the election, many local financial institutions could no longer expect financial support from the central government, and faced insolvency. In the name of protecting the interests of depositors, the Ministry of Finance sent management teams to take over thirty-six local financial institutions in August 2001, and another seven in July 2002.<sup>40</sup> The political consequence of the management takeover was that most of the KMT legislators, who controlled these financial institutions, lost their re-election in 2001 or were under indictment.

With more political autonomy, the financial authority continued to push reforms of local credit institutions, especially the credit departments of farmers' and fishermen's associations. However, the KMT-controlled farmers' and fishermen's associations fought back desperately. In November 23, 2002, about 120,000 farmers marched in Taipei streets in protest of the newly enacted Agricultural Financial Law and the forced mergers and takeovers of the credit department of farmers' and fishermen's associations. Under powerful pressure from the local financial community and in consideration of the forthcoming 2004 presidential election, the DPP government suspended and postponed some of the reform policies.

In sum, the presidential election in 2000 largely destroyed the market-distorting crony capitalism of the KMT regime. The DPP did not and could not replace the role of the KMT in the economy dominated by protected conglomerates and local factions. The financial administration regained its political autonomy from the weakened legislature and the internally divided DPP. Democratization, after an initial stage of setback, finally produces a positive impact on the economy (see Table 2 for summary).

[Table 2 about here.]

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<sup>39</sup> Wu has documented the increasing political autonomy of local factions in recent years, particularly at the lowest administrative levels, see Yiming Wu, *Buzhujin Zhidu Xia De Taiwan Paixi Zhengzhi Wending Yu Bianqian: Xinzhidu Lilun Fenxi Guandian* [The Stability and Transition of Factional Politics of Taiwan under the Grant System: The Perspective of New Institutional Theory] (MA Thesis, National Chengchi University, 2000).

<sup>40</sup> United Daily News, August 11, 2001, p.2; and United Daily News, July 13, 2002, p.2

But due to the pressure of re-election, President Chen seems to be building a new breed of crony capitalism not only with new conglomerates in tradable sectors (e.g., semiconductors, computers, petrochemical exports, international shipping) but also those in the protected sectors (e.g., real estate and construction) as well as the local factions and local financial institutions which are the targets of reform. Although the old formal and informal institutional relationships are broken or transformed, especially among the ruling party, conglomerates and local factions, the informal relationship between President Chen and the new set of cronies may turn out to be another tumor in the future economic development.

## **VI. Conclusion and Future Reforms**

The above analysis demonstrates that the relationship between democratization and economic development in Taiwan is more complicated than the pessimist and the optimist have predicted. Against the wishes of the liberal optimist, the Taiwanese economy took a nosedive immediately after the martial law was lifted, and the downward trend continued until one year after the presidential turnover. Financial conditions in Taiwan experienced a similar downward trend. Thus, this seems lending support to Huntington's earlier thesis of "no easy choice," or a necessary tradeoff, between democracy and economic development. However, financial reform policies were installed after the presidential turnover and the economy began to show signs of recovery after 2001, thus, affirming the neo-modernization thesis that there is a N-shape relationship between democratization and economic development.

In addition to the structural changes occurred in 1987 and 2000, the political elites' strategies seem to play a critical role in shaping the fortune of the economy. Former President Lee chose to actively incorporate local factions and conglomerates into the central state and party central in order to consolidate his power. He successfully achieved his political goals but at great expense of the economy. It took the first turnover of government leadership to break down the crony capitalism Lee established during his term. Except for the administrative control over the financial markets, other institutional links among the state, the political party, legislators, conglomerates, and local factions were largely shattered by the DPP government. Furthermore, this paper shows that the impact of presidential turnover works not only on the state institutions per se, but also on the institutions linking the state and society.

Based on the above analysis, we propose seven reforms in order to consolidate the positive relationship between democratization and economic development in

Taiwan. First, following Huntington's argument,<sup>41</sup> we propose that two turnovers of the Taiwanese government will help to suppress an emerging crony capitalism, unless President Chen resumes his reform programs in his second term.<sup>42</sup>

The presidential turnover in 2000 has verified Huntington's arguments to a large extent. Old conglomerates lost their political influence, bureaucrats regained political autonomy, and legislators no longer unilaterally dictated government policies. However, the DPP government began to emulate the past in "greening" the state enterprises and in building up clientelistic relationships with new conglomerates in both tradable and non-tradable sectors. Most worrisome is the revision of the DPP party constitution in August 2002 that confers President Chen the chairmanship of the DPP. Will Taiwan experience the KMT party-state again? If that happens, the second turnover recipe is certainly in order.

Secondly, the democratic government needs to re-establish the Central Bank's autonomy and leadership over financial policies.<sup>43</sup> We propose that the legal status of Central Bank be relocated from the Executive Yuan to the Presidency, and become an independent agency like the Federal Reserve Board of the United States. The Central Bank should have the highest authority over financial policies, not sharing the power with the politically dependent Ministry of Finance.

Thirdly, prudential regulation needs to be strengthened. Scholars have found that the weakness of the financial system and regulation forbearance were primary causes of the Asian financial crisis in 1997.<sup>44</sup> Taiwan is no exception to the findings. In order

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<sup>41</sup> Samuel Huntington, *The Third Wave: Democratization in the Late Twentieth Century* (Norman, OK: University of Oklahoma Press, 1991).

<sup>42</sup> Mingtong Chen, "Heijin Xianshi Paihangbang" [Ranks of Counties and Cities in Black and Gold] (Mimeo, 1999).

<sup>43</sup> On the relationship between economic development and central bank independence, see John Goodman, *Monetary Sovereignty: The Politics of Central Banking in Western Europe* (Ithaca: Cornell University Press, 1992); C. Randall Henning, *Currencies and Politics in the United States, Germany, and Japan* (Washington, DC: Institute for International Economics, 1994); Maxwell J. Fry, Charles A. E. Goodhart, and Alvaro Almeida, *Central Banking in Developing Countries: Objectives, Activities and Independence* (New York: Routledge, 1996).

<sup>44</sup> Karl D. Jackson, ed., *Asian Contagion: The Causes and Consequences of a Financial Crisis*, (Boulder: Westview Press, 1999); Kuotsai Tom Liou, ed., *Managing Economic Development in Asia: From Economic Miracle to Financial Crisis* (London: Praeger, 2002); Arvid John Lukauskas, and Francisco L. Rivera-Batiz, eds., *The Political Economy of the East Asian Crisis and its Aftermath: Tigers in Distress* (Cheltenham: Edward Elgar, 2001).

to centralize the authority of financial regulation and supervision, the Financial Supervisory Board Law was passed in July 2003. The Financial Supervisory Board (FSB) is designed to provide effective monitoring and discipline over domestic and foreign financial institutions, and will likely increase the transparency and accountability of Taiwan's financial markets. However, the FSB is still on the drawing board due to the turf war among financial bureaucracies. It is time for the democratic leadership to exercise strong administrative muscle to put the FSB in action. The DPP government should also discontinue its practices of assigning political clients without strong professional credentials to state-owned enterprises and banks or to those private institutions where the state owns significant stocks. Even better, the government should continue its privatization programs of these state enterprises and banks so that the ruling party in the future will not employ these instruments for electoral purposes.

Fourthly, conflict-of-interest laws need to be promulgated. One of the institutional causes of financial market distortions in Taiwan was the participation of representatives in those legislative committees that had jurisdiction over their businesses. In order to reduce such conflicts of interests and their negative impacts, we propose that the legislature pass laws prohibiting such behavior at all levels of representative bodies. In January 1999, the departing legislators passed a mild code of conduct concerning conflicts of interests, but the next two legislatures have left the code in the attic. It is time to jumpstart the code.

Fifthly, the power of business associations can be strengthened. Scholars have found a positive correlation between corporatism and economic development.<sup>45</sup> Chengtian Kuo argues that state corporatism was one of the major factors for the island's economic success.<sup>46</sup> We propose that the Taiwanese government establish corporatist institutions in the financial market and incorporate these associations into the policymaking and implementation process (e.g., delegation of monitoring power and enforcement capability).

Sixthly, remove the local factions' monopoly rights. For the moment, local factions have had limited influence on the national financial market. But within local credit institutions, their corrosive effects have been significant and deteriorating. We

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<sup>45</sup> John R. Freeman, *Democracy and Markets: The Politics of Mixed Economics* (Ithaca: Cornell University Press, 1989).

<sup>46</sup> Chengtian Kuo, *Global Competitiveness and Industrial Growth in Taiwan and Philippines* (Pittsburgh: University of Pittsburgh Press, 1995); Linda Weiss, *The Myth of the Powerless State* (Ithaca, NY: Cornell University Press, 1998).

propose removing the credit departments out of farmers' and fishermen's associations and transforming them into local branches of a national agricultural/fishery bank, which would be subject to the independent FSB's supervision. Local credit unions should be merged with or reformed into commercial banks, and be opened to non-local members (including foreign investors). These reform measures will not only dilute the influence of local factions, but also strengthen monitoring mechanisms.

Finally, although we have focused our attention on the domestic politics of the financial reform in Taiwan, foreign dimension is indispensable in Taiwan's financial development. Financial liberalization will increase the scale and competition of financial markets. More importantly, the presence of foreign actors will complicate the relationships among the ruling parties, conglomerates, local factions, and the state. Thus, the domestic crony capitalism will be more difficult to sustain. Financial liberalization here refers not only to the liberalization of capital flow, as most Asian countries had done so before 1997. But, more importantly, it refers to the encouragement of foreign financial institutions to establish branches in Taiwan and engage in the same business activities as their Taiwanese counterparts do. New laws that provide national treatment to foreign financial institutions are certainly in order.

In sum, Taiwan is at a critical juncture to reverse the negative relationship between democratization and economic (or financial) development. Many old institutional relationships that have retarded the functioning of the market have been removed by the presidential turnover. The transparency and accountability of financial actors have increased significantly. However, the new government needs to redefine itself as a "self-restraining state"<sup>47</sup> by halting the construction of crony capitalism which the KMT government had incorrectly done so.

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<sup>47</sup> Andreas Schedler, Larry Diamond, and Marc F. Plattner, eds., *The Self-Restraining State: Power and Accountability in New Democracies* (Boulder, CO: Lynne Rienner Publishers, 1999).

**Table 1**  
Economic and Financial Indicators of Taiwan (1985-2003)

	Economic Growth Rates	Unemployment Rates	NPL Ratios
1985	4.95	2.91	
1986	11.64	2.66	
1987	12.74	1.97	
1988	7.84	1.69	1.23
1989	8.23	1.57	0.88
1990	5.39	1.67	0.93
1991	7.55	1.51	0.97
1992	7.49	1.51	0.81
1993	7.01	1.45	1.17
1994	7.11	1.56	1.85
1995	6.42	1.79	3.00
1996	6.10	2.60	4.15
1997	6.68	2.72	4.18
1998	4.57	2.69	4.93
1999	5.42	2.92	5.67
2000	5.86	2.99	6.20
2001	-2.18	4.57	8.16
2002	3.59	5.17	6.84
2003	3.10	5.14	6.39

Sources:

<http://140.129.146.80/dgbas03/bs8/world/gnprate.htm>;

<http://www.moea.gov.tw/~meco/stat/four/a-13.htm>;

<http://www.boma.gov.tw/files/sta/index-10.xls>

**Table 2**  
**Transformation of Crony Capitalism Before and After 2000**

	Before 2000	After 2000	Reform Proposals
Ruling Party	KMT was a major player in the financial market.	DPP maintained weak institutional relationship with the banking industry.	1. Hungtinton's "two-turnover" argument.
State	The legislature had asserted its control over the bureaucracy, and helped to distort the financial market.	Financial administration regained its autonomy; the distorting influence of the legislature reduced.	2. Re-establish the Central Bank's autonomy and leadership in financial policies. 3. Strengthen prudential regulation (FSB). 4. Promulgate conflict-of-interest laws.
Conglomerates	KMT-related conglomerates dominated the financial market.	New DPP connections were not yet consolidated, but President Chen established informal ties with new cronies.	5. Strengthen the power of business associations.
Local Factions	Local factions controlled the local financial community.	Local factions faced serious financial problems.  But due to re-election pressure, local financial reforms are suspended or postponed.	6. Remove local factions' monopoly rights.
National Financial Market	Dominated by conglomerates	Some liberalization	7. Financial liberalization will increase the scale and competition of financial markets.