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An Alternative Perspective on Post-1997 Corporate Reform in Korea

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Abstract

The article critically examines the current corporate reform agenda in Korea. We argue that the view behind this agenda misdiagnoses the problems with the *chaebols* and therefore is unlikely to adequately address their real problems, namely, over-investment and abuse of power. We then criticise various arguments that see the country's government-business relationship as corrupt and inefficient, and conclude that the current agenda based on these arguments is unlikely to restructure this relationship in a productive and sustainable way.

1. Introduction

The financial crisis of 1997 has brought about a sea change in the prevailing view on the Korean economy. Once hailed as a “miracle”, now the country is described as an inefficient, corrupt economy full of obsolete and irrational institutional arrangements. Nowhere is this about-turn more apparent than in the analysis of the Korean big business, or the *chaebol,* and its relationship with the government. Once seen as a highly effective, if somewhat idiosyncratic, protagonists of the country’s impressive industrial catching-up, the *chaebols* are now regarded as pathological business organisations that are responsible for the downfall of the economy. Likewise, the cooperative government-*chaebol* relationship, which was previously regarded by most as one important ingredient in the country’s economic success, is now condemned as a corrupt league that destroyed economic rationality and efficiency in the country.

The now-prevalent view has it that the *chaebols* had made excessive investments that caused the 1997 financial crisis of the country because they were controlled by family patriarchs who were more interested in empire-building than in profitability and efficiency. At the same time, it is argued, the *chaebols* were able to invest in projects that are overly risky and subject to low returns, safe in the knowledge that their large size and their corrupt link with the government will guarantee government rescue if they get into trouble. The *chaebol* “owners” maintained their control over vast conglomerates, the argument goes, by eschewing stock issues and relying on debt financing to absurd degrees, which was helped by the practice of intra-group mutual loan guarantees. In this view, the unsustainable level of debts of the *chaebols* is the direct cause of the country’s 1997 financial crisis, and the pathological corporate governance system and the corrupt government-*chaebol* relationship, which encouraged such high debt build-up, the underlying cause.

Given this diagnosis, the IMF and the current Korean government have paid enormous attention to “reforming” the *chaebols*, and also extricating the government from the business of corporate governance through radical deregulation. The “reform” package, at least on paper, is far-reaching and includes everything short of the forceful disbandment and ownership transfer that the large German industrial concerns and the Japanese *zaibatsus* were subject to immediately after the Second World War.

The main aims of this reform agenda may be summarised as the following four elements. First of all, it aims to make the *chaebols* reduce their reliance on debt financing by encouraging asset sales, new share issues, and the elimination of mutual loan guarantees. For this, the *chaebols* have been pressured by the current government through their main lending banks to bring down their debt-equity ratio from over 400% in 1997 to 200% by the end of 1999 and all but eliminate their intra-group mutual loan guarantees by 2000. Secondly, this agenda aims to make them concentrate on “core competences” by putting pressure on them to sell off “non-core” subsidiaries, which is also regarded as a good way of reducing debts. Thirdly, it has strengthened the powers of minority shareholders and outside directors, in the hope that this will make the *chaebols* pay more attention to profitability. Fourthly, strengthening of market discipline, especially through further financial liberalisation, is seen as a way not only to ensure increased efficiency of the *chaebols* but also to sever the “corrupt” link between government and big business that has characterised the Korean political economy.

In this paper, we critically examine the corporate reform agenda currently pursued in Korea. We argue that the analyses that lie behind this agenda is theoretically ill-informed and empirically weak. As a result, we argue, the current reform has not only failed to address many of the very problems that they are meant to address, but that they are also unable to address what we regard as the “real” problems of the *chaebol* system – the tendency to over-investment and the abuse of their economic and political power. In relation to the current reform agenda for the reform of the government-*chaebol* relationship, we argue that what is necessary is the refinement of methods and the democratisation of the process of state intervention, and not a wholesale disengagement by the government in industrial and corporate matters, which is neither likely nor desirable.

2. Characterising the *Chaebol*

The currently popular view sees the *chaebol* as an “abnormal” type of business organisation, which is “pathological” in its ownership and financing, “excessively” diversified, and “highly” inefficient. Portraying of the *chaebol* in this light, however, is based on the implicit consensus among mainstream researchers that the Anglo-American, especially American, type firm organisation is the standard against which the “normality” of other types of firm organisation should be defined. In other words, the Korean firms, like those from other non-Anglo-American countries, have been usually “viewed through a looking glass that has an American frame” (Cottrell, 1997, p. 2).

This is somewhat understandable, given that the US is where modern corporations emerged first, but this does not make any less acceptable the prejudice against non-Anglo-American-style firms, especially the ones from developing countries – or what we propose to call the "Third World version" of Williamson's "inhospitality tradition".[1]

So the first question to ask is whether "normality" can be defined with reference to the institutional norms prevailing in the Anglo-American countries. When we think of it, there are more countries in the world whose institutional features do *not* conform to the Anglo-American norm than the ones whose institutional features do. If this is the case, why should the Anglo-American institutions become the "norm"? Indeed, economic historians have shown us that that international differences in firm organisation have been an essential feature in the development of capitalism during the last century or so (Chandler, 1990).

Moreover, to call an organisational form "abnormal" can be misleading when what is "normal" is not defined clearly. For example, what counts as an "excessive" degree of diversification for a corporate group? Where has figures like 200% been plucked out as the "norm" (or even the "necessary minimum", according to some people in the current Korean government) for a corporation's debt-equity ratio? Without clear answers to these kinds of questions, the targets of *chaebol* reform will remain elusive at best and misleading at worst.

While directly confronting these fundamental methodological questions may be beyond the scope of our paper, we will try to address them indirectly in this section by empirically examining whether the allegedly pathological features of the Korean

[1] Williamson (1985, p. 200) talks of the "inhospitality tradition" in industrial economics towards non-standard firms, although not explicitly mentioning the Third World firms.

chaebols are indeed totally off the international norms and are driven by an irrational and corrupt institutional structure, as the conventional wisdom has it.

2.1. Low profitability

The feature of the *chaebols* that is regarded as the clearest sign of their pathological nature is their low profitability. Indeed, by some accounts, Korea boasts one of the lowest profitabilities of the corporate sector in the world. And this is cited by many as the proof that the Korean firms, and the *chaebols* as their representatives, are inefficient firms that have survived only because of government supports and/or insider financing (in the case of the *chaebols*).

The first thing to note when discussing profitability as a measure of enterprise performance is that it is not necessarily a good indicator of a firm's social contribution (e.g., Blaine, 1993; Chang & Singh, 1993). As clearly revealed by the literature on social cost-benefit analysis, as a financial variable, it is affected by various imperfections in markets, which means that it may not correctly measure an enterprise's "true" efficiency (if exactly defining and measuring such thing is possible at all). Profitability figures also do not address distributional concerns and other "social" objectives that one may want the firms to contribute to.[2]

[2] It may be argued that firms should not worry about anything other than profits, as the society can always tax the profits and use the revenue for any "non-efficiency" purpose it wants. This is an evasion, as there are serious political and administrative obstacles to raising taxes. See Chang & Singh (1993) for a further discussion on this point.

Most importantly, low profitability in the case of the Korean firms (and the Japanese firms before them) should be seen as a result of vigorous investments that were necessary for achieving greater international competitiveness, which may in the end bring more benefits to the society (Blaine, 1993; Singh, 1992 and 1998). At the same time, through its impact on investor expectations (i.e., the lowering of expected profitability), low profitability may increase investments, which are vital for generating employment and growth.

Even if we agreed that profitability is “the” best measure of a firm’s social contribution, it is difficult decide which measure of profitability should be used. To put it simply, there is no agreement either on what should be the numerator (e.g., gross income, net income, etc.) or on what should be the denominator (e.g., sales, assets, equity, etc.) in the calculation of profitability. And needless to say, different measures give different results. Together with many others (e.g., Blaine, 1993), we think that the best measure is given by the ratio of gross income (or operating income) to sales[3], according to which the Korean firms tend to do quite well (see below), but others may not agree. We cannot settle this debate within this paper, but would like to register our deep concern with the fact that many of the current discussions on the *chaebols’* profitability are simply oblivious to this problem. Moreover, comparing profitability

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[3] We believe that gross income is better than net income, the most serious alternative, as the numerator in the profitability formula, because the letter is net of things that have relatively little to do with intrinsic enterprise efficiency, such as interest payments (subject to changes in monetary policy and macroeconomic conditions) and the proceeds from the sales of assets (subject to valuation problems and even financial engineering to evade taxes). We believe that sales is better than assets as the denominator, because the latter are notoriously subject to definitional and measurement problems.

across countries is notoriously difficult. Different countries have different accounting standards and therefore a direct comparison of profitability figures always carries a danger (including our own exercise below).[4]

It is also doubtful whether we can "explain" the 1997 financial crisis in Korea (and other Asian countries) with low corporate profitability. For example, at least according to one profitability criterion – in this case returns on assets – Korean corporate profitability was indeed very low by international standard. According to a study by Calessens et al. (1998), it had the 44th lowest returns on assets among a sample of 46 countries (p. 5, figure 1). However, it will be wrong to use this as an example showing that the Asian crisis was due to low corporate profitability as some people argue. For one thing, Korean profitability has not been so low if profitability is defined differently, but more interestingly, the other crisis economies had very high returns on assets. Thailand and Indonesia ranked the 1st (by a huge margin) and the 3rd in this sample countries (the 2nd was the Philippines, a semi-crisis country), and Malaysia ranked a very respectable 8th. So if there is any simple link between corporate profitability and corporate vulnerability (and thus financial crisis), the Southeast Asian economies should not have had a crisis in 1997.

Now let us see whether Korean corporate profitability was so pathologically low as it is often claimed. As we can see from table 1, a salient feature of the Korean firms, including the *chaebols*, in terms of their profit structure is the big difference between

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[4] Some, for example, claim that, the Japanese corporate profitability has been under-estimated because of the differences in accounting methods from those used in other, especially Anglo-American, countries (e.g., Blaine, 1993).

gross profitability (operating income to sales) and net profitability (ordinary income to sales) due to high financial costs (as ordinary income is net of interest payments). The gross profitability of the Korean manufacturing firms during 1973-96 was 7.4% (similar to that in Japan during its high growth period, i.e., 1955-73, as we can see from table 1). However, their net profitability was only 2.8% due to high financial costs (lower than the Japanese figure of 4.3% during its high growth period). The difference between the operating income and net profitability in Korea (and to a lesser extent in Japan) is caused by the high rate of investment financed by external borrowing.

Table 1. Major Business Indicators of Korea and Japan during Their High Growth Periods (Manufacturing) (%)

	Korea (1973-96)	Japan (1955-73)
Current growth rate of sales	24.6	17.3
Operating income to Sales	7.4	7.2*
Financial expenses to Sales	5.5	3.4
Ordinary income to Sales	2.8	4.3
Debt ratio	338.4	320.7

*1961-73

Definitions:
Operating Income = Gross profit - Selling & Administrative Expenses.
Financial Expenses = Interest and Discount Expenses.
Ordinary Income = Operating Income + Net Non-Operating Income.

Sources: The Bank of Korea (BOK), *Financial Statement Analysis*, each year.
Bureau of Statistics, *Japan Statistical Yearbook*, each year.

While we do not have the data that we can use for deciding whether Korean corporate profitability was exceptionally low by international standards, table 2 gives us some insights. Table 2's limitations are clear (very limited sample size, the particular types of profitability measures, point observations for a single year, etc.), but it shows that, at least in 1995, while net profitability of the Korean firms was the lowest among the 4 countries in the sample, their gross profitability was higher than that of their counterparts in Japan and not much lower than those in the USA and Taiwan. The data from Claessens et al. (1998) also confirm this observation (p. 7, table 3). They show that the "operational margin" (which is similar to the notion of gross profitability[5]) among the Korean firms during 1988-96, at 19.6%, was higher than that in the USA (14.4%) and Germany (14.6%), although it was lower than that in 5 of the 8 other East Asian countries for which the figures were available (Japan, Indonesia, Taiwan, the Philippines, and Thailand; Hong Kong, Singapore, and Malaysia had lower figures)

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[5] The notion of "operational margin" used by Claessens et al. is defined as the difference between sales and the costs of goods sold as a share of sales. This is slightly different from the notion of "gross profitability" that we use, as it does not subtract selling and administrative expenses from the numerator. We think our measure is somewhat superior because the measure used by Claessens et al., by not subtracting the selling and administrative expenses, does not fully reflect the managerial efficiency of the firm.

Table 2. Structure of Profit in Manufacturing Corporations in Korea, Japan, the USA and Taiwan (%)

	Korea (1995)	USA (1995)	Japan (1995)	Taiwan (1995)
Operating income to Sales	6.5	7.7	3.3	7.3
Ordinary income to Sales	1.0	7.9	2.9	5.1
Financial expenses to Sales	5.8	n.a.	1.3	2.2
Total borrowing to total assets	47.7	26.4	34.8	26.2

Source: BOK, 1997, *Financial Statement Analysis for 1996*.

Thus seen, there is no clear evidence that Korean corporate profitability is exceptionally low by international standards. On some measures, it had very low profitability, but on others, it is not the case at all. Especially in terms of the measures that we think are better (such as our "gross profitability" or "operational margin" used by Claessens et al.), the Korean firms do not have low profitability by international standards and have even done as well as, or even better than, the US firms, which they are constantly asked to emulate.

2.2. High Financial Leverage

High financial leverage of the *chaebols* has been widely blamed as the primary cause of Korea's financial crisis of 1997. According to this view, high financial leverage is considered the product of "irrational" empire-building desire by the *chaebol* patriarchs. Is this view justified?

First of all, there is a well-known and still-inconclusive debate in financial economics on the relative merits of equity financing and debt financing (Harris & Raviv, 1991; Brennan, 1995). It is needless to say that there is, therefore, no such thing as the "optimal" level of corporate leverage.

Moreover, the debt-equity ratio of Korean corporations (historically between 300% and 350%, depending on the phase of business cycle) is not exceptionally high by international standards. A World Bank study covering the period between 1980 and 1991 (Demigruc-Kunt & Maksimovic, 1996) shows that, at 366%, the average debt-equity ratio for Korean corporations was similar to that in Japan (369%), France (361%), and Italy (307%). Rather surprisingly, it was much lower than what is the norm in Scandinavia, that is, around 500% - 538% in Norway, 555% in Sweden, and 492% in Finland (see table 3).[6]

6 Of course, given the differences in the stages of growth that they are at, and consequently in their financing capabilities and requirements, it seems inappropriate to compare the capital structure of the Korean firms with those of their counterparts in the more advanced countries during the same periods. A more appropriate comparison between the two may be to compare the Korean figures of the 1980s or the 1990s with the advanced country figures of, say, the 1960s or the 1970s. In this regard, a more detailed comparison with Japan is instructive. Japan may now have debt-equity ratio of just over 200%, but as we see from table 3, its debt-equity ratio was basically at the same level as that in Korea throughout the 1980s (369% vs. 366%), and in the 1970s, it was around 500%.

Table 3. Capital Structure of Firms in Selected Countries (1980-91)

Countries	*Debt-ratio*	*Long-term debt to total equity*	*Short-term debt to total equity*	*Depreciation to total assets*	*Dividend to total assets*	*Earnings to total assets*
Australia	1.248	0.563	0.653	0.033	0.025	0.064
Austria	2.696	1.121	1.495	0.051	0.017	0.075
Belgium	2.023	0.764	1.259	0.039	0.022	0.092
Brazil	0.560	0.139	0.421	-	0.014	0.057
Canada	1.600	0.990	0.539	0.045	0.007	0.064
Finland	4.920	3.094	1.856	0.042	0.014	0.077
France	3.613	1.417	2.108	0.043	0.013	0.094
Germany	2.732	1.479	1.188	0.070	0.057	0.087
Hong Kong	1.322	0.309	0.967	0.017	0.019	0.121
India	2.700	0.763	1.937	0.038	0.014	0.132
Italy	3.068	1.114	1.954	0.041	0.070	0.080
Japan	3.688	0.938	2.726	0.026	0.007	0.067
Jordan	1.181	0.266	0.915	-	0.033	0.073
Korea	3.662	1.057	2.390	0.053	0.008	0.100
Malaysia	0.935	0.284	0.639	0.021	0.026	0.087
Mexico	0.817	0.375	0.442	-	-	0.076
Netherlands	2.156	0.710	1.297	0.043	0.020	0.094
New Zealand	1.527	0.752	0.776	0.030	0.025	0.106
Norway	5.375	3.495	1.880	0.049	0.009	0.092
Pakistan	2.953	0.595	2.358	0.038	0.028	0.115
Singapore	1.232	0.491	0.718	0.022	0.018	0.077
South Africa	1.115	0.597	0.518	0.013	0.062	0.206
Spain	2.746	1.086	1.649	0.040	0.016	0.095
Sweden	5.552	2.879	2.321	0.036	0.011	0.100
Switzerland	1.750	0.878	0.872	0.043	0.016	0.073
Thailand	2.215	0.518	1.769	0.030	0.029	0.129
Turkey	1.996	1.511	1.511	-	0.068	0.239
UK	1.480	1.065	1.065	0.032	0.025	0.025
USA	1.791	1.054	0.679	0.045	0.016	0.016
Zimbabwe	0.801	0.187	0.615	0.031	0.028	0.028

Source: Calculated from the International Finance Corporation's Corporate Finance Data by Demigruc-Kunt & Maksimovic (1996, p. 354)

What distinguishes Korea from Japan is that high corporate leverage in Korea was closely related to the chronic capital shortage – manifested in the balance of payments deficits – at the economy level.[7] Korea was the only one amongst the North East Asian "miracle" economies that has suffered from a serious capital shortage. Japan has never had a savings shortage since the early 1960s, and even Taiwan basically stopped having one from the early 1970s. In contrast, Korea had a staggering capital shortage until the early 1970s, which lessened over time but has continued right up to the 1997 crisis except for the 1986-88 period.

The heavy reliance on foreign capital made the Korean firms vulnerable to the instability of international financial market, which led to rapid accumulation of debts when there was turmoil in the international financial market. Korea has twice experienced a structural upward shift in the level of corporate debt-equity ratio as seen from figure 1. The debt-equity ratio surged abruptly after the international financial turmoil following the collapse of Bretton Woods system in the early 1970s, and following the debt crisis in Latin America in the early 1980s. In striking contrast, this kind of fluctuation in debt-equity ratio was not observed in Japan, which also had high corporate leverage but did not rely on foreign borrowing during the high-growth period, as it can be seen from figure 2.

What is interesting to ask at this point is why the high leverage did not have negative effects on investment despite the conventional wisdom that, as their leverage

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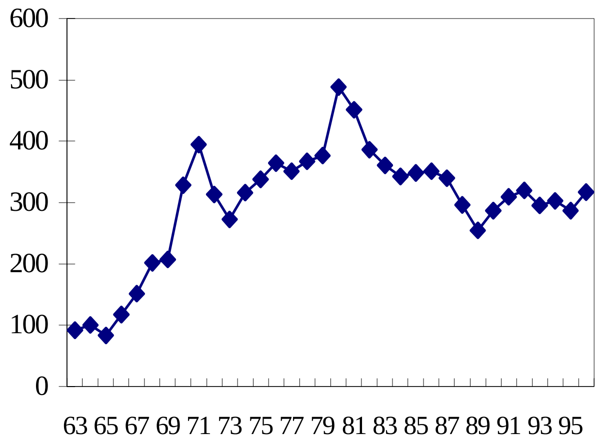
[7] This is, of course, not to say that high corporate leverage happens only under capital shortage. The best counter-example is Japan, where corporate leverage had been very high until recently, despite the absence of capital shortage since the 1960s.

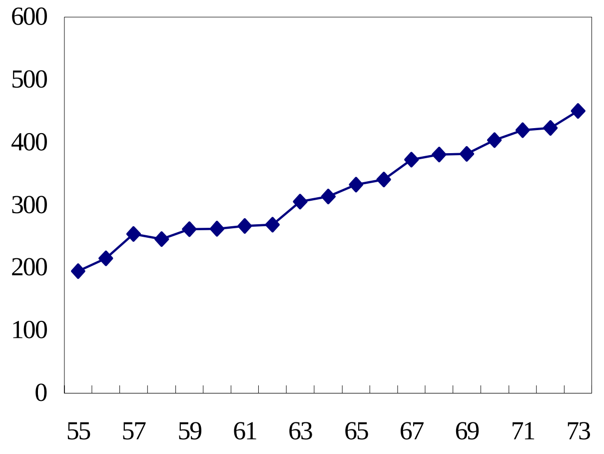
rises, firms would response to it by reducing investment rather than by reducing borrowings (Lavoie, 1995, p. 166).

Figure 1. Debt-equity ratio of Korean Firms (1963-1996)



Source: BOK, *Financial Statement Analysis* , *Statistical* each year.

Figure 2. Debt-equity Ratio of Japanese Firms (1955-73)



Source: The Bureau of Statistics, *Japan Yearbook*, each year.

Socialisation of risk through government industrial and financial policies, which encouraged risk-taking beyond the scales that can be borne by individual firms (or even individual *chaebols*) provides a partial answer to this (more on this later in section 3), but more important was the fact that that financial incomes were recycled back to the corporate sector through various government control mechanisms (see Akyuz et al., 1998).[8] Strict capital control kept the financial incomes inside the domestic financial sector, and control on luxury consumption ensured that only a small proportion of them was consumed. They were then ploughed back to the corporate sector through government control over bank lending. These institutional arrangements made it possible for the Korean firms to maintain high rate of investment despite high financial leverage. And it was the breakdown of this recycling mechanism, rather than the high leverage itself, which was behind the 1997 financial crisis (see Chang et al., 1998, for further details).

2.3. Abnormal Ownership Structure

It is frequently argued that the *chaebol*s have "abnormally" high share of family shareholding because they have been reluctant to turn to the stock market for fear of losing corporate control by the "owner's family" (Yoo, 1995; Yoo & Lim, 1998).

What is overlooked by those who hold this view is that the *chaebols* have *not* been afraid of going to the stock market. As we shall see in the next section, they have actually relied quite heavily on stock financing. And as a result, the proportion of family

[8] It was the main banks that performed this recycling function in Japan. The institutional difference between two countries is related to the economy-level capital shortage in Korea that led to dependence on foreign capital, a stable supply of which required government repayment guarantees and consequently a much stronger government say in corporate decision-making.

shareholdings has been on the decline over time. Table 4 shows that, for the top 30 *chaebols*, this declined from 17.2% in 1983 to just above 10% by the mid-1990s (the average of 10.2% during 1993-6). For the top 5 *chaebols*, the decline was even more marked. It came down from 15.6% in 1987 (the 1983 figure is not available, but must have been higher than the 1987 figure, given the trend) to 8.6% in 1996. If this is the case, it seems difficult to maintain that the desire to maintain *family* control has kept the *chaebols* away from the stock market.

Table 4. Changes in the Share of "Insider" Ownership of Chaebols (%)

	1983	1987	1989	1990	1991	1992	1993	1994	1995	1996
Top 30	57.2	56.2	46.2	45.4	46.9	46.1	43.4	42.7	43.3	44.1
Family	17.2	15.8	14.7	13.7	13.9	12.6	10.3	9.7	10.5	10.3
Subsidiaries	40.0	40.4	32.5	31.7	33.0	33.5	33.1	33.0	32.8	33.8
Top 5	-	60.3	49.4	49.6	51.6	51.9	49.0	47.5	48.1	45.2
Family	-	15.6	13.7	13.3	13.2	13.3	11.8	12.5	9.4	8.6
Subsidiaries	-	44.7	35.7	36.3	38.4	38.6	37.2	35.0	38.7	36.6
Hyundai	81.4	79.9	-	60.2	67.8	65.7	57.8	61.3	60.4	56.2
Samsung	59.5	56.5	-	51.4	53.2	58.3	52.9	48.9	49.3	46.7
Daewoo	70.6	56.2	-	49.1	50.4	48.8	46.9	42.4	41.4	40.1
LG	30.2	41.5	-	35.2	38.3	39.7	38.8	37.7	39.7	38.3

Note: The figures for the top 30 and the top 5 *chaebols* are the weighted average of individual *chaebols* (according to the size of their capital base) in the respective grouping.

Sources: Korean Fair Trade Commission

Having said that, we must point out that the share of “insider” ownership in the Korean *chaebols* still remains high.[9] As we can see from table 4, the “insider” ownership share for the top 30 *chaebols did* fall substantially from 57.2% recorded in 1983, but it still remained at 43.4% in the mid-1990s (the average for 1993-6). In the case of the top 5 *chaebols*, it fell from 60.3% in 1987 down to 47.2% in the mid-1990s (the 1993-6 average).

What is important to note is that, after the recent crisis, the insider ownership share rose back again to 50.6% (as of 1999), because of the marked increase in the share of inter-subsidiary holdings. The share of inter-subsidiary holding rose from 33.2% in the mid-1990s (the average for 1993-6) to 44.1% in 1999 (KFTC, 1999). This sudden rise in the share of insider ownership, especially that of inter-subsidiary holdings, may seem paradoxical, given that the recent corporate “reform” measures were supposed to reduce, among other things, the excessively high insider ownership by liberalising and opening-up the stock market. However, the “reform” has created even bigger incentives and opportunities for increased insider ownership. In terms of the incentives, the allowance of hostile take-overs has made the *chaebols* increase the insider ownership for defensive purposes. In terms of opportunities, the full-fledged liberalisation of the stock market allowed the *chaebols* to increase their insider ownership by mobilising large-scale funds through investment and trust funds, a disproportionate part of which they have invested in their own subsidiaries.

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[9] What is interesting to note here is that, somewhat paradoxically, the use of inter-subsidiary holding has had the effect of encouraging stock market financing, as this allowed the “owning” family of the *chaebols* to dilute family shareholding while maintaining corporate control.

Now, one important question that we may ask is why the Korean *chaebols* have maintained such a high proportion of “insider” ownership. We know from the experiences of the postwar Japanese business groups that an insider shareholding of 20% or so is enough for maintaining corporate control.[10] This is even more puzzling when hostile take-overs were banned in Korea before the recent “reform”. Then why have the *chaebols* maintained such high degree of insider ownership?

First of all, unlike in Japan, the most effective method of inter-subsidiary shareholdings, namely, cross-shareholding, has been forbidden in Korea, and consequently there had to be a lot of “roundabout” shareholdings, which increased the amount of inter-subsidiary shareholdings necessary for the maintenance of corporate control.

However, a more important reason for the high share of inter-subsidiary shareholdings in the *chaebols* is that it was seen not just, or even mainly, as a device to maintain corporate control. If this was the case, the Korean *chaebols* may have also ended up with the 20% or so of insider ownership share that we see in Japan. Inter-subsidiary shareholding was also seen by the *chaebols* as a means to amplify their investment funds by creating “fictitious capital” on the basis of which new share can be

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[10] Inter-subsidiary shareholdings were also widely used by the so-called “new” *zaibatsus* of pre-war Japan, such as Nissan and Nichitsu, which aggressively invested in heavy and chemical industries in the early 1930s (Shimotani, 1984). During the war, the “old” *zaibatsus*, such as Mitsui and Mitsubishi, also used cross-shareholdings as a means of overcoming the limit of family ownership in mobilising the finance necessary for their entries into heavy and chemical industries.

issued. And it is this that gave them the incentive to create much more inter-subsidiary holding than what was necessary for the purpose of maintaining corporate control. [11]

2.4. Peculiar Mode of Financing

Closely related to the question of the capital and the ownership structures of the *chaebols* is the question of the mode of financing. Currently the most influential argument in this vein is that the *chaebol*s have avoided financing through the stock market to an "abnormal" degree for fear of losing corporate control by the "owning family". This peculiar mode of financing has, the argument goes, resulted in abnormally high financial leverage and abnormally high ownership concentration. As we have already raised some problems with this argument as applied to the question of ownership in the previous section, in this section we look at it in relation to the mode of investment financing.

[11] By creating fictitious capital, inter-subsidiary shareholdings can facilitate stock financing. Suppose a *chaebol* that has four subsidiaries. Assume that one of the subsidiaries, A, has 2 billion Won of internal reserve and invests it in another subsidiary, B. B also reinvests this capital in C, and C in turn in D, and finally D in A. At the group-level, capital has increased to 10 billion Won in book value from only 2 billion Won. Of course, inasmuch as it remains an increase only in book value, it does not increase the volume of investment funds available. However, when subsidiaries issue new stocks based on this fictitious capital, inter-subsidiary shareholdings can multiple the volume of investment funds. Suppose that every subsidiary issues new stocks twice as big as the amount of inter-subsidiary investment and sells them in the stock market. New equity amounts to 20 billion Won, ten times the original capital, and the net increase in investment funds (net of the fictitious capital) is 8 billion Won. Needless to say, whether such increase in investment funds can be realised depends on the liquidity in the stock market. If the stock market is sufficiently liquid, a *chaebol* will have the incentive to raise low-cost investment funds by lowering the share of inter-subsidiary shareholding as much as it is consistent with maintaining corporate control.

To begin with, note that there is no evidence that the dependence of the Korean *chaebols* on stock market is lower than that of their counterparts in other countries. A number of recent researches have revealed that, together with the large corporations in other developing countries, large Korean firms, most of them *chaebol* subsidiaries, have actually relied *more* on equity financing than their counterparts in the advanced countries, which rely mostly on financing through retained earnings (see Mayer, 1998 and 1990; Corbett & Jenkinson, 1994; Sing, 1994 and 1995; Singh & Hamid, 1992)

Table 6 shows that until the early-1980s, the Korean firms had very heavily relied on credit-based finance, bank-loans in particular, but since then, market-based financing – bonds and stocks – emerged as the dominant mode of corporate financing in Korea. As we can see from table 5, the ratio of direct financing to total external financing, at 36% over the 1982-94 period was much higher than that in the USA (27.1%; 1993) and Japan (16.7%; 1994) in the 1990s (Kim & Suh, 1998, p.59).

Table 5. Trends in Gross Financing of Non-Financial Korean Firms (Flow of Funds) (%; Unweighted Annual Average)

	1963-65	*1966-71*	*1972-76*	*1977-81*	*1982-86*	*1987-91*	*1992-94*
Internal fund	47.7	25.4	32.9	23.3	33.5	26.4	27.3
External funds	52.3	74.6	67.1	76.7	66.5	73.6	72.7
Indirect finance	25.3 (48.4)	31.2 (41.8)	34.3 (51.1)	41.2 (53.7)	27.8 (41.8)	26.5 (36.0)	27.1 (37.4)
Banks	17.5 (33.5)	24.5 (32.8)	23.0 (34.3)	25.0 (32.6)	15.0 (22.6)	12.5 (17.0)	11.8 (16.3)
NBFIs	7.8 (15.0)	6.7 (9.0)	11.3 (16.8)	16.2 (21.1)	12.8 (19.2)	14.0 (19.0)	14.5 (20.0)
Direct finance	14.4 (27.6)	10.7 (14.3)	14.6 (21.8)	19.0 (24.8)	18.3 (27.5)	27.5 (37.4)	32.3 (44.3)
Bonds	0.6 (1.2)	0.5 (0.7)	1.7 (2.5)	3.2 (4.2)	7.3 (11.0)	10.7 (14.5)	12.9 (17.7)
CBs & CPs	N.A.	N.A.	1.2 (1.8)	4.2 (5.5)	2.6 (3.9)	2.4 (3.3)	7.2 (9.9)
Stocks	13.8 (26.4)	10.8 (14.5)	13.0 (19.4)	12.5 (16.3)	11.0 (16.5)	16.9 (22.9)	12.1 (16.9)
Foreign borrowing	11.0 (15.4)	27.0 (36.2)	17.8 (26.6)	11.7 (15.2)	1.3 (1.9)	2.3 (3.1)	0.4 (0.6)
Trade credit & Others	4.4 (8.5)	5.8 (7.8)	-0.2 (-0.3)	0.6 (0.8)	16.6 (24.9)	14.9 (20.2)	11.0 (15.1)
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Note: The figures in brackets are as share of total external funds.

Sources: BOK, *Flow of Funds*, each year.

Particularly, table 5 shows that the contribution of stock financing to investment funds in Korea remained at around 11-17% of total funds from the early 1960s on. This is an impressive figure, even compared with that we find in the country with the most developed stock market, namely the USA, where the highest share of equity financing ever reached was 19% (in the 1930s), which included the issuance of equity for take-overs and therefore is not a net figure (Taggart, 1985). Moreover, in table 6, we can see that the contribution of stocks in investment financing in Korea during the 1970s and the 1980s was, at 13.4% (1972-91), much higher than that in Germany (2.3%), Japan (3.9%), the UK (7%), or the USA (-4.9%).

Table 6. Gross Sources of Finance in Selected Countries (1970-89) (%)

	Germany	Japan	UK	US	Korea*
Internal	62.4	40.0	60.4	62.7	29.0
Bank finance	18.0	34.5	23.3	14.7	18.9
Bonds	0.9	3.9	2.3	12.8	5.7
New equity	2.3	3.9	7.0	-4.9	13.4
Trade credit	1.8	15.6	1.9	8.8	n.a.
Capital transfer	6.6	n.a.	2.3	n.a.	n.a.
Other	8.0	2.1	2.9	5.9	n.a.

*1972-91

Sources: All figures other than those for Korea are from Corbett & Jenskinson (1994, p. 9). The Korean figures are calculated from table 5.

Thus seen, there is no substance to the claim that the *chaebols* have avoided financing through the stock market.[12] They have large debts not because they eschewed stock financing, but only because they have found even these large sums raised in the stock market insufficient for the aggressive investment strategy that they have pursued with impressive results. And as a result, the stock market in the country has been one of the most rapidly developing in the world – according to one World Bank study, Korea ranked the 10th in terms of stock market capitalisation as a proportion of GDP among

[12] Of course, the figures that we have used are not exclusively for the *chaebol* subsidiaries, but given the weight of the *chaebol* subsidiaries in the corporate sector, they can be taken as a rather close representation of the *chaebol* sector.

the 30 countries surveyed, higher than several advanced countries such as Canada, France, Italy, and Sweden (Demirguc-Kunt & Levine, 1996).

2.5. Excessive Diversification

The *chaebols* are often accused of having pursed “excessive” diversification of their business, which is often described as the “octopus tentacles” strategy in the Korean media. This view has an apparently validity, given that many *chaebols* are engaged in a truly wide range of activities. However, looks can be deceptive.

The *chaebols*, especially the large ones, may own 50-60 subsidiaries operating in tens of different industries, but most of their sales revenues are generated by a few core firms. Between 1988 and 1995, the 4 largest subsidiaries of the top 4 *chaebols* generated an average of 79.0 % of their total sales. Especially in the case of Samsung, the four largest firms, two of which were in the same industry (electronics), alone accounted for about 90 % of sales - a striking concentration (rather than diversification) of activities given the number of its subsidiaries (55 as of 1995). The same can be said of the smaller *chaebols*, with the reliance on a small number of subsidiaries tending to increase as their size diminishes. For instance, in 1994, the *chaebols* that ranked between the 6th and the 10th generated 72.6% of their sales from the 4 largest subsidiaries. In the case of the *chaebols* that ranked between the 11th and the 20th, the 3 largest subsidiaries generated 72.1% of their sales, and in the case of the *chaebols* that ranked between the 21st and the 30th, as much as 72.3% of the sales were generated by the 2 largest subsidiaries.

These figures tell us that the *chaebols* are actually much more focused than what we normally think of them as. In other words, the large number of subsidiaries and their presence in a wide range of industries seems to have blinded people to the fact that most of the subsidiaries are insignificant.[13]

This is *not* to say that the *chaebols* have not pursued some unrelated diversification – they have pursued it quite a lot. However, their diversification strategy is better described as an alternating pursuit of related diversification and unrelated diversification, rather than an indiscriminate strategy of unrelated diversification. Their strategy has been to enter into a range of industries at the same time (the unrelated diversification phase) and then consolidate these ventures by diversifying from them into related areas (the related diversification phase).[14]

Related diversification was necessary for the continued development of the Korean *chaebols* because they chose to concentrate on heavy and chemical industries, whose success requires extensive backward and forward linkages.[15] In other words, they "had to integrate into the production of many basic intermediate goods in order to

[13] This is not to deny that *chaebol* subsidiaries, however insignificant they may be in terms of their contribution to their own groups, may still be very significant in some industries they operate in.

[14] Quite a few instances of the unrelated diversification seem to be motivated by inheritance motives. Unfortunately, we do not have enough data to tackle this issue here, but its importance in the evolution of the *chaebols* should not be ignored.

[15] This is what distinguishes the *chaebol* from the pre-war Japanese *zaibatsus* before they diversified into heavy and chemical industries (they originally concentrated in commercial and service activities). After their entry into heavy and chemical industries, the *zaibatsus* also underwent a period of related diversification. And it was through such process that the seeds of the postwar vertical *keiretsus* emerged (Shimotani, 1991).

secure necessary inputs as well as to exploit the economies of scale", given "the rapid pace of industrialisation and the low starting level of capital and technology accumulation"(Chandler et al., 1997, p. 20).

That consolidation through related diversification was necessary for the continued expansion of the *chaebols* is confirmed by the fact that there seems to be a strong positive correlation between related diversification and the size of the *chaebol*. Table 7 shows that the degree of related diversification (ER in the table) of the top 5 *chaebols* was higher than that of any strata (grouped in 5, according to the ranking) of the next 25 *chaebol* in the years 1984, 1987, and 1994, except for the group comprising the ones ranked from 16th to 20th in 1994.

Table 8. Diversification of the Top 30 *Chaebols* in the Mining and the Manufacturing Sectors (Entropy Diversification Index)

	1984				1987				1994			
	ET	ER	EB	EB/ET	ET	ER	EB	EB/ET	ET	ER	EB	EB/ET
1-5	1.455	0.616	0.839	0.568	1.463	0.816	0.647	0.421	1.967	0.652	1.315	0.668
6-10	1.263	0.444	0.819	0.578	1.152	0.448	0.704	0.637	1.510	0.470	1.040	0.688
11-15	0.981	0.325	0.656	0.727	1.196	0.329	0.867	0.759	1.683	0.588	1.095	0.650
16-20	0.825	0.330	0.495	0.710	0.945	0.432	0.513	0.578	1.413	0.703	0.727	0.514
21-25	0.836	0.231	0.605	0.636	0.896	0.225	0.671	0.801	1.268	0.549	0.718	0.566
26-30	0.486	0.105	0.381	0.715	0.867	0.183	0.684	0.812	1.134	0.510	0.624	0.550
Avg.	0.974	0.342	0.632	0.653	1.087	0.406	0.681	0.668	1.498	0.579	0.919	0.613

Notes: ET = Total diversification entropy index. ER = Related diversification entropy index. EB = unrelated diversification entropy index. ET=EB+ΣSijER, ET=ΣΣSijlogSi, ER=ΣSijlogSij, EB=ΣSilogSi [Si= the share of ith industry within the firm, Sij= the share of jth industry within ith industry {i=1,2,---, n; KSIC 2- digit industry), j=1,2,….,m; KSIC 3-digit industry (1984, 1987), KSIC 4-digit industry (1994)}].

Source: Lee & Lee (1990, p. 39: 1996, p. 12)

If the degree of related diversification has a positive correlation with the size of the *chaebols*, does it mean that unrelated diversification is bad? Not necessarily. The benefits of unrelated diversification derive from what we propose to call *economies of grouping,* which refers to the benefits resulting from internalising positive externalities within the bounds of the business group.

For example, grouping creates financial synergies which enable the *chaebol* to mobilise large-scale investment funds effectively and quickly. Grouping also helps the *chaebol* firms invest more aggressively in new technologies, by enabling them to share risk with their member firms. In addition, grouping stabilises cash flows, which is especially important when many of the industries that the *chaebols* are engaged in are subject to large swings in demands (e.g., semiconductor, shipbuilding, automobile). These are functions that are critical for the late-comers like the *chaebols* in achieving scale and scope, which are essential for competing with the first-movers in the world market.

To sum up, the *chaebols* have *not* pursued an indiscriminate unrelated diversification *but* a strategy that systemically alternates related and unrelated diversification. It is also important not to dismiss unrelated diversification out of hand, as it often confers “economies of grouping”.

2.6. Over-investment and Abuse of Power: The “Real” Problems with the *Chaebols*

In the preceding sections, we have tried to show that the *chaebol* is not such a pathological form of corporate organisation as it is these days often made out to be. Of course, to say that the *chaebols* are not as pathological organisations, however, is not to say that the *chaebol* system has no shortcomings. It is a system with many problems. However, most of the problems that the currently popular view identifies are false as we have seen. We believe that the real problems with the *chaebols* are, firstly, their strong tendency to over-invest, and, secondly, the abuse of their ever-growing economic and political power.

2.6.1. The Over-investment Problem

Periodic over-investment, or the phenomenon also known as "excessive competition", has been a well-known feature of capitalism since its early days, but the *chaebols*, because of their exceptional ability to mobilise large funds and their fierce competition with each other, have been particularly prone to it.

The logic here is that oligopolistic competition that characterises many modern industries with significant scale economy (that is, many of the industries in which the *chaebols* specialise) often leads to excess capacity, unless there is a coordination of investment activities across the competing firms. Excess capacity leads to price war, which damages the profit of the firms concerned and may force them to sell some of their assets, and sometimes to bankruptcy.

Now, transfer of asset ownership through sales and bankruptcy is a necessary and costless way of re-arranging property rights in a world without transaction costs and "specific assets" (assets whose values outside their current employment are low – the term is due to Oliver Williamson), but we are not living in such a world. This means that the specific assets involved in this process have to be scrapped or sold to alternative uses that can create much less value out of the assets concerned, thus incurring a social cost. (for more detailed arguments, see Chang, 1994, ch. 3, and 1999; also see Telser, 1987, and Amsden & Singh, 1994).

Many mainstream economists have argued that over-investment is a non-problem, especially for small economies that are price-takers, because what cannot be consumed in the domestic market can always be exported. However, this is often not a viable option, at least in the short-run (and it is the short run that counts here).

First of all, at least since the late 1970s, many industries have been suffering from chronic over-capacity on a world scale.[16] Moreover, real-world markets are often segmented along the lines of quality, design, brand image, and geography, and therefore the “world market” may not be as large as it seems, given that it takes time and resources to break into new market segments. In addition, some small economies have deliberately built capacities which are far beyond its domestic markets and have become price-makers, rather than price-takers, even on the world scale – Korea’s positions in industries like shipbuilding, memory chips, and steel are the best example.

And it is for these reasons that the Korean government had played an active role in controlling over-investments in many industries at least until the late 1980s, by coordinating entry, exit, and capacity adjustments (for the details of such practice, see Chang, 1993). And indeed the end to this practice during the 1990s, together with financial liberalisation, led to over-investment in a number of key industries (notably

[16] Of course, this does not mean that new entries into these industries cannot happen. The East Asian producers have been quite good at gaining market shares in some industries with chronic over-capacity problem. However, successful entry into these industries will be much more difficult than that into other industries.

semiconductors, steel, and automobile) that contributed to the current crisis (see section 3 for further details; also see Chang, 1998, and Chang et al., 1998).

Given these, we believe that it is necessary in the current Korean situation to restore the role of investment coordination by the government through industrial policy measures, albeit in a modified form, if we are to avoid more episodes of over-investment and crash in the future (more on this later). And given the growing importance of *chaebol*-controlled financial institutions, a tougher financial regulation will also be necessary in order to prevent the channelling of a disproportionate share of their funds into their sister firms, which may aggravate the over-investment problem.

2.6.2. The Abuse of Power

The abuse of economic and political power by large corporations has also been a major concern at least since the late 19th century in all capitalist societies, but the problem in Korea has become recently quite worrisome.

The abuse of *chaebols'* economic power has a long history and is already well known. As most of the firms with market power belong to the *chaebols*, they have often exploited the consumers. They also financially exploit their suppliers by routinely issuing long-term post-dated cheques and squeezing them through price cuts and other concessions in times of financial trouble. Many of their procurement officers are known to take bribes from the suppliers who are anxious to get new contracts or not to lose the existing ones.

The abuse of the *chaebols'* political powers is a more recent phenomenon. In Korea, there has always been a close (but not necessarily cronyistic) relationship between the government and the *chaebol*, but the worst abuse of the *chaebol* power had been contained by the domination of the government over them until the 1980s (see section 3 for more details). However, as symbolised by the running of Mr. Chung Ju Young, the founder of the Hyundai group, in the 1992 presidential election, the *chaebols* have organised themselves into a powerful political group, and have been exercising increasingly greater influence on government policy, without corresponding accountability (more on this later).

The conventional wisdom holds that these abuses of power can best be controlled by exposing the *chaebols* to greater market discipline. However, this is not going to work because the natural tendency of the market is towards concentration. The fact that 80% of the bond issues during 1998 was secured by the top 5 *chaebols*, once the government removed restrictions on bond issues, lends support to this view – and indeed the government re-imposed restrictions in an implicit recognition of this view. The recent legislation strengthening the rights of minority shareholders are hoped to restrain the abuse of power by top management of the *chaebols*, but this has the limitation that many minority shareholders are likely to acquiesce in the abuse of power, as they will usually benefit from this if it involves exploitation of others (e.g., suppliers, consumers). The recent introduction of the requirement that companies should recruit more than 25% of the directors from the outside (and there is a proposal to increase it to 50%) is also hoped to do the same, but it is not clear how much the outside directors can do, when many of them are “friends” of the corporations, are non-experts in corporate matters, and have the burden of multiple directorship.

Therefore, we need to go beyond the rather narrow shareholder-centred notion of corporate governance behind the recent legislations, if we want a more effective control over the *chaebols*. While discussing the details of this alternative strategy is beyond the scope of this paper, we can say that this should involve a wide range of governmental agencies (as the ultimate guardians, however imperfect, of social interests) and private-sector actors (e.g., suppliers, unions, consumer groups, NGOs, local communities) – or the "stakeholders" for a short-hand – as "countervailing forces" to these giant corporations.

3. Understanding the Government-*Chaebol* Relationship in Korea

Together with the *chaebol* system, the government-*chaebol* relationship has been identified by many commentators as an important pathological element in the traditional Korean system. Two arguments along this line have been popular – the so-called "crony capitalism" argument and the so-called "Too Big To Fail" argument (see Chang, forthcoming [2000] for further discussion, including the comparisons with other crisis-stricken Asian economies).

According to the crony capitalism argument, the corrupt symbiosis between the government and the *chaebols* has meant that the latter have bought government favours through legal and, more importantly, illegal political contributions. Lenders naturally regarded, the story goes, enterprises with cronyistic connections as having no downside risk (as the government will rescue them if they get into trouble), and were willing to lend them as much as they wanted, thus inflating asset bubbles that led to the crisis (e.g., Krugman, 1998).

The so-called "Too Big To Fail" argument focuses on the fact that the Korean *chaebols* are very large in relation to the size of the national economy and therefore their failure can have very large impacts on the national economy. These *chaebols*, it is argued, took excessive risk because they knew that the government cannot afford to sit and watch them go bankrupt for fear of large-scale "ripple effects" such as large-scale unemployment and widespread bankruptcy of subcontracting firms - a case of "moral hazard" (e.g., Yoo, 1997; Pyo, 1998; Burton, 1998).

These arguments have very strong *prima facie* validity. However, as we shall soon see, these arguments are of dubious theoretical solidity and not supported by empirical data.

3.1. Crony Capitalism

The story of cronyism has been very popular, especially in the early days of the Korean crisis, given the widespread perception that in the country there has always existed a close and often corrupt relationship between the government and business, especially the *chaebols* – or what is known in Korea as *jungkyung yoochahk* (meaning literally the "adhesion between politics and economics").

The biggest problem with the cronyism story is that cronyism, if precisely defined as the conferring of political favour on the basis of personal relationship and/or financial transfer, was never a central, or even an important, feature of Korea's "traditional" developmental model. It is true that there were a lot of funds flowing from business to politicians and bureaucrats. However, these were usually general extractions applied to all firms (hence the popular description of these as "quasi-taxes") and were rarely tied to specific favours *as far as the key manufacturing sectors were concerned* (although it was a different story in areas like urban planning, constructions, and defence). In other words, the traditional Korean government-*chaebol* relationship may have been corrupt, but in the key manufacturing sectors, the corruption that existed was a "generalised" one rather than a "cronyistic" one.

It is true that since the late 1980s, and especially under Mr. Kim Young Sam, "cronyistic" relationships have spread into some key manufacturing sectors. And contrary to the conventional wisdom, this was not least because of the weakening of government industrial policy. In the traditional system, it was very difficult, if not impossible, to change the course of industrial policy for cronyistic reasons, as the policy goals were pretty clear and well-publicised. Since the late 1980s, the weakening of industrial policy meant that there were probably fewer benefits from establishing cronyistic relationships than before, but it also meant that, once such relationship is established, there was a much greater room for changing the policies in one's favour, as policy guidelines were now much less clearer (if they existed at all). The corruption surrounding Hanbo's entry into the steel industry is the best example, but the existence of a few *chaebols* which were regarded by many people as being particularly close to Mr. Kim's government suggests the spread of cronyism under Mr. Kim.

Having said that, however, even under Mr. Kim, the spread of cronyism did not go far enough to make it a central feature of the Korean political economy that it was not before. In fact, for whatever its worth, the "corruption perception index" compiled by the Transparency International shows that corruption was perceived to be *diminishing* in Korea on the eve of the crisis, *in spite of* the well-established historical regularity that during financial euphoria the incidences of corrupt behaviour tend to increase both in the private sector and in the public sector (Kindleberger, 1996, Ch. 5).[17]

3.2. The Logic of "Too Big To Fail"

The logic of "Too Big To Fail" (henceforth TBTF) seems difficult to dismiss, especially given that it is indeed practised by all governments in all capitalist countries, including the ones that claim to be the most market-oriented. The rescue of the US hedge fund, Long Term Capital Management (LTCM), is one prominent recent example, but other examples abound. In the late 1970s, the bankrupt Swedish shipbuilding industry was rescued through nationalisation by the country's first right-wing government for over 50 years, which came to power with the promise of introducing greater market discipline. In the USA, it was the avowedly free-market Reagan administration which organised a rescue operation for the carmaker Chrysler in the early 1980s.

However, there is theoretical confusion in the TBTF story between the rescue of a firm and the rescue of its owners or managers who are responsible for creating the

[17] On a scale of 0 (very corrupt) to 10 (very clean), Korea's score went down from 3.93 during 1980-85 to 3.50 during 1988-92, but significantly went up to 5.02 in 1996. Similar pictures exist in other crisis economies in Asia, thus questioning the validity of the crony capitalism story as an explanation of the 1997 crisis over Asia in general (see Chang [2000] for details.

situation where the rescue is needed. To the manager, it is not much of a consolation that his/her firm is saved by the government due to its large size, if the rescue operation involves the termination of his/her contract. So if a manager know that he/she will lose the job when his/her firm performs badly, there is little incentive on his/her part to take excessive risk. The same goes for the owners. If the owners know that the rescue operation requires ceding of their corporate control, they cannot afford to be lax in management (in case they are owner-managers) or in supervising the hired managers. In other words, whether government bail-out of some large firms encourages moral hazard by the managers of other large firms depends on whether they are accompanied by punishments for bad management.

The evidence from Korea is not on the side of the TBTF story. Especially in the 1960s and the 1970s, when the country was going through rapid structural changes, even some of the largest *chaebols* went bankrupt and their carcasses were divided up through state-mediated take-overs. The second largest *chaebol* during the 1960s, Samho, had all but disappeared by the late 1970s after a series of bankruptcies of its core firms. The Gaepoong *chaebol*, which ranked between the 3rd and the 4th during the 1960s virtually disappeared by the mid-1970 following a series of business failures. The Donglip *chaebol*, which ranked the 9th in the early 1960s, went bankrupt by the end of the decade. The owner of the once-largest car manufacturer in the country, Shinjin, was forced to sell it off to the state-owned Korea Development Bank (which then sold it to Daewoo) in the late 1970s, when it got into trouble. Dongmyung, the *chaebol* built around what was the world's largest producer of plywood around the early 1970s, went bankrupt in 1980.

These are striking statistics. For example, the collapse of the three of the top-10 *chaebols* of the 1960s (namely, Samho, Gaepoong, and Donglip) is equivalent in American terms to the disappearance by the early 1980s of Standard Oil (New Jersey), Ford Motor, and IBM, which ranked the 2nd, the 3rd, and the 9th respectively in the *Fortune* US enterprise ranking in 1964. As a result, until the mid-1980s, there was a very high turnover even in the ranks of the top 10 *chaebol*s. Only three of the top 10 *chaebol* in 1966 were among the 1974 top 10 and only five of the 1974 top 10 were in the 1980 top 10 (Chang, 1994, p. 123).

After the mid-1980s, and especially in the 1990s, the ranking of the top 10 *chaebols* remained highly, if not completely, stable, but among the lesser *chaebols* there was still a high turnover.18 Between 1990 and 1996 alone, three of the top 30 *chaebols* (Hanyang, Yoowon, and Woosung) went bankrupt, showing that there is no substance to the claims such as: “In Korea, none of the *chaebol* had been allowed to fail for a decade before Hanbo steel collapsed in early 1997” (Radelet & Sachs, 1998, p. 42). In 1997, in the build-up to and at the beginning of the crisis, six of the top 30 *chaebols* (Kia, Halla, Jinro, Hanbo, Sammi, and Haitai) went bankrupt, again debunking the TBTF story (Chang et al., 1998).

Of course, all these are not to deny that the Korean government not infrequently injected money into ailing large enterprises through the state-owned banks (especially the development bank, Korea Development Bank). However, these financial injections were conditional, with very few exceptions, on the change of ownership and top management, and were always accompanied by tough terms of financial restructuring.

In other words, the rescue of large enterprises by the Korean government should be seen as government-mediated take-over or restructuring rather than as bail-out in the strict sense.

3.3. The Changing Nature of Government-*Chaebol* Relationship

If, as we argued in the previous section, the currently popular arguments about the nature of the government-*chaebol* relationship in Korea – namely, the crony capitalism argument and the "Too Big To Fail" argument – fundamentally misrepresent the relationship, how are we to understand it?

We propose to characterise the "traditional" corporate governance system of Korea as a "state-controlled insider system". It is an "insider" system in that the owner-managers of the *chaebols* were insulated from the influence of the outside investors through an intricately-developed system of intra-group shareholding, against the backdrop of a corporate law banning hostile take-over. However, the system was fundamentally "state-controlled", although it became increasingly less so over time, in the sense that the government exercised strong influences on corporate investment decisions and mediated the process of changes in corporate control.

The mot important (and also most controversial) aspect of government's role in this system was to minimise over-investments (see section 2.6.). This was done through various policies of *ex ante* investment coordination and the *ex post* facilitation of

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18 Between 1986 and 1996, among the 20 *chaebols* that ranked between the 11th and the 30th, there were on average 14 changes in the rankings and 2.2 new entries into the

industrial and corporate restructuring when an over-investment problem emerged for whatever reason (e.g., some firms defying government policy, external shocks, erroneous government projection). *Ex ante* investment coordination involved restrictions on entry, exit, and capacity expansion, in line with the Five Year Plan (practised between 1962 and 1993), sectoral promotional plans, and sectoral rationalisation programmes. *Ex post* management of the over-investment problem involved government mediation (and sometimes imposition) of corporate take-overs, mergers, forced exits, business swaps, and market-sharing arrangements.

The most important examples of such government-mediated industrial restructuring include the following: (i) the series of state-mediate corporate take-overs in 1969 amid the emerging domestic debt crisis that lasted until 1972 (see Chang & Yoo, 1999); (ii) the 1980 "Industrial Re-organisation" programme following the Second Oil Shock, which involved forced exits, government-mediated mergers, business swaps, and market-sharing arrangements in 6 major industries (see Chang, 1993); (iii) the series of government-mediated mergers in a number of industries in the mid-1980s (see Chang & Yoo, 1999); and (iv) the so-called "Big Deal" programme under the current government, which involves merger and business swaps in 9 industries suffering from over-investment (see below and Chang & Yoo, 1999).

In this system of "state-controlled insider system" of corporate governance, the *chaebols* did not have to worry about short-term financial profitability, as it was an "insider" control system. However, they knew that they had to deliver results (although not necessarily measured in terms of financial profitability) in the medium- to long run, if they were to get continued government support (Amsden, 1989; Chang, 1993; Evans,

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group every year (Park, 1999, Table 8-7).

1995). This was because the Korean government was willing and able to discipline the non-performers through various means ranging from the control over credit and foreign exchange allocation to its ability to force transfer of corporate control.

What is important to note here is that what made this system effective was not simply the state control over financial resources and regulatory measures but the widespread (even among businessmen) perception of the corporations, and especially the *chaebols*, as "social" entities that are integral parts of the national project of industrial development, and not as mere properties of the shareholders.

While the shareholder-centred view of the corporation never had any deep root in the country, the decisive event that clearly established the society-centred view of the corporation was the so-called "Illicit Wealth Accumulation" episode in 1961 (see Jones & Sakong, 1980, for details). Right after it seized power through the military coup, the Park Chung Hee government arrested some prominent businessmen on charges of illicit wealth accumulation through what these days may be called cronyistic connections and through illegal activities such as smuggling. Subsequently, the government pardoned these businessmen, but only on the promise that they will "serve the nation through enterprise" (*Sah-up Bogook).*

Such view of corporations was not simply a slogan imposed on a reluctant business community. At least in the early days of the country's industrial development, many leading business figures believed in such view and often made public proclamations to that effect. Mr. Jung Chu Young, the founder of the Hyundai group, is once reported to have said that "I firmly believe that anyone who puts his own business interests ahead of his country's cannot succeed in the long run" (cited in Steers, 1999, p.

236). Although what the business leaders saw as their "social" or "national" interests may not be always (or even usually) the same as what the government thought them to be, this is something difficult to imagine in an Anglo-American corporate world. At the same time, the public was willing to tolerate the use of taxpayers' money in corporate rescue operations because they implicitly regarded these companies as semi-public entities.

Of course, over time, such "social" view of the corporation has come under increasing attack. With their growing economic and political power, the *chaebols* started resenting government intervention and became more aggressive in demanding liberalisation.[19] With their privileged background (which few of their fathers had) and stints in the US (whether education or business), the second generation *chaebol* leaders, most of whom started taking over the business from the 1980s, were much more inclined towards the shareholder-centred notion of corporations and therefore much less willing to tolerate government intervention. The increasing influence of Neo-Liberal ideology since the 1980s, combined with spreading share ownership, also meant that the public, especially the intellectuals, was also increasingly influenced by the shareholder-centred view of corporations.

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[19] In the spring of 1997, the Korea Federation of Industries, the association of the *chaebols*, prepared a report arguing for the abolition of all government ministries except the ministries of defence and of foreign affairs and for the consequent reduction of government staff by 90%. The report had to be officially withdrawn because it was unfortunately leaked before the end of the end of the embargo and created a popular uproar. While the chance of such proposal being taken seriously was non-existent even in the anti-statist mood that the country was then in, the incident is illustrative of the aggressiveness that the *chaebols* were showing in pushing for greater business freedom in the recent period.

Especially with the series of changes in corporate laws and industrial regulation following the 1997 crisis, the shareholder-centred view of corporation has now become, politically and legally, the "correct" view. However, it is well known that formal institutional changes cannot define the whole universe of our behaviour, and the recent corporate governance "reform" has not been an exception to this.

First of all, there is the dissonance between the formal institutions and social perceptions. In a recent survey (25 March 1999) by the leading business newspaper, *Mae-il Business Daily*, it was revealed that the 500 "members of the public" interviewed believed very strongly that corporate profits belong more to the society (7.35 on a scale of 10) than to the shareholders (5.46 on a scale of 10). They also believed that employee welfare (8.09 on a scale of 10) and "social contribution" (7.99 on a scale of 10) are almost as important as profit-making (8.16 on a scale of 10) as an objective of business corporations. In other words, after a decade of onslaught of the Neo-Liberal ideology and the wide-ranging changes in corporate law after the 1997 financial crisis, the Korean public still strongly believes in a "social", or stakeholder-centred, view of corporations.

Secondly, there is the dissonance between the formal and the informal institutions. Despite the formal institutional changes towards a shareholder-centred model of corporate governance and towards *laissez faire* industrial and financial policies, the Korean government has actively intervened in the process of corporate restructuring following the recent crisis. Although it is now using methods that are less explicit than before (e.g., "indirect" influence through the Financial Supervisory Commission, calculated pronouncements by key government figures), it has nonetheless played a critical role in pushing through the so-called "Big Deal" corporate restructuring programme. Its involvement in the recent re-organisation of some technically bankrupt *chaebols* (such as Daewoo) has also been largely in line with the past practice, however much it likes to present its action as a “radical” departure from the past.

Thus seen, it is true that the government-*chaebol* relationship in Korea has recently, especially after the 1997 crisis, gone through some very important changes, but elements of the old corporate governance system still survives and sometimes exert strong influences. However, it would not be right to regard the behaviour of the current Korean government as basically cynical – doing the same things as before while giving lip service to shareholder sovereignty and free market in order to avoid international criticisms. The point is that informal institutions change much more slowly than formal institutions, and therefore that the recent changes in formal institutions cannot transform overnight the way in which the corporations relate to each other, to the government, and to the wider society.

3.4. The Future of Government-*Chaebol* Relationship

What emerges from our analyses above is that the “traditional” system of corporate governance, while not without important limitations, was by no means as corrupt and inefficient as it is now widely believed. Also, the traditional system is not completely dead, despite public pronouncements to the contrary. However, many people argue that, whatever the merits of the old system may have been, Korea is better off parting with it completely as soon as possible, because the changes in the country’s economic and political conditions have made the old system infeasible anyway.

Apart from the effect of globalisation, a proper discussion of which is outside the scope of this paper, two arguments in this regard are popular. The first such argument is that the attainment of economic maturity by the country has made centralised coordination very difficult, if not completely impossible. The other popular argument is that increasing democratisation has made state intervention politically less acceptable, as it interferes with freedom. Let us examine these arguments more closely (further discussions can be found in Chang, 1999).

3.4.1. Economic Maturity

There are two variants to the "economic maturity" argument – one based on the problem of complexity, and the other based on the problem of uncertainty.

The "complexity" variety is that, with economic development, economies become more complex, and therefore it becomes more difficult to administer. Is this true?

It is true that, other things being equal, a more complex problem increases the informational requirements for an effective policy action, and therefore is more difficult to manage centrally. But the point is that other things are *not* equal.

To begin with, a more mature economy is likely to have a better administrative capability, if only because its bureaucracy will have had more opportunity to engage in "learning-by-doing". Secondly, a more developed economy is typically better organised into larger and better-managed units (e.g., large modern corporations, producer associations, community organisations), which means that it has more effective “intermediate” enforcement mechanisms.[20] In short, a more mature economy typically (but not always) has more complex tasks at hand, but at the same time it typically has better capabilities (both at the governmental level and at the societal level) to manage those tasks. Therefore, it is not clear whether centralised coordination through industrial policy becomes necessarily more difficult with economic maturity.

A related, but different, variety of the “economic maturity” argument is based on the problem of uncertainty, rather than complexity. The argument is that, when a country reaches the frontier of technological development, it becomes much more uncertain what the government should be doing to help the industry.

However, first of all, many of the justifications of industrial policy hold for frontier industries too (e.g., investment coordination, restraint of predatory monopoly practices), and some of them may become even stronger with economic maturity (e.g., learning externalities). Secondly, even in a frontier industry with genuine uncertainty about its future, there is no reason why an intelligent bureaucracy, in close consultation with the private sector, cannot identify the broad trends and provide support for certain productivity-enhancing activities - the best example being that of Japan during the 1980s and the early 1990s (e.g., see Okimoto, 1989, Fransman, 1990, and Weiss, 1998). Thirdly, most Korean industries are yet to reach the “frontier”, and therefore this argument is not relevant for them. Seen from this perspective, we may say that, if

20 The point can also be made from the opposite end. It is well known that industrial policies are typically very difficult to implement in industries where firms are very small and are not organised into industry or regional associations.

industrial policy worked well in Japan as late as the late 1980s and the early 1990s, it should work for Korea for another few decades, if not necessarily beyond.

3.4.2. Democratisation

It is now widely accepted that interventionist industrial policy requires a strong state which can over-ride sectional interests (Amsden, 1989; Chang, 1993; Evans, 1995). Many people have interpreted this statement, in our view wrongly, as implying that increasing democratisation of the Korean society will make such policy politically less acceptable and therefore less feasible.

Contrary to the popular perception, industrial policy *is* perfectly compatible with a democratic polity, as we can see from the experiences of countries like France, Japan, Austria, Norway, and Finland during the postwar period. In fact, in many of these countries, industrial policy was *strengthened* rather than weakened following the greater democratisation of their societies after the Second World War.

These examples tell us that the implicit assumption underlying the conventional wisdom – namely, if the decisions are made democratically, people will naturally opt for less interventionist policies – is wrong. As our examples show, many democratic societies have adopted and successfully implemented strong interventionist industrial policies. Indeed, we can go one step further and even argue that, industrial policy, or for that matter any other policy, can be more effectively implemented in a democratic society, since it is likely to have greater political legitimacy.

It is certainly true that the conduct of industrial policy in Korea in the past has been often undemocratic, although probably not to the extent that it is often made out to be – there was at least some degree of policy consultation not just with the business sector but with the wider public. However, it will be erroneous to believe that reducing government intervention brings more democracy. Especially when there are large private sector entities like the *chaebols* which have enormous economic and political power, less government intervention can even mean a *reduction* of democratic control over the society. Indeed, given the strongly stakeholder-oriented view of corporation governance that prevails in Korea, the main problem that the Korean public seems to have against the old system of government-*chaebol* relationship is that of democratic accountability rather than their objection to government intervention itself. If that is the case, what is needed is not simple reduction in the scope of government intervention, but the construction of a mechanism through which policy consensus can be reached more democratically and policy actions made more democratically accountable.

4. Conclusion

In this paper, we have argued from many angles that the conventional wisdom regarding the *chaebol* system and the government-*chaebol* relationship has many serious flaws. We argued that some of the "pathological" features that according to this view distinguish the *chaebols* from the firms in other countries – such as extremely low profitability, excessively high leverage, and excessive aversion to financing through stock markets – do not have much empirical substance. Some other features – such as excessive diversification and high concentration of “insider” ownership – are partly true, but they are not as pathological as they are often thought to be. The most serious problem with the currently dominant view, however, is that it fails to understand the nature of the investment-growth dynamics that has characterised the Korean economy during the last few decades, and how many of the allegedly “pathological” features of the Korean *chaebols* were integral features of this rather successful dynamics.

If they are based on such flawed empirical bases and partial analyses, it is only natural that the recent “reforms” of the corporate governance and the financial systems in the country have not been able to address some of the very problems that they are supposed to address and have in some cases made them even worse. For example, financial liberalisation has led to an increasing dominance of the largest *chaebols* by enabling them to mobilise more funds through the bond market and the newly-allowed investment funds. And when these changes were combined with the abolition of the ban on hostile take-overs, they have created the incentives and the opportunities for the *chaebols* to dramatically increase the importance of “insider” ownership.

We argued that there are even more worrying problems with these reforms than these “unintended consequences”. Firstly, these reforms are very likely to weaken some strengths of the “traditional” Korean system, such as the ability to mobilise “patient” capital. And secondly, they are not going to be able to address the real problems posed by the *chaebols* – especially, their tendency to over-invest and the possible abuse of their enormous economic and political power.

We then argued that addressing what we see as the real problems of the *chaebols* requires a revival of industrial policy and financial regulation. In doing so, we pointed out some problems with the currently dominant view on the government-*chaebol* relationship – namely, the “crony capitalism” story and the “Too Big to Fail” argument – and suggested how this relationship should be restructured. We argued that, what we need is not the transformation of institutions in the Anglo-American image (and a very idealised and partial version of it at that) as the currently dominant reform agenda pursues, but a restructuring of the government-*chaebol* relationship (and the industrial and the financial policy regimes which governs that relationship) in a way that is more consensual and more open to democratic scrutiny.

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