Business Groups as an Organizational Device for Development and Transition

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I. Introduction

While Berle and Means (1932) discussed the rise of managerial capitalism long time ago, a recent survey by La Porta, Lopes-de-Silanies, and Schleifer (1999) observes that the classical separation of ownership and control observed in is rather an exception, and that it is more common around the world to have family-controlled firms often taking the form of business groups. Khanna (2000) and Granovetter (1995) provide a good survey of several issues regarding the business groups, including the very essential question of how to define the business groups. One of the issues is dynamic performance and efficiency of the business group. Actually, the business groups, like Korean Chaebols, have been subject to political scrutiny as the financial crises swept Asia that is perceived as the home of “crony capitalism.”

The concept of the controlling minority structure (CMS) firms proposed by Bebchuk, Kraakman, and Triantis (2000) helps to understand why the business groups tend to fall into the serious agency problem which led to unjustifiable investment drives and the moral hazard problem. In the CMS firms, a shareholder exercises control while retaining only a small fraction of the equity claims on a company's cash flows. Such a radical separation of control and cash flow rights, which is the cause of the agency problem, can occur in three principal ways: through cross-ownership ties, a dual-class share structure, and stock pyramids. These methods are used by business groups in many countries, including Chaebols in Korea.

Then, two questions surface; first, why the business groups are developing in so many countries, and, second, what went wrong in many of them. This paper tries to tackle this question. Of course, the first question is not new, and there are old answers. That is, the business groups develop in the settings with market failures, like in emerging economies (Leff 1978; Goto 1982; Khanna and Palepu 1997). The fact that the business groups abound in such emerging and/or transition economies as Korea (Chang and Choi 1982; Steers, Shin and Ungson, 1989), India (Ghemawat and Khanna, 1998), Hong Kong (Au, Peng, and Wang, 2000), Latin America (Khanna and Palepu 2000; Guillen, 2000; Strachan 1976), China (Lee and Woo 2002; Peng, 2000; Keister, 1998) and in Russia (Freinkman, 1995) should be an evidence of their association with market failure or ‘institutional voids.’ However, if we see the business groups simply as an evolutionary response to the institutional environment of the economy, there is no interesting policy or strategic issues involved.

This paper will look at the first question from a new perspective, namely economic catch-up perspective. We will see the business groups as an organizational device for economic catch-up, and suggest that the business groups not only just emerge in response to market failure but also serve as a vehicle for economic catch-up. In this light, we call for attention to the phenomenon that the business groups facilitate affiliate firms to enter new markets by providing cross-subsidy during their initial phase of business and that the business group firm, often enjoying lower than average profitability, tend to settle down with lower variation of profitability.

Regarding the second question, namely why they tend to fall into trouble, we argues that while the business groups is effective in response to market failure and/or catch-up, the benefits comes with long term caveats in three dimensions. The following three potential dangers are discussed in sequence. First, the benefits of economic value creation by the business groups tend to decline over the long run as institutions evolve and markets get mature. Second, family-controlled business groups, taking the form of the CMS firm, tend to be subject to increasingly serious agency problem resulting in value-destroying, inefficient investment drive. Third, the existence of the big players like business groups in an economy might hamper the sound development of competitive market economy by distorting or manipulating the course of liberalization, deregulation, or opening-up.

The two questions raised above will be dealt, with primary reference to the Korean Chaebols for which we have some new evidences and data, although examples from the other countries will be resorted, too. The following section discusses the first question, namely two alternative perspectives to the business groups, market failure and economic catch-up perspectives. Section 3 addresses the three long-term dangers with the business groups. The paper concludes with a brief summary and remarks.

II. Fulfilling the Institutional Voids and the task of Economic Catch-up

A. Filling the Institutional Voids

It was since as early as works by Leff (1978) and Goto (1982) that the existence of the business groups became associated with the underdeveloped nature of the market mechanism in developing countries. This ‘market failure’ story regarding the emergence of the business groups has further developed into the ‘institutional voids’ argument by Khanna and Palepu (1997; 2000).

Their argument is that since many of the institutions that support business activities are absent in many parts of the world, the business groups emerge to fill the institutional voids. Below let me provide brief summary of their argument. First, in product markets, given the lack of information about products and transaction-related claims-processing institutions, companies in emerging markets face much higher costs in building credible brands than their counterparts in advanced economies. Thus, conglomerate with some reputation can use its group name to enter new business and they can also spread the costs of maintaining the brand names. In capital markets, without access to information, investors refrain from putting money into unfamiliar ventures. In such context, established diversified groups have superior access to capital markets.

In labor markets, given the lack of well-trained business people and educational facilities, the groups can create value by developing promising mangers within the group, and can spread the fixed costs of professional development over the businesses in the group. Also, when labor market is rigid, running an internal labor market within a group can provide additional room for flexibility. Finally, given that the governments in emerging economies intervene much more extensively in business operations, diversified groups can create value by acting an intermediaries when their affiliate companies need to deal with the regulatory bureaucracy. The larger the group is, the easier it is to carry the costs of maintaining government relations.

The fact that so many emerging economies have seen and saw the development of various forms of business groups is evidence in support of this market or institutional failure argument. Also, there exist a large volume of empirical research that have confirmed the positive contribution of the business groups in terms of financial performance, internal capital market, and so on in emerging markets, whereas the literature finds the opposite results with the American case (Berger & Ofek 1995; Lang and Stulz 1994).

Thus, the important matter to remember, as Khanna and Palepu (1997; 2000) observes, is that groups compensate for a variety of missing institutions in an environment, so that such benefits of group affiliation as do exist may manifest themselves in quite different ways in different contexts and at different times. To put it slightly differently, we should also note that specific forms the business groups take in each country vary depending upon economic, political and legal condition of the countries.

Actually, no single firm in the developing or transition economies has taken the form of the business groups as an outcome of intentional strategic decision-making. The firms evolve to be a group or others. The famous story of the LG group in Korea, introduced in Milgrom and Roberts (1992), well illustrate the evolutionary nature of the firm growing out of a single U-form firm into a business group. If we see the business groups an evolutionary response to the institutional environment of the economy, there is no interesting policy or strategic issues involved. Fortunately, in the next subsection, we will argue that the business groups is not simply a passive response to the environment but can serves as an organizational device for economic catch-up.

B. Device for Economic Catch-up

Most catch-up economies face the problem of capital scarcity unless they have enough domestic savings even from the early stage of industrialization, like Taiwan and China. When Korea started on the course of industrialization in the early 1960s, it was evident that its growth potential was seriously constrained by savings available for investment. Given the limited size of the financial resources available, it was a reasonable solution to pool the capital into several big hands in the business. In other words, the government wanted to promote a few number of the big business to expedite economic growth.

Since then, rapid economic growth achieved in Korea has often been associated with the growth of big business groups, so-called Chaebols, whose Chinese characters are the same as zaibatsu, namely the pre-war ancestor of keiretsu in Japan. Gerlach (1998) and Steers, etc.(1989) take an active position such that Japanese keiretsu and Korean Chaebols are the organizational basis for rising strength of their economies, and that this form of industrial organization makes it more difficult for foreign firms to penetrate the Japanese or Korean markets. We call this view as a catch-up device view of the business groups, and contrast this with the market failure view originated with Leff (1978) and Goto (1982). It is also interesting to see that in China, another catching-up economy, the government promoted the development of the big business groups, while there were also very strong and bottom-up voluntary emergence of more small scale business groups, too (Chi 1996; Han 1997; Lee and Woo 2002).

If we see the business groups as a device for economic catch-up, the main function or benefits of such organization should be something beyond merely filling the "institutional voids." We observe that the main strength of the business groups in catch-up is to facilitate entry into new markets or lines of business that were formerly monopolized by the forerunning companies. The business groups can facilitate market entry by mobilizing financial resources into new affiliates and helping them during the initial period of business by providing markets, capital, technology and brand names.

As a matter of fact, Lincoln, Gerlach, and Ahmadjian (1996) finds that the keiretsu ties go beyond the main bank-based network, and that there is a redistribution effect reducing variability of the keiretsu firms. In other words, weak companies, like those in their starting period, benefits from group affiliation (they recover or grow faster), while strong ones do not (they are subsequently outperformed by independent firms).

In a similar context, Lee, Ryu and Yoon (2001) examined the variation in productive efficiency of Chaebol and non-Chaebol firms to investigate the observation that Chaebols are constantly engaged in the launching of new ventures but that they try to maintain a certain level of efficiency at the group level. This observation translates into a hypothesis that there would be a higher “within-Chaebol” variation in inefficiency but a lower “between-Chaebol” variation. Actually, they found that the variation among the Chaebol affiliates is 0.013, while that among the independent firms is only 0.0045 or even 0.0021.[1]. In sorting out the “between-Chaebol” efficiency, after assigning an inefficiency index for each Chaebol group, they calculate the inefficiency variation among the top 22 Chaebols. The variation in this case turns out to be only 0.0022, a value quite similar to that of the non-Chaebol firms. So we confirm that the “between-Chaebol” inefficiency variation is a lot smaller than its “within-Chaebol” counterpart.

The group-level initiative to launch new business by setting a new firm and covering its losses during the initial period was well-known phenomena in Korea. A famous example would be Samsung’s memory chip business. This business is now Samsung’s biggest cash cow while it was making huge losses during the initial period. This kind of collective catch-up strategy is especially effective when the involved technology show rapid learning curve such that efficiency improves rapidly with the accumulation of production experience.

The finance literature also finds the so-called “socialism” in internal capital markets of the business groups such investment flows into loss-making or under-performing affiliates or division in the group or conglomerates (Shin and Park 1999). While the literature tends to interpret this an inefficient behavior, alternative interpretation would be that this is market entry strategy by the group level endeavor and it makes sense in dynamic context.

III. Long-Term Danger with the Business Group

A. Reduction of the Group Premium with Institutional Changes

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[1]) To see whether this difference arises from the fact that in the sample many of the Chaebol affiliates are not listed companies, while all of the non-Chaebol firms are listed, they also tried the same method using the listed companies to get the same results.

As discussed above, value creation by unrelated group diversification is possible as there are diverse institutional voids that could be filled by the business groups. However, as market institutions evolve over time, such diversification premium can decrease. Khanna and Palepu (2000) provide an empirical verification of such reasoning using the long term data of Chilean firms. Evolution of institutions in general means maturing of market mechanism characterized by a gradual emergence of intermediaries and a gradual reduction of ambient transaction costs. Therefore, it becomes increasingly difficult for the business group to create value through running internal (labor an capital) market across their diverse affiliates.

There is some literature trying to measure the diversification premium or discount by comparing group firms with non-group firms. Some of them use the 'chop-shop' approach.[2] If a firm is composed of multi-industry segments/ divisions, the value of the firm is assumed to be the sum of the several segments' values. Then, the excess value of the firm is defined by the difference between the firm's actual value and the imputed value. In US multi-segment firms; Berger and Ofek (1995) found negative value creation or diversification discount. The diversification discount of the US firms in Berger and Ofek (1995) was 13% to 15% during the 1986-1991 period. However, Fauver, et al. (1999) reported that the different diversification effect on firm value depends on the income level and legal systems, and found that no diversification discount or premium exists in low income countries and in countries whose legal system is of German origin.

G. Lee (1999) confirmed the decline of diversification premium over the long run using the data of the Korean firms. He also used the 'chop-shop' approach. To calculate the imputed value, he used two alternative variables: sales revenues and earnings-before-income taxes (hereafter EBIT). He first calculated the industry median of capital-to-sales ratio (capital to EBIT ratio) for the stand-alone companies in each industry. Here, capital is the sum of the market value of equity and the book value of debt.[3] Then, the imputed value of a group-affiliated company is obtained by

[2]) For the 'chop-shop' approach, see Lang and Stulz(1994).

multiplying this median (or mean) ratio to the actual sales revenues or EBIT. This way, the imputed value represents the hypothetical value of a group-affiliated company, assuming that it was operated as a stand-alone business.

G. Lee found positive value creation by the group formation, but thought that the value premium of the group-affiliated companies may be due to other firm-specific characteristics than the group-induced diversification. To check this possibility, he has also run the regression model for the two excess value measures, controlling for various firm characteristics, such as size, profitability and growth potentials. The regression results also confirmed the positive value premium of group-affiliated companies as show significantly positive coefficients of the group dummies. The premium using the sales multiplier is 6.3% and that using the EBIT multiplier is 7.5%.

To check the changes in the premium, he divided the sample period into 4 sub-periods, and run the regressions. He found that the diversification premium decreased over the years, finally turning to a negative value during the1994-1996 period. In 1984-1987, the premium was about 10.5%. However it decreased to about 8.9% in 1988-1990, 6.3% in 1991-1993 and finally -4.7% in 1994-1996.

With continuing decrease of diversification premium in the 1990s, we had finally the financial crisis in 1997, which was triggered by the successive collapses of Chaebols. Based on our framework, we think that the fundamental change in the nature of the institutional environment lay at the bottom of the crisis of the Chaebols. As clues to the declining performance of Chaebols, we note the following two important changes (Lee 2001).

First, the government has gradually stopped the explicit promotion of, or giving favor to, the specific industries and the firms. This does not mean that the government stopped intervention in the private sector, but it means that many kinds of once legal promotional policies of the government have disappeared. These policies included the so-called "policy loans" which were given to the designated firms in the target industries at interest rates much lower than market rates, special export credits given at lower

[3]) To get the market value of equity, we multiply a total number of stocks by the year average of the stock price.

interest rates, and arbitrary tax exemptions to the target industries.[4] Since the big business groups had been the main beneficiaries of such preferential treatments, these changes in the government attitude and its actions toward the private sector contributed to the lowering of the rents enjoyed by the Chaebols.

Second, we should note the rising wave of globalization and the WTO spirit of free trade in the 1990s. The 1990s is the decade that the Korean economy saw the fulfillment of most of its liberalization programs, including both trade and capital markets. Such liberalization measures caught further momentum following the Korean entry into the OECD in 1996. There has been the steady downward trend of effective protection rates over the 1963-1990 period. Toward the end of the 1980s, the effective protection rates for manufacturing goods were reduced to less than 10 percent or even fell to negative levels. Furthermore, the custom rates for the imported goods decreased from more than 20 percent in the early 1980s to about 5 percent in the mid 1990s.

With the domestic market opened and liberalized, the Korean firms including Chaebols have faced the increasing competition from foreign firms. In the world markets, on one hand, Korean comparative advantages as a low wage country have disappeared with the rise of ASEAN and Chinese exporters, and, on the other hand, Korean products cannot afford to compete with the products from an advanced country, like Japan, in terms of quality and product differentiation. In general, this trend of globalization and liberalization has contributed to the lowering of the rents and decrease in profit rates enjoyed by the Korean Chaebols. Since Chaebols were the dominant players in the protected domestic markets and the main exporters of Korea under the government support, we can reason that Chaebols were hit more badly than the small and medium-sized companies. As a matter of fact, according to Yoon’s estimation (Yoon 1998) of the long term trend of the profit rates (ROE: net income to stock holders' equity) over the 1980 to 1996 period, the profit rates for the large sized firms, namely largely Chaebol firms, tend to be consistently lower than the small or medium-sized firms since the mid 1980s when the trend of profitability passed the peak. [5]

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[4]). It was actually during the 1980s that the government itself first declared it was switching from the policies of selective intervention to those of functional intervention. Since then, this policy lines has been basically maintained.

[5]). The estimated profit rates are the adjusted measures, which are different from the profit rates measured in terms of the book values; they are estimated using the market values of the assets of the firms. In general, it shows the decreasing trend over the concerned period. For the large-

What do these changes mean for the balance sheet of the costs and benefits of the Chaebol-type firms and their diversification strategy? It is clear that the benefits side has lost. With lower benefits, balancing the costs and benefits of the Chaebol have become difficult, and now the costs side has started to loom largely. In other words, the costs of over-diversification suddenly felt much more strongly than before. As mentioned before, diversification was a somewhat rational response of the Chaebols to the environment. But, now that the environment had changed, it was not easy to make money in many industries. Unfortunately, the Chaebols did not command enough flexibility to meet the new challenge, or were too big to change quickly. The source of the inflexibility has to do with both the seemingly M-form like over-diversified organization with few exit possibility and the unchanged mind of the top management.

The founder-managers of Chaebols were succeeded by their sons, who often did not have verified managerial talents. The challenge to the inherited management was in general more demanding as the size of the firms had grown bigger and the entry into the global business environment was more complicated as well. In other words, the burden on the top management had become much heavier and the need for decentralization was evident. Decentralization was necessary as the member firms in the Korean Chaebols enjoyed much less autonomy than the division in the M-form and because the necessary separation of the strategic and operational decision-making processes was not made. In short, Chaebols' problem was that they pursued diversification strategy while their structure was a quite centralized one. In other words, the tension between "strategy and structure" had become serious as the institutional environment had changed.

In sum, the above discussion suggests that the business groups should try to find the optimum level of diversification as the external institutional environment changes, and that pursuit of the same level of diversification is value-destroying, rather than value-creating.

B. Inefficiency of Investment Drive in a Leveraged CMS firm.

The literature on corporate organization tends to perceive two kinds of the firms. The

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sized firms which include most of the Chaebol firms, the profit rates have changed from 0.3 % during the 1980-84 period and 13.3 % during the 1985-89 period to 0.2 % during the 1990-96 period.

one is the firm of concentrated ownership where there is an owner of the firm with controlling share of the firm, and the other is the firm of dispersed ownership where ownership is quite dispersed over a large number of shareholders each with only a negligible share of the firm. The literature finds that the firm with concentrated ownership is free from agency costs of hired management while it is exposed to the danger of management entrenchment. In contrast, the firm with dispersed ownership could enjoy the benefits of professional management whereas it is potentially exposed to the agency costs of the hired management. It is not hard to notice that neither form of the firm can commands a priori dominance over the other, and, as a matter of fact, so many empirical papers end up with the conflicting results over the relative performance between the two types of the firms.

Then, what about the business group? What kind of the firm is this? Concentrated ownership or dispersed ownership. Of course, ownership of business groups can be concentrated or dispersed. But, we contends that there is great possibility that ownership of the business group can be in-between the two extreme. Bebchuk, Kraakman, and Triantis (2000) proposes the controlling minority structure firms as the third kind of the firms, and find that the firms of controlling minority structures are widespread around the world, especially in the form of the business groups. In CMS firms, a shareholder exercises control while retaining only a small fraction of the equity claims on a company's cash flows. Such a radical separation of control and cash flow rights can occur in three principal ways: through cross-ownership ties, a dual-class share structure, and stock pyramids. These all three methods are by the business groups in many countries, including the Korean Chaebols.

Then, what is the problem with the CMS firm. The CMS structure resembles controlled structure insofar as it insulates controller from the market for corporate control, but it resembles dispersed ownership insofar as it places corporate control in the hands of an insider who holds a small fraction of equity. Thus, the CMS threatens to combine the incentive problems associated with both the concentrated structure and the dispersed ownership in a singly ownership structure.

Theoretical models Bebchuk, Kraakman and Triantis (2000) explain why inefficient projects are chosen and unprofitable expansion are pursued under the CMS.

Suppose that there are projects which can produce a value of V that includes cash flow (S) available to all shareholders and private benefits of control (B). Then, between the two alternative projects that generate different cash flow and private benefits, the model shows that the probability that the project generating a bigger private benefits is chosen increase at a sharply increasing rate as α decreases (α is cash flow rights of the controlling minority shareholder). For example, with a value of α as 10 %, which is roughly the average value in the top 30 Chaebols, a controller will reject the efficient project unless the value gap between the two projects is more than 27%.

Another model in Bebchuk, Kraakman and Triantis (2000) also explains that given any distribution of opportunities to expand and contract, the likelihood that a CMS firm will make an inefficient decision--and thus the expected agency cost--grows larger as the controller's equity stake α becomes smaller. In their model, a controller will prefer to expand (or not to contract) a firm if $\alpha(V\text{-}B) + B > \alpha P$, where P is the buying or selling prices of the asset. For example, with a value of α as 10%, the controller will refuse to sell the asset unless the firm receives a price 45% higher than the real value of the asset to the firm. Equivalently, the controller will acquire the asset unless the price is more than 45% higher than its real value to the firm.

In this model, too, the deciding factor is the magnitude of private benefits accruing to the controller when he keeps or acquires the asset, and private benefits tend to come from self-dealing or appropriation opportunities. In the Korean context, typical private benefits also took the form of arbitrary and preferential borrowing from the firms and many kinds of outright cash payments to the controlling shareholders. These models suggest that the unique agency costs structure of the Chaebols as a CMS firm pushes Chaebols to pursue more growth than otherwise.

Bebchuk, Kraakman and Triantis (2000) find that the similar kind of agency costs happens to the borrower-controller of the firms as the debt-equity ratio increases. In other words, the higher the debt-equity ratio, the more likely the controller is to take risky projects which provide more return upon success. This is the agency cost of the highly leveraged firm. Milgrom and Roberts (1992) also observes that unjustifiable expansion drive can prevails when the controller of the firm expect that the costs of any failure were shared or transferred to the lenders, whereas benefits of any success are monopolized by the incumbent management.

Relative performance comparison between the business groups and stand-alone firms has been one of the important issues in both academia and practices. In the Korean context, the debate has been the comparison between the Chaebols and non-Chaebols. In this debate, Chaebols are considered as the firm under concentrated ownership since they find a controlling family in each Chaebol group. This paper does not buy this perception of Chaebol to argue that it is misleading and cannot explain the observed behavior of the Chaebols. We observe that Chaebol is neither dispersed ownership firm nor a concentrated ownership firms, and is rather a kind of the CMS (controlling minority structure) firm. If we perceive Chaebols as a kind of the CMS firms, it become quite easy to explain several important features of the Chaebols, including aggressive expansion which is often unjustifiable in terms of the interests of the shareholders.

If we look the growth of Chabols in terms of artificial rents associated with institutional voids or state intervention in terms of domestic market protection and preferential loans, it would be natural for Chaebols to take advantage of these rents in pursuing growth with diversification. However, existence of rents does not seem enough to explain the expansion tendency of Chaebols, especially given the fact that there was substantial degree of market liberalization and reduction of subsidized loans since the 1980s. As a matter of fact, the Chaebols were perceived to acquire, or enter into, a business which was not justifiable in terms of rate of return of investment even in the 1990s. In other words, we need to look at the intrinsic mechanism leading to the unjustifiable investment drive which had contributed to the declining financial performance of the business groups. This is the reason we need to resort to the concept of the CMS firms. According to this model, a CMS firm like Chaebols tend to pursue “unjustifiable” growth since the actual share of the controller is so small. Such investment drive should lead to over-capacity and low productive efficiency as confirmed by the regression analysis of the production functions done in Lee, Ryu and Yoon (2002). Joh (2002) also finds that the separation of control rights and cash flow rights in Korean Chaebols led to lower profitability.

Lee, Ryu, and Yoon (2002) have examined the controller’s share in the Chaebol and non-Chaebol firms to find that the owner-controller’s shares are significantly higher in non-Chaebol firms. It confirms that in the Chaebol firms, the owners’ share continued to decline over the sample period, which is confirmed by a simple regression using time-trend as an explanatory variable. We can thus infer that the decreasing share of the owner-controller aggravated the agency costs of the controlling-owner, and led to the inefficient investment drive in the Chaebol firms.

To verify this argument, Lee, Ryu and Yoon (2002) have run the regressions where the difference in the investment rate between Chaebols and non-Chaebols is specified as a function of cash flow of the firm, the difference between Chaebols and non-Chaebols in the share of owner-controller, and a proxy for Tobin’s Q measured by the market value divided by the book value of the firms. The model is similar to the model used in Sharfstein (1998) and Kim (2002). They found that the coefficient of the ownership difference variable is negative and significant in the 1990s, while it is negative and not significant in the 1980s. It shows that the investment rate difference between Chaebol and non-Chaebol firms in the 1990s can be explained by the difference in the shares held by the owner-controller, and that the smaller the owner-controller's shares is in each firm as in Chaebol firms, the more the firms invest. As a matter of fact, the Chaebol firms started to invest much more in the 1990s, compared to non-Chaebol firms.[6]

This result with long term trend of controller' share and investment drive has important implications for the business group as a device for development and transition. We know that the controller's share tend to decrease with firm growth over time unless he/she has enormous personal financial resources to keep up his share at a certain level. Given the CMS structure in place, the continuing decrease of the share of the controlling family implies the aggravation of the agency costs and the increasing possibility of inefficient investment decision and firm expansion. What would be the final consequences of this dynamic process had already shown by the sad story of the Korean Chaebols. The strategic implication is then that the business groups should act to correct the CMS structure of the firm. Various things are to be done. The first is to reduce the private benefits of the controller by making the management more transparent and accountable since it is this private benefit that the controller is aiming at. Formation of stock pyramids itself might not be regulated. As long as there is active participation of non-controlling shareholders and high protection of their rights, for instance, by derivative suits and class actions, any expropriation of non-controlling shareholders in the CMS firm may be checked better. Enhanced checks and balance with better corporate governance would also help solve the problem of inefficient investment decisions by the controller.

C. The Vested Interests of the Big Business Hampering Liberalization

As explained above, while it was good to have big business groups for the purpose of fast track approach to economic development, it might become a hurdle in further economic development in the long run. In other words, as Khanna (2000) and Kali (1999) points out, the mere existence of group might hamper the development of market. The explanation goes like this. Since groups rely on internal source of financing, the demand for analyst services might be attenuated. Analysts might find it difficult to evaluate groups. In this context, we would like to illustrate the case of Korea where the

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[6]). Lee, Lee, and Yoo (2001) also find that Chaebols' investment was inefficient compared to non-Chaebols, and this has to do with the ownership problem.

existence of big players like Chaebols distorted the course of financial liberalization.[7]

In the early phase of Korea's economic development, when the government was in the position to select *Chaebols* for subsidized credit, the quasi-internal organization was efficient as it could economize on the cost of information gathering and policy implementation (C. Lee 1982). Thus, the role of its financial system was largely that of financing the growth of *Chaebols* at the behest of the government. It was the state that made the decision in allocating subsidized credit, and the commercial banks, which were nationalized, served in effect as a channel of government-directed credit allocation.

The success of the quasi-internal organization, however, planted the seeds of its own demise as *Chaebols* grew and became a dominant force in the national economy. This system encouraged *Chaebols* to pursue a heavily indebted growth strategy, and as long as the state was in control of credit allocation and *Chaebols* had no major alternative source of credit the state was able to use them as an effective instrument for economic development. In time, however, *Chaebols* grew and their power vis-à-vis the state increased as their place in the economy expanded. In consequence, the government could no longer unilaterally change its financial policy, freeing interest rates, as the resulting higher rates would have put a heavy debt burden on *Chaebols*.

Thus, even after the big business grew beyond "small infants," the government tended to find it difficult to initiate policies that would affect the big business adversely. For example, in the early eighties the government began undertaking several measures of financial liberalization under the influence of rising free-market ideology and pressures from abroad to open financial markets. Actually, throughout the 1980s the government undertook several measures of financial liberalization, but they did not change its basic stance of low interest rate policy. Rather, the government had to allow the Chaebols to acquire and/or start several NBFIs's as they wanted to have alternative financial sources other than the commercial banks that were under the government control.

Thus, one of the byproducts of the limited financial liberalization in the 1980s was the growth of NBFIs, many of which were owned by *Chaebols* and were used by them as a source of external financing. This access to an alternative source of finance gave *Chaebols* greater independence from the government, and this independence plus their importance in the national economy gave them the political power to influence the government policies, especially various liberalization manners. Granted that free-market ideology and the increasing pressure from the outside world set the stage for financial

[7]). For more details, see Lee, Lee and Lee (2002).

liberalization in Korea, it was the interest politics of *Chaebols* that shaped the final outcome of Korea's post-1993 financial liberalization.

Economic liberalization, if correctly carried out, is supposed to establish a competitive market in which many sellers of financial instruments compete in an open, rule-based manner. But, in an economy where there are a few dominant players with a strong stake in controlling their sources of finance, the course that economic liberalization takes may not be what many of its advocates had in mind. It will be manipulated to reflect the interests of big players, and its outcome is likely to be different from a competitive market.

We can point out at least two abnormalities in the course of economic liberalization in Korea. First, it is natural and desirable that liberalization and inducement of foreign direct investment should go first before liberalization of portfolio investment is enacted. However, in the case of Korea, even until the late 1990s, the amount of FDI was very small. The MNCs, that could pose potential threat to Chaebols playing in oligopolistic domestic markets, were not much either welcomed nor encouraged by the dominant policy coalition between the government and Chaebols.

Second, "inward" financial liberalization should go first, so as to allow foreign banks and financial institutions to come into Korea and compete against local financial institutions. However, in the case of Korea, it was done in reverse order; in other words, "outward" financial liberalization was carried out first so that Chaebols and Chaebol-owned banks and NBFI's may go abroad to borrow at much lower interests than the local rates. Actually, it was a kind of "give-and-take" between the government and Chaebols; the government wanted to initiate full-scale financial liberalization which was expected to increase interest rates, and, in return, had to give Chaebols alternative and attractive sources for financial transactions, that is, offshore banking. But, none of the government and Chaebols wanted to open fully the domestic financial markets for foreign financial players. The outcome was simply "asymmetric" financial liberalization.

Our analysis of the Korean experience clearly demonstrates that simply removing the state from financial markets in an economy dominated by a few large players will not necessarily lead to the establishment of a well-functioning financial system. In such an economy, as in Korea with its *Chaebols*–a legacy of the earlier development strategy, a few dominant players will manipulate financial liberalization to achieve their parochial objectives that are not necessarily in the nation's interest. Thus, unless this structural problem of a few players dominating the economy is first resolved, deregulation—simply removing state intervention from markets—will not necessarily bring about an outcome beneficial to the nation. Worse, it may plant the seeds for a financial crisis on a later date.

IV. Summary

There is a growing number of research papers on the business groups as they are now found in numerous economies around the world. The majority of the literature looks at the business groups as response to market failure or institutional voids in emerging economies. However, if we see the business groups an evolutionary response to the institutional environment of the economy, there is no interesting policy or strategic issues involved. This paper has argued that the business groups is not simply a passive response to the environment but can serves as an organizational device for economic development and transition. We observe that the main strength of the business groups in catch-up is to facilitate entry into new markets or lines of business that were formerly monopolized by the forerunning companies. The business groups can facilitate market entry by mobilizing financial resources into new affiliates and helping them during the initial period of business by providing markets, capital, technology and brand names.

This paper also address the important question of why the business groups tend to fall into trouble. In this regards, it is argued that while the business groups is effective in response to market failure and/or catch-up, the benefits comes with long term caveats in three dimensions. The following three potential dangers are discussed in sequence. First, the benefits of economic value creation by the business groups tend to decline over the long run as institutions evolve and markets get mature. Second, family-controlled business groups, taking the form of the CMS firm, tend to be subject to increasingly serious agency problem resulting in value-destroying, inefficient investment drive. Third, the existence of the big players like business groups in an economy might hamper the sound development of competitive market economy by distorting or manipulating the course of liberalization, deregulation, or opening-up.

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