The Visible Arm of Government - Corporate Governance of South Korean Chaebols

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Abstract

Private sector ownership in South Korea is dominated by chaebols. Chaebols are business groups and are “collections of firms bound together in some formal and/or informal ways, characterized by an 'intermediate' level of binding.” (Granovetter 2001: 69-70)

This paper discusses the corporate governance environment of South Korea and its chaebols. While chaebols are key actors in South Korea’s development, this paper extensively discusses the very visible arm of government and how chaebols have had to navigate their relationship with the state in order to continue their operations. The might of the state will continue to dominate chaebol decision-making and structure.

Keywords

Corporate governance, governance case studies, political leadership, power, chaebols, business-government relationship
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Introduction

Family-owned business groups known as *chaebols* in Korea (Chung 2005) are large, influential and dominant.

The paper poses the following question: What are the features of the South Korean corporate governance environment?

Chaebols, and their relationship with the state, show that not only does history matters (Jones and Khanna 2006) in the formation of these groups but how they continue to matter is explored in this article. The structure of the chaebols is influenced by the ruling South Korean government of the day. The close relationship the state has with the business groups of the country have ensured that South Korea has particular characteristics that impact their corporate governance behaviour.

Business groups in the region can be pinpointed to different catalysing events and upheavals in East Asian history such as colonialism, war, post-war colonialism and independence. Some business groups emerged from 19th century trading houses established by British, Dutch, Japanese and Spanish colonialists. In the 20th century, some business groups emerged in the wake of political destabilization in 20th century China with the post-Chinese civil war and Chinese Cultural Revolution era catalyzing the exodus of entrepreneurs throughout the region with the emergence of ethnic-Chinese owned business groups. Lastly, the rise of Japanese foreign investment (encouraged by its government) in the latter half of the 20th century under the ‘flying geese’ model (UNCTAD 1993) also favoured investment in by-now well-established family-owned business groups in the region as the Japanese *keiretsu* form attracted like with like. (Bello 1992; Hart-Landsberg & Burkett 1998) This ‘flying geese’ model has been emulated by other groups including South Korean chaebols.

History

The nexus of state-led industrial development policies and business group development could not be more exemplified by the experience of South Korea. From its very beginnings, chaebols were inextricably linked to its political masters. The government unequivocally played a pivotal role in
their establishment, development and expansion. The chaebol form had its origins under Japanese colonialism and was heavily influenced by the keiretsu structure. When Japanese rule ended, the colonialists’ properties were seized with “industrial interests sold far below the market value” (Kim 2004) to favoured participants. This formed the basis of the emergence of the chaebol. As Lim (2003) narrates:

“In the post-war environment, the Rhee government sold “vested properties” of formerly Japanese-owned industrial properties taken over by the US military government and subsequently transferred to the new Korean government. The Rhee government set the conditions for the sale of these properties so as to preclude competitive bidding and to favour the interim plant managers as well as the politically well-connected....Certainly not everyone who was privileged to pick up an industrial property at a fire-sale price had the entrepreneurial talent to build a business empire. But vested properties provided the initial base for many of the largest chaebol.”

Hence, the chaebol emerged out of favourable government policies which also included low interest rates from Korean banks. In a financial coup, South Korean commercial banks in the 1950s were privatized and the recipients of this process explicitly favoured the chaebols which utilised their political connections to control the financing of the economy. The privatization of these banks led to the consolidation of control by the chaebols (Lim 2003: 42).

By the 1970s, export-oriented government policies were in full-swing which allowed the chaebols to expand with the backing of state banks. This strategy allowed chaebols to internationalize while their financing was being underwritten by the government. However, the South Korean government did impose a measurement of “export performance” which allowed the policymakers to objectively assess whether the expansion of its stable of national champions overseas were successful.( Lim 2003: 44)

The reciprocal benefit from the private sector in pursuing or aligning itself with the government policies of the day led to mutually beneficial progress and successful outcomes (Amsden 1995, 2001). The government disciplined capital as well as labour. As Lie points out, the control of labour was
pivotal to South Korea’s economic growth – “cheap labour kept cheap by the state.” (1992: 287) Thus, the selective relationships and attachments by governments of the day with certain business groups allowed the latter’s progress to occur and their form to continue. This was a formidable combination as “economic authoritarianism…[was] reinforced by political authoritarianism” (Lie 1991: 505).

Some local and international scholars have sought to explain the success of the Korean state’s interventionist strategy in a theory called the Capitalist Developmental State (CDS) thesis.¹ This CDS thesis argues that interventionist policies managed to deliver strong economic growth because, unlike some other interventionist strategies in other developing countries, it did not ignore the market. The state picked winners by setting export performance in the international market as the main criterion for receiving government assistance. Vulnerable to pressures from the international market, South Korean industry maintained its competitive edge throughout the authoritarian period. Also, the state provided Korean companies with the support they need to respond quickly to changes in comparative advantage by stepping in when the costs of restructuring became too high. For example, in the 1970s during the “Big Push,” government assistance effectively reduced the burden for many companies seeking to upgrade to heavy industry. For this reason Korean economist Hyun-chin Lim (1985) has described the Korean state’s interventionist strategy as “market-conforming.”

However, this close nexus between politics and business did unravel. The 1997 East Asian Crisis and the collapses of Enron and WorldCom heightened the awareness that poorly run and weakly managed business groups in the region need to institute robust controls that promote transparent and accountable decision-making (Faure 2002; Reed 2002; Trivellato 2002). By the time of the 1997 East Asian crisis, the concentration of economic power and the management culture of dynastic dictatorship in the chaebols saw the “too big to fail” (Kim et al 2004: 12) nature of this private sector form of organizing with immediate short-term severe effects for the rest of Korea’s economy and society. The chaebols’ economic success had become a government policy issue which soon became a regional problem. Questions of legitimacy and financial sustainability hung over the partnership that had underpinned Korean’s economy for the latter half of the 20th century: “…much of the ‘chaebol
problem’ encompassing both moral hazard and corporate governance issues, remained unsolved even as the economic crisis of 1997 approached.” (Lim 2003: 49)

For other countries and their business groups in the region, the troubles of the Korean chaebol during the crisis instigated an inward-looking search for reform. Reform was actively promoted by international financial institutions such as the OECD and the Asian Development Bank. However, while political discourse improved due to the contagion effect of the crisis (Derichs & Heberer 2002), apart from notable internal improvements of some Korean chaebols both financial crises did not lead to fundamental, structural reform of the ownership concentration of Asian business groups

However, appetite for further corporate governance reform stemmed in the wake of the 2008-2009 global financial crisis which showed the moral bankruptcy of some Western corporations and the Western-led corporate governance reforms lost some credibility to the Eastern form of business group organizing. It was also notable that during the crisis of 2008-09, Asian family-owned business groups confidently managed to weather the storm. Indeed, these groups proved resilient in the aftermath of both crises with some opportunistic business groups consolidating their interests in the insurance sector after the bailout of American Insurance Group (AIG) and its divestment of extensive Asian interests in 2009. The owners of these Asian business groups remain solidly family-based.

Within a decade – or in the space of two crises - the internal structure of chaebols now became a source of strength rather than a hindrance in navigating through the fickles of global capital.

State-chaebol relationship

In modern South Korea, the vast majority of capital has been channelled into state-approved chaebol projects and thus political influence became crucial to chaebol’s capacity to secure access to capital. In this context, institutional and legal arrangements emerged to both facilitate and disguise the consequent flow of funds from the corporate world into the political sphere. In particular, successive authoritarian governments came to regularly collect ‘political contributions’ from senior businessmen in return for benefits including preferred access to state-controlled capital, business licences, government contracts or commercially useful information.
Under Park Chung Hee and Chun Do-hwan

Under President Park Chung-hee, government relations with the chaebols were for the most part relatively smooth. This was highlighted by the President’s close relationship with Hyundai’s Chairman Chung Ju-yung.

The Park government extended its control over the financial sector and by the mid 1960s brokered all low cost foreign loans and then re-lent them to select businesses for sizeable commissions. The justification for this was a matter of convenience – a select few was easier to deal with than a dispersed, heterogeneous group. The businesses that capitalized upon this generous scheme included Lucky Goldstar, Hyundai Construction, Samsung, and Ssangyong.

However, under Chun Do-hwan cracks began to emerge in the state-chaebol relationship. For example, Hyundai Chairman Chung grew increasingly frustrated with Chun Do-hwan, in part because of disagreements over relinquishing one of the Hyundai subsidiaries to the state in the name of industrial reform.

Under Roh Tae-woo

In 1987, South Korea held free elections, which the ruling party candidate Roh Tae-woo narrowly won with 36% of the vote. Despite significant progress in the areas of democratic institution-building, during Roh’s presidency the practice of collecting political contributions continued unabated. A statement by the Hyundai Group founder, Chung Ju-yung, about a donation made to the Roh Tae-woo government of around 10 billion (US$12.7 million) suggests that businessmen often acted on the presumption that only large ‘political donations’ were likely to placate and satisfy the government.

The scale of the donations brokered is unknown; although later admissions by corporate members Hyundai Chairman, Chung Ju-yung, and Hanbo Chairman, Chung Tae-soo, to contributing 500 million won (US$625,000), the subsequent building of an impressive new party headquarters in the Seoul business district of Yeoido, and the rapid expansion of the number of DLP staff suggest that they were sources to highly effective fund-raising vehicles.
One of the biggest scandals during the Roh Tae-woo presidency (1988-1993) was the Suso real-estate scandal that erupted in 1991. One of the major benefits businesses could secure from government was information relating to real estate and planned infrastructure projects. Inside information on where the next highway was to be located or state cooperation in re-zoning “green-belt” land gave some investors an opportunity to turn massive profits. In early 1991, the Hanbo chairman, Chung Tai-soo, admitted to paying a total of 1.2 billion won (US$1.65 million) in bribes and political donations in return for the government re-zoning of Hanbo owned land to allow for property development. The ensuing scandal implicated a presidential aide, several legislators, a leading businessman, and employees at several government agencies and private companies.

Tensions continued between Chung and Roh Tae-woo and Chung was strongly opposed to the government’s proposal to build a new high-speed rail link between Seoul and Pusan. Chung’s decision to challenge Kim Young-sam for the presidency in 1992 ensured that their relationship never got off on the right foot and it continued to deteriorate during the Kim Young-sam government. Jung-en Woo chronicles the rise of business discontent with excessive government intervention during this period. (1991: Chs. 4 and 5.)

_Under Kim Young-sam_

When he was elected in 1992, Kim Young-sam was celebrated as the “civilian president” and became hugely popular with his promise to usher in “a new era of clean politics.” However, Kim Young-sam also relied on a cozy relationship with the chaebol and soon fell victim to a succession of corruption scandals. As with his ill-fated predecessor, rumours of corrupt dealings with Hanbo Iron and Steel plagued Kim Young-sam’s presidency. The investigation into the collapse of Hanbo Iron and Steel revealed how indebted companies could still manage to secure huge bank loans. With assets of little more than US$100 million, the company raised nearly US$6 billion to build a steel plant (Shim 1997). In the ensuing court case the President’s son, Kim Hyun-chul, and a top presidential aide, Kim Ki-sup, were found to have used their political influence to pressure banks to give loans to Hanbo in return for around US$30 million in bribes. They were also charged for receiving bribes from other
Korean conglomerates as well as failure to pay tax on the income generated from this “influence peddling.”

Under Kim Dae-jung

President Kim has been a life-long critic of the chaebols and under his presidency it appeared that the feeling was mutual. Samsung, for example, funded Kim’s rivals for decades. In particular, the Kim Dae-jung government faced strong resistance from powerful chaebols on the implementation of the so-called Big Deal - a corporate asset-swapping plan that is central to government’s program to restructure the economy. In fact, despite the government’s calls for the chaebols to concentrate on core-businesses and reduce their debt-to-equity ratios, several conglomerates have taken on more debt since the Asian economic crisis (Lee 1999).

After the 1997 Asian financial crisis, corporate governance changes saw government-led initiatives to improve the country’s overall institutional environment. Changes in ownership structure saw a mixture of government-issued guidelines such as the required elimination of cross-guarantees, the forced reduction in financial leverage, special requests for the larger chaebol to reduce their investments and consolidate their operations, a specific process for large-scale corporate financial restructuring, recapitalization and financial restructuring of the banking system as part of wider financial sector reform, and increased market pressures facilitated by a number of institutional reforms.

Current features of the Korean corporate governance environment

Where the crisis would have been considered as a catalyst, even today Korean politicians have typically tried to excuse their relationship with chaebol through political corruption as functional (it is not wrong because it is good for the economy), as an institutional privilege (it is not wrong because other members accept it) or as an institutional fault (it is not wrong because other members do it). Many also argued that their actions were, to an extent, excusable because corruption was part of Korean political life and that in order to succeed in politics one must sometimes be prepared to behave corruptly (it is wrong but not so bad because we had to do it).
Meanwhile, the chairmen of the giant conglomerates implicated in the presidential slush fund scandals claimed they had no choice but to donate to the ruling party, that it was the way business was always done and that it had made economic sense at the time.

In this way, political and economic elites have an interdependent relationship which lead them to mutually reinforce the legitimacy of each other’s practices: with the state defending its behaviour as ethical as it disciplined the chaebols to deliver economic growth, while the chaebols argue that the Korean economy would not have been propelled to the high levels it has achieved had chaebols not been granted extensive privileges by the government. While the chaebol-military state relationship is characterised by troubled interaction (Korean businessmen have long resented state interference in their corporate affairs as well as the burden of having to pay large political contributions), this mutual support for each other’s ethical reasoning kept the relationship relatively stable and allowed each to pursue, relatively unfettered, their own objectives.

It has been chaebol standard practice for the heads of chaebols to be given lenient sentences followed by presidential pardons when they are found guilty of crimes. Since 1990, the heads of seven of the 10 biggest chaebols have been convicted for bribery, tax-evasion or embezzlement. All received presidential pardons, and all returned to management positions. For example, Samsung Chairman Lee Kun-hee was found guilty of bribing officials and fined $100 million in 2008. He was given a prison sentence, but was pardoned, ostensibly because he was an International Olympic Committee member and was central to Seoul’s successful 2018 Winter Olympics bid (Pontell & Geis, 2010).

According to economist Kim Woo-chan, “When the courts are deciding on the sentences, they actually look at whether they have contributed to the Korean economy. The president takes into consideration what sort of job they do and how many jobs they can create, for example.” (quoted in Hazlehurst 2013).

Some of the corporate governance problems preceding the crisis still remain today. In spite of many reforms, the corporate governance practices of Korean corporations are still perceived to be below
those of firms in many comparator countries. Ownership structures remain characterised by high levels of family ownership which create structural internal challenges.

Conclusion

This paper looked at chaebol development in South Korea and how they prospered under successive South Korean governments which emphasised export-oriented development policies. This paper highlighted the close relationships certain chaebols have had with successive governments. Economic development in South Korea shows the strong arm of the state – which finances chaebol operations– to make explicit and implicit demands from owners. This ensures that the very visible arm of government will continue to impact the strategy, structure and corporate governance of chaebols.
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