1 Introduction: The Political Economy of Corporate Restructuring

Wonhyuk Lim, Stephan Haggard and Euysung Kim

The financial crisis that swept through Asia in 1997–98 had many roots, but one that has received increasing attention is the nature of the Asian business group (Pomerleano 1998; Claessens, Djankov and Lang 2000b; Rajan and Zingales 1998; Johnson et al. 2000; Johnson and Mitton 2001). These highly diversified, family-owned conglomerates have been the entrepreneurial engine of Asia's rapid growth over the last three decades. But at the same time they exhibited a number of troubling weaknesses, from high leveraging to weak corporate governance, lack of transparency and outright corruption.

In no country in the region is this ambivalence about the business group more pronounced than Korea. Influential accounts of Korea's growth have put the Korean groups, or *chaebol*, at the very center of the country's economic transformation (Amsden 1989). Yet the *chaebol's* close and collusive ties with the government, increasing dominance of Korea's economy and oligopolistic practices also made them politically controversial (Cho 1990). These perceptions only strengthened with the financial crisis, for which many Koreans held the *chaebol* directly responsible.

This book offers a comprehensive overview of "the *chaebol* problem." We look at the economic and political origins of the *chaebol* as a corporate form, their performance, and the role they played in the financial crisis of 1997–98. That crisis provided a powerful stimulus for reform of the financial system, the regulatory environment, and the *chaebol* themselves. The economics and politics of these reform efforts are the central focus of this book.

This book makes a break from the pre-crisis literature by providing a comprehensive look at the evolution of the *chaebol* from a corporate governance perspective.[1] We define corporate governance as the entire set of institutions, both inside and outside the firm, through which the objectives of the company are set and executed and the performance of the firm is monitored. This book looks at both the internal and external dimensions of the *chaebol's* corporate governance and focuses on a

number of significant changes that have reshaped the *chaebol* and redefined their relationship with the government since the 1980s.

After highlighting major features of the *chaebol* as a corporate form, we discuss internal governance problems that arise from the *chaebol's* ownership and control patterns. In particular, we emphasize that the *chaebol* form consists of subsidiaries rather than divisions. This multi-subsidiary structure may be exploited to advance the interests of the founder's family at the expense of other stakeholders (as well as efficiency) when countervailing legal measures are not available. Although the pre-crisis literature typically presumed the *chaebol* were characterized by concentrated ownership, we note that important changes have taken place in ownership patterns since the early 1980s.

We also show that the external dimension of the *chaebol's* corporate governance has undergone significant change as well. Democratization and liberalization increasingly shifted the balance of power from the government to the *chaebol*, but expectations for implicit government protection from bankruptcy continued to operate and distorted the resource allocation process (Hahn 2000). At least by the mid-1990s, the efficiency advantage of the *chaebol* was more presumed than real, and systemic risks were building up as Korea was caught between the old developmental state model and a market economy.

In this introduction, we begin by placing the *chaebol* in comparative perspective, focusing on both similarities and differences with business groups in other Asian countries. We then turn to theory, examining the role of market forces, corporate governance and politics in the emergence and operation of the *chaebol*; these two sections correspond to the first part of the book (Chapters 2–5). In the second part, we examine some of the causal links between corporate governance and the financial crisis of 1997–98. We also take a look at the role played by financial liberalization and lax supervision.

We then turn to the management of the crisis, beginning with the short-run management of "systemic distress": the simultaneous bankruptcy of large numbers of banks and firms (Chapters 6–8). We conclude by examining the longer-run institutional reform agenda: the reform of the bankruptcy system (Chapter 9), liberalization of rules governing foreign direct investment (Chapter 10), competition policy (Chapter 11), and corporate governance (Chapter 12).

1 The *Chaebol* in Comparative Perspective

Although the *chaebol* have a number of distinctive characteristics, the diversified family-based business group is a common feature of

the industrial structure of many developing countries (Leff 1976, 1978; Granovetter 1995). The defining elements of this business group form – to which the Japanese *zaibatsu,* Korean *chaebol* and other Asian enterprises belong – are not easy to identify. Many of the main policy issues surrounding the Asian business groups do not have to do with the organizational features of the firm itself, but with the larger political and economic setting of which they are a part. For example, the problems associated with the *chaebol* are not limited to weak internal corporate governance, but to such factors as size, market dominance, a weak legal infrastructure, undue political influence and corruption.

We return to these problems below, but it is useful to begin with a more restricted definition that focuses on the group itself. Yasuoka's definition of the *zaibatsu* is a useful starting point: "a business group in which one parent company (holding company) owned by a family or an extended family controlled subsidiaries operating in various industries, with large subsidiaries occupying oligopolistic positions in the respective industries" (cited in Morikawa 1992: 250).[2] Note that, while this definition reflects the concerns about firm size and market dominance, it also encompasses three distinct *structural* elements: a *governance structure* of family dominance; an *organizational structure* of a holding company controlling legally independent firms (multi-subsidiaries rather than multi-divisions); and a diversified *business structure* encompassing a number of discrete products and services. Since the three elements of this definition are not categorical, however, the basic type exhibits important variations. Some of this variation may reflect differences in the economic and political environment in which firms operate, but some of it may reflect different stages in a common pattern of historical evolution.

With respect to the *governance structure*, recent studies by Claessens, Djankov and Lang (1998, 2000a, b) have examined the distribution of ultimate control and ownership rights in major corporations in Asia.[3] Japanese firms are now widely held. Southeast Asian business groups, by contrast, continue to show a pattern of concentrated family ownership; this appears to be the case with many Chinese groups in Taiwan and Hong Kong as well.[4] The *chaebol*, by contrast, are distinctive in that they combine effective family control with a relatively *low* concentration of ownership. As of the year 2000, the average ownership share of the thirty largest *chaebol* held by the *chaebol chongsu,* or boss, was only 1.5 percent, a level approached by some professional managers of widely held American companies.

This governance structure must be placed in historical perspective. Prior to the mid-1970s, the ownership and control of the *chaebol* was also characterized by a high degree of concentration. As Table 1.1

shows, after 1983 it declined steadily. These changes reflected the government's efforts to push the *chaebol* to go public in the mid-1970s and a stock market boom from the late 1980s to the mid-1990s that formally diluted ownership, although not, as we will show, control. Yet it may be too soon to tell whether this combination is in fact unique to Korea. Family-based business groups in Southeast Asia could follow a similar trajectory of declining family ownership with continuing control if stock markets expand in the absence of well-developed shareholder rights.

With respect to its *organizational structure*, the Asian business group combines the unified control of multi-divisional firms with the legal separateness of group firms (Granovetter 1995: 95–6). The *chaebol* broadly fit this model, typically consisting of legally independent affiliates that act like a single corporation under the control of the founder's family. The Chairman's Office serves as the command center for the whole group, often through meetings of a management committee that consists of the CEOs of the other firms in the group. An apparent difference in the Korean *chaebol* is the absence of pure holding companies, visible in the pre-war Japanese *zaibatsu* and in some Southeast Asian countries. The Korean government has subjected such pure holding companies to very restrictive conditions. Nevertheless, the *chaebol* typically use a lead or "flagship" business as the core company, and build a controlled pyramid structure that relies on in-group ownership of affiliates. Thus, in spite of superficial differences, the *chaebol* as a corporate form is closer to the *zaibatsu* than to the post-war Japanese business group (*kigyoshudan* or *keiretsu*), which is a much less hierarchical confederation of companies.

Taking Samsung as an example, Figure 1.1 shows how the founder's family uses a multi-subsidiary structure to maintain corporate control with only a small amount of its own equity. The Lee family has almost complete ownership of Samsung Everland, an unlisted firm operating an amusement park, and uses it as a *de facto* holding company. The family relies on the inter-subsidiary shareholdings of cash-cows such as Samsung Life Insurance and Samsung Electronics to establish exclusive family control over a great number of subsidiaries.[5]

Finally, with respect to *business structure*, Asian business groups typically engage in a wide variety of activities, in some cases reflecting the full range of a country's economic activities from agriculture to manufacturing to services.[6] One important difference across countries, however, has to do with the role of financial institutions in the group structure. The Japanese *zaibatsu* typically included financial institutions. Group-owned banks, trust companies, and insurance companies provided funding to non-financial subsidiaries. Family-based business groups in Southeast Asia also share this characteristic. By contrast,

Table 1.1 In-group ownership share for the top *chaebol* (%)

Chaebol	1983	1987	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Top 30	57.2	56.2	46.2	45.4	46.9	46.1	43.4	42.7	43.3	44.1	43.0	44.5	49.6	43.4
Family	17.2	15.8	14.7	13.7	13.9	12.6	10.3	9.7	10.5	10.3	8.5	7.9	5.4	4.5
Subsidiaries	40.0	40.4	31.5	31.7	33.0	33.5	33.1	33.0	32.8	33.8	34.5	36.6	45.1	38.9
Top 5	n.a.	60.3	49.4	49.6	51.6	51.9	49.0	47.5	n.a	n.a	45.2	46.6	53.5	n.a
Family	n.a.	15.6	13.7	13.3	13.2	13.3	11.8	12.5	n.a	n.a	8.6	n.a	n.a	n.a
Subsidiaries	n.a.	44.7	35.7	36.3	38.4	38.6	37.2	35.0	n.a	n.a	36.6	n.a	n.a	n.a
Hyundai	81.4	79.9	n.a	60.2	67.8	65.7	57.8	61.3	60.4	61.4	56.2	53.7	n.a	n.a
Samsung	59.5	56.5	n.a	51.4	53.2	58.3	52.9	48.9	49.3	49.0	46.7	44.6	n.a	n.a
Daewoo	70.6	56.2	n.a	49.1	50.4	48.8	46.9	42.4	41.4	41.7	38.3	41.0	n.a	n.a
LG	30.2	41.5	n.a	35.2	38.3	39.7	38.8	37.7	39.7	39.9	40.1	41.9	n.a	n.a

Note: The in-group ownership share for a *chaebol* is calculated by obtaining the weighted average of the combined ownership share of the founder's extended family and subsidiaries for all subsidiaries.
Source: Korea Fair Trade Commission; Yoo (1999).

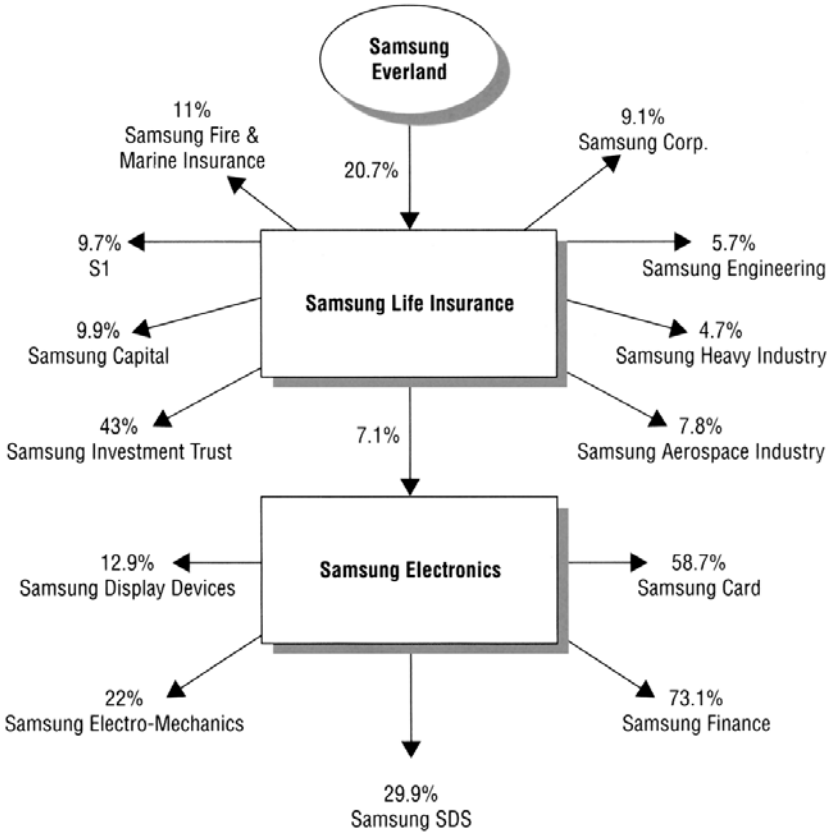

Figure 1.1 Multi-subsidiary structure of the *chaebol*: Samsung Group, 1999

Note: Figures represent inter-subsidiary shareholdings.

Source: Financial Supervisory Commission. Cited from *Chosun Ilbo*, August 19, 1999.

major commercial banks in Korea, having been nationalized in 1961, were not privatized until the mid-1980s and then only with restrictions on ownership. As a result, the Korean *chaebol* did not have banks in their business portfolios through most of the high-growth period.

However, this observation requires some qualification. The *chaebol* owned and operated commercial banks briefly after their privatization in the late 1950s, but the banking sector was renationalized under the military government in 1961. The government prohibited the *chaebol* from entering the banking sector and restricted licenses for non-bank financial institutions, but it never prohibited the *chaebol* from owning

them. A number of *chaebol* established merchant banks, securities firms, and insurance companies in the 1980s and 1990s as the financial market was progressively liberalized.[7] The *chaebol's* increasing diversification into the non-bank financial sector suggests that the difference between the *chaebol* and other family-based business groups in Asia has diminished somewhat over time (see Chapter 4).

2 Theoretical Approaches to the *Chaebol*

If we set aside cultural approaches that focus on purported national or ethnic idiosyncrasies – common in the vast literature on Chinese business groups in particular – at least three different avenues exist for explaining the business group as a corporate form.[8] The first approach is an efficiency model that emphasizes profit-maximizing motives, especially in a context of underdeveloped or imperfect markets for inputs and services. A second approach focuses on principal-agent problems and the ability of owner-managers to exploit informational asymmetries to their advantage. The third explanation is political and emphasizes the role of business–government relations and policy in the evolution of the business group.

These three theoretical models are partly complementary.[9] But since they have important policy implications, we seek ways in which they might be tested against one another.[10] For example, if the *chaebol* is basically an efficient organizational form, then the appropriate reforms are those that guarantee that firms operate in a competitive setting through market liberalization and strengthened competition policy; Kwangshik Shin presents such an argument in Chapter 11 and it is implicit in Mikyung Yun's discussion of foreign direct investment in Chapter 10. If the *chaebol* operate primarily to advance the interests of the founder's family at the expense of other shareholders, then reforms in corporate governance are essential; Myeong-Hyeon Cho makes this case in Chapter 12. If, however, the *chaebol* are the creature of politics, then even more fundamental reforms of the business–government relationship may be required; these issues are addressed in Chapter 3 by Byung-Kook Kim and Chapter 6 by Jongryn Mo and Chung-in Moon.

The efficiency model

The economic theory of the firm looks at corporate form as a rational and efficient response to some set of constraints. The prevalence of the

business group in developing countries can be explained by the imperfect or underdeveloped nature of the legal system and the markets for inputs, services, and managerial control itself (Khanna 2000).

The logic of this approach can be seen by considering three distinct types of business expansion: vertical integration, related horizontal diversification, and unrelated horizontal diversification.[11] In pursuing vertical integration, the firm is choosing to do more activities in-house instead of procuring from others; as Coase (1937), Williamson (1975) and others have noted, the firm's make-or-buy decisions critically depend on transaction costs that arise from uncertainty, asymmetric information, and incomplete contracting. The level of development for markets as well as legal and social institutions affects these costs.[12] As Wonhyuk Lim argues in Chapter 2, individual corporate histories of the *chaebol* contain numerous examples of vertical integration arising from precisely these considerations.

The decision to diversify horizontally – to enter a new line of business with which the firm has few forward or backward linkages – has a different logic. One motive is risk diversification. A firm – or more precisely the owner of a firm – may want to develop a range of businesses in order to reduce overall risks, especially in the absence of a well-developed capital market. A second efficiency motive for horizontal diversification is to utilize a common, essentially non-rival, factor of production across a variety of different economic activities. For example, a group may use overseas marketing information collected through a general trading company as a common factor of production and manufacture various products adapted to overseas customer needs. Related to this is the "internal markets" hypothesis. When capital and labor markets are underdeveloped, the *chaebol* form can exploit well-developed internal factor markets to diversify. Alice Amsden (1989) showed how *chaebol* growth was fueled not just by intra-group financial transfers but also by efficient use of the group's pool of managerial and engineering talent.

In short, the efficiency model argues that the business structure of the *chaebol* and other family-based business groups is a rational response to underdeveloped markets. Since this approach treats the firm as a monolith, however, it does better at explaining business structure than governance and organizational structure: the questions of how the founder's family maintains control or why the business groups choose the controlled pyramid structure over a multi-divisional one. Principal-agent models are better equipped to address such problems, and they reveal a number of internal inefficiencies that the efficiency approach misses.

The principal-agent model

The principal-agent approach focuses on conflicts of interest among the stakeholders of the firm, particularly the problem of incentive compatibility and asymmetric information between shareholders and professional managers. The high concentration of ownership, particularly in Southeast Asia's family-based business groups, should make this conventional corporate governance problem less relevant; owner-managers should be committed to maximizing the value of their own companies. For such companies, the main governance issue is not the internal one of how shareholders monitor professional managers but the external one of how – and whether – banks and capital markets can exert control over large inside shareholders who also occupy top management positions. As Joon-Ho Hahm shows in Chapter 4, this problem was particularly acute in Korea.

In fact, internal agency problems also abound in the *chaebol*, but as Myeong-Hyeon Cho shows in Chapter 12, they take a somewhat different form. As we have seen, the founder's family typically has only a *small* ownership stake; nonetheless, it exercises control by using extensive inter-subsidiary shareholdings. The members of the founder's family who take top managerial positions are similar to professional managers in that they do not have a significant ownership stake. Unlike professional managers, however, they have considerable control rights and cannot easily be removed. We call this the *entrenchment problem*. Unless checked by incentive and monitoring schemes to protect outside shareholders, the founder's family can expropriate shareholder value with impunity.

These observations allow us to revisit the efficiency approach with a less innocent eye. Suppose that a *chaebol* enters a line of business through a new subsidiary in order to lower the costs associated with monopolistic or oligopolistic suppliers. The new subsidiary provides intermediate inputs to the firm at marginal cost, but sells the same goods to outside customers at noncompetitive (oligopolistic) prices. In this case, the firm is not engaging in any wrongdoing; the real problem is noncompetitive market structure. The *chaebol* is simply using vertical integration to reduce cost and maximize joint profit.

However, the *chaebol* is not a multi-divisional firm but a group of nominally independent companies. Therefore the ownership structure of the new subsidiary can differ from that of others in the group. Important redistributive issues can thus arise. In the case just cited, the new subsidiary could make more money by selling to outside customers rather than within the group. Its shareholders should therefore insist on

some form of compensation from the shareholders of other subsidiaries in the group. Because of the centralized control of group decisions by the chairman, such compensation does not necessarily occur; rather, the controlling family can exploit asymmetries in ownership, control and profitability in order to expropriate shareholder value.

The focus on expropriation allows us to understand cases that are wholly anomalous from the perspective of the efficiency theory, such as subsidiaries that provide intermediate goods or services to the existing organization at prices that are *higher*, rather than lower, than market prices. The motive for such transfers is to effect resource transfers for private gain, for example, by shifting profits from subsidiaries in which the controlling family has a low stake to those in which it has a high stake.[13] The mechanisms for effecting such transfers are multiple, and extend far beyond the pricing of intermediates and other inputs to inter-subsidiary lending and the extension of loan guarantees (see Chapters 2, 4 and 11). Inter-subsidiary sales of shares often reflected expropriation motives as well, most blatantly in the case of Daewoo (see Chapter 7). Transfers of technology, real estate and even labor among groups could also reflect effective cross-subsidization and expropriation.

In short, the principal-agent model provides a rather different view of the *chaebol* and other family-based business groups than does the efficiency model. Focusing on the conflict of interest among stakeholders, the principal-agent model offers a consistent explanation for the business, governance, and organizational structure of family-based business groups.

Political economy approaches

While the efficiency and principal-agent models focus on relationships between and within firms respectively, the political economy approach examines the exchange relations between the government and the private sector. This approach has many variants, but the central insight is a simple supply and demand model of politics.[14] Either the politician or bureaucrat extends a rent to the private sector and collects a bribe in return (personal corruption), or the rent is extended in return for some form of political support, such as money or the mobilization of votes, that maximizes the politician's longevity in office. Although the former type of exchange is typically proscribed – at least formally – the latter may be either legal (legitimate campaign contributions) or illegal (political corruption).