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Business Groups Looted by Controlling Families, and the Asian Crisis

Sang-Woo Nam

November 2001

Why do the founding families of many East Asian companies hold on to day-to-day management? Is there more going on than meets the eye?

This paper uncovers the disturbing patterns of unfair internal transactions among subsidiaries to maximize the wealth of controlling families at the expense of individual corporate or group profits and minority shareholders.

The author recommends that concerned governments should adopt as their primary policy focus the strengthening of corporate governance mechanisms and transparency so as to counter this abusive behavior by some controlling owners.



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**Business Groups Looted by Controlling
Families, and the Asian Crisis**

Sang-Woo Nam

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PREFACE

The ADB Institute aims to explore the most appropriate development paradigms for Asia composed of well-balanced combinations of the roles of markets, institutions, and governments in the post-crisis period.

Under this broad research project on development paradigms, the ADB Institute Research Paper Series will contribute to disseminating works-in-progress as a building block of the project and will invite comments and questions.

I trust that this series will provoke constructive discussions among policymakers as well as researchers about where Asian economies should go from the last crisis and recovery.

Masaru Yoshitomi
Dean
ADB Institute

ABSTRACT

The Asian financial crisis is, to a large extent, a corporate governance failure for large business groups, where their over-leveraged and inefficient business expansions could not be checked. The problem has been most serious in family-controlled and extensively diversified business groups. This paper is concerned basically with the question of why corporate governance has been so weak and what has been the operational objective of these business groups. After briefly discussing managerial characteristics of family businesses, as well as the explanations of why family-based groups might be more prevalent in Asia, the paper reviews various motivations for choosing the organizational form of business groups with a view to deriving their operational objectives. Finally, the behaviors and performance of Korean *cheabols* are evaluated in light of their hypothesized objective.

Various motivations for diversification including those for vertical and horizontal integration, might be realized within a multidivisional stand-alone enterprise except for one — motivation to expropriate from outside shareholders by controlling owners. This expropriation is rather easily pursued through inter-firm transactions within a group, and may actually be an important motive for forming business groups in East Asia. Family-based businesses have both distinctive advantages and risks. Although family-based business groups are more or less universal, their prevalence in East Asia might be attributable to several factors: Confucian culture emphasizing the value of (extended) family, inadequate institutions geared to protecting property rights and minority shareholders, traditional modes of inheritance and the strength of capitalist groups, limited competition and entrenched interests of powerful families interfering in the policymaking process.

Incentives for expropriation seem strong since, through ownership pyramiding or cross-shareholding, controlling owners usually have much smaller cash flow rights than voting rights. It may be a reasonable approximation to assume that the ultimate objective of controlling families is to maximize their long-run wealth. This explanation seems to be well borne out by the behavior and performance of Korean *chaebols*. They have been preoccupied with management control, resisted instituting sound corporate governance mechanisms, depended mainly on debt to finance their business expansion, pursued aggressive diversification, and attempted to enter into the financial industry whenever they had a chance. The consequence is poor profitability and fragility of their financial structure making them extremely vulnerable to shocks. Environmental changes that East Asian enterprises have faced since the 1980s — globalization and democratization — have made these strategies all the more vulnerable. Failure of East Asian big businesses and authorities to be more sensitive to these developments was also responsible for the crisis.

Evidences confirm the concern that the real corporate governance challenge is the agency problem of how to protect outside shareholders from the expropriation of controlling owners. It is imperative to put basic corporate governance mechanisms in place and ensure their effectiveness. The governments of crisis-hit economies have often directly intervened in reforming the organizational

structure of business groups and imposed outright bans on some of their problematic behavior. However, primary policy efforts should be better directed toward curing the root cause of the problems rather than treating their symptoms. Effective corporate governance reform and enhanced transparency geared to protecting the interests of outside shareholders would certainly contribute to rebuilding the crisis-hit economies by reorienting the operational objectives of business groups more toward efficiency and profitability.

TABLE OF CONTENTS

| | |
|--|-----|
| <i>About the Author</i> | II |
| <i>Preface</i> | III |
| <i>Abstract</i> | IV |
| <i>Table of Contents</i> | VI |
| 1. Introduction | |
| 2. Family-Based Business Groups in Asia | 3 |
| 2.1. Advantages and Risks of Family Businesses | 3 |
| 2.2 Why Family-Based in Asia? | 5 |
| 2.3. Motivations for Forming Business Groups and Their Operational Objectives | 10 |
| 2.3.1 Motivations for Diversification | 10 |
| 2.3.2 Operational Objective of Family-Controlled Groups | 14 |
| 3. Korean <i>Chaebols</i> : Build-up of Vulnerabilities | 16 |
| 3.1. Behavioral Characteristics | 16 |
| 3.1.1 Preoccupation with Management Control and Weak Internal Governance Mechanisms | 16 |
| 3.1.2 Aggressive Investment with Debt-Financing | 21 |
| 3.1.3 Extensive Diversification and Group-Wide Internal Transactions | 23 |
| 3.2. Profit Performance | 33 |
| 4. Conclusions | 38 |
| Tables and Figures (in body of text) | |
| Table 1. Number of Executive Officers: Controlling Family and Others in Hyundai Group (May 1997) | 17 |
| Table 2. Cross-Shareholding: Samsung Group (1997) | 19 |
| Table 3. Succession Pattern for <i>Chaebol</i> Chairmanship | 21 |
| Table 4. Average Number of Subsidiaries and Industries Operating: Korean <i>Chaebols</i> | 29 |
| Table 5. Trend of Diversification for Korean <i>Chaebols</i> | 30 |
| Table 6. Share of Value-Added by Industry: 5 Largest <i>Chaebols</i> (1998) | 31 |
| Table 7. Number of Financial Subsidiaries Held by Top 5 <i>Chaebols</i> (1997) | 32 |
| Table 8. Market Share of Top 5 <i>Chaebols</i> in the Nonbank Financial Industry | 33 |
| Table 9. Rate of Ordinary Profit to Total Capital: Korea | 35 |

| | |
|---|----|
| Figure 1. In-Group Ownership Share: 30 Largest <i>Chaebols</i> | 18 |
| Figure 2. Share in Korea's Value-Added: 30 Largest <i>Chaebols</i> | 22 |
| Figure 3. Debt / Equity Ratio: Non-Financial Firms | 22 |
| Figure 4. Debt Guarantees and Equity Investment in Other Firms: Top 30 <i>Chaebols</i> | 23 |
| Figure 5. Internal Transactions: SK Group (1997) | 24 |
| Figure 6. Cross-Guarantees of Debt Repayment: LG Group (1997) | 26 |
| Figure 7. Net Cross-Repayment Guarantee and In-Group Ownership Ratio of <i>Chaebol</i> Subsidiaries (1997) | 27 |
| Figure 8. Relation between <i>Chaebol</i> Profit and Ownership Share of Controlling Family | 36 |
| Figure 9. Relation between Profit Rate and In-Group Ownership Ratio of <i>Chaebol</i> Subsidiaries (1997) | 37 |
| References | 42 |

Business Groups Looted by Controlling Families, and the Asian Crisis

Sang-Woo Nam *

1. Introduction

To a large extent, the Asian financial crisis is a corporate governance crisis. This was particularly so in Korea, where a series of bankruptcies of large business groups, called *chaebols*, was mainly responsible for the triggering of the crisis. The mismanagement of foreign exchange assets and liabilities was another critical factor for the loss of confidence in the Asian economies. However, even with substantial improvement in their liquidity conditions, these economies are hardly out of the trouble, indicating the seriousness and tenacity of the structural weaknesses in these economies (Nam, 2001). The main problems of the corporate sector are widely believed to have been attributable to weak corporate governance that could not check over-leveraged business expansion and inefficient investment. Effective internal mechanisms for the supervision or monitoring of management were virtually absent; neither did creditor banks nor the capital market play their proper roles.

At the center of the crisis — and a still lingering problem in each of the crisis-hit Asian economies — are family-based business groups exerting extensive control over national wealth. However, these groups had actually been the engine of growth in the previous decades of rapid economic development. We could not adequately explain the Asian crisis without due account of the nature and behavior of the family-based business groups in these economies, which is the primary purpose of this paper. Lacking a solid theoretical basis, there have often been confusions and inconsistency in interpretation of the behavior and performance of business groups as well as proposals for associated reform. For instance, it has usually not been made clear whether some of the problems can be attributed to their organizational structure (diversified conglomerate) or their governance type (family-based). This distinction has to be made clear when advice is given to some of the transitional economies including the People's Republic of China (PRC) that are interested in fostering business groups for their industrial development.

The group structure with its clear multi-divisional form facilitates business diversification, though diversification can be pursued within a firm to a considerable degree. A more important difference between diversification within a firm and within a group has to do with the difference in their ownership structure. Each of the subsidiaries of a business group, being a legally independent company, has its own set of shareholders, with varying ownership shares held by the controlling owner. This could enable the controlling shareholder to get personal benefits by transferring resources from one subsidiary to another where he has a bigger stake. Incentives for

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expropriation are strong since, through devices like ownership pyramiding, controlling owners usually have much smaller cash flow rights than voting rights. Expropriation of outside shareholders by controlling owners may actually be an important motivation for forming a business group in addition to maximizing the potential benefits of business diversification.

In Section 2, our attention is directed to family-based groups — a dominant form of business groupings in East Asia — with the discussion of their advantages and risks. Several explanations as to why business groups are dominantly owned and controlled by families are also discussed, even though this is a rather universal phenomenon except for a few countries. Then, after a brief review of motivations for forming business groups, a hypothesis is presented concerning the primary objective of family-based business groups. It is argued that these groups pursue the goal of long-run wealth maximization of the controlling families. This goal would generally deviate from the profit or equity-value maximization of a business group or its member subsidiaries. It is so because the interests of controlling families can be furthered at the expense of outside shareholders mainly through the internal transactions among subsidiaries. If the deviation is substantial, efficiency in group-wide resource allocation will be greatly compromised and their competitive position weakened.

The above hypothesis is evaluated in Section 3 by discussing the behavior and performance of Korean *chaebols* before the crisis. Business groups with the objective of maximizing the interests of controlling families are expected to show a set of distinct behavior. First of all, the controlling families would make every effort to keep their management control by directly involving themselves in managerial functions or tightly controlling managers. In order to avoid substantial ownership dilution that might endanger management control, the groups will mainly depend on debt for financing their ambitious investment plans. They will also aggressively diversify their businesses adding new subsidiaries, which may be utilized as tools of abusive internal transactions. Entry into the financial industry should be of strategic importance, since it further opens a large room for internal resource reallocation. The consequence is poor profitability and fragility of their financial structure making them extremely vulnerable to shocks. These predictions are borne out strongly by the behavior and performance of Korean *chaebols*.

The discussions and existing empirical evidence seem to confirm the concern that the real corporate governance challenge is the agency problem of how to protect outside shareholders from the expropriation of controlling owners. The expropriation is not just a distribution problem between controlling and outside shareholders, since much of the distorted resource allocation is occurring before corporate profits are determined. It is imperative to put basic corporate governance mechanisms in place and ensure their effectiveness. Some governments of crisis-hit economies have directly intervened in reforming the organizational structure of business groups and imposed outright bans on some of their problematic behavior. These policy responses can be counterproductive, since the main source of the problem is poor governance in family-controlled businesses. Thus, primary policy efforts should be better directed to corporate governance reform and let the strengthened governance mechanisms deal with the dubious behavior of controlling owners.

2. Family-Based Business Groups in Asia

When a business firm is newly started, it is typically financed by the founder (and his family members), who serves as the manager. Since reliance on external funds, borrowings or issuance of equity shares, is minimal, there is no agency problem for him to serve as the manager. As the firm keeps growing and starts to issue new shares and borrow from various sources, the founder and his family members may decide to resign from the managerial positions and restrict their role to supervising the professional management. As the firm gets big enough to form a group, it will need to be more serious about putting sound governance mechanisms in place. Otherwise, it is likely to face difficulties in financing its expanding businesses cheaply enough, because potential equity investors and lenders would not be very willing to entrust their funds to a firm with poor corporate governance.

The realities in large enterprises in Asia, however, are far from this prediction. The founding owners tend to remain in the top management positions even after the enterprises have grown to large groups and their equity shares have dwindled to a relatively small level. Furthermore, the relatives of founding owners practically monopolize major managerial positions of the groups, and the ultimate controlling power, the 'chairmanship' is transferred to the next generation of the founding owners when they get very old. This managerial control by the founding family has typically been made possible by the pyramiding of ownership, or extensive cross-shareholding among subsidiaries. Such internal governance mechanisms as the board of directors and general shareholders meeting do not function properly. Nor does outside governance by creditor banks or markets for corporate control. Why have Asian enterprises, particularly large business groups, remained family-based (meaning here both family-owned and managed)? Why have the founding owners been so much preoccupied with management control by themselves? Have socio-cultural factors in East Asia played any role in making it possible? Before we review these questions, it may be useful to discuss strengths and weaknesses of family businesses in general.

2.1 *Advantages and Risks of Family Businesses*

Large family-based corporations hold and have held dominant positions in many Asian economies, including Korea, some Southeastern countries, and pre-war Japan. But, this phenomenon is hardly unique to Asia. It is estimated that over a third of the Fortune 500 largest companies are family-owned or controlled.¹ Family-controlled *Grupos* in Latin America are also main players in the economic activities of these economies. The omnipresence of successful family-owned and controlled big businesses might be an evidence of their efficiency.

Family and work are supposed to be two of the most important values of people the world over. A family-owned and managed business is where family members may realize these two values at the same time. Even though there is no guarantee that success in one would automatically ensue in the other, they are likely to be mutually reinforcing. This will be particularly so if the family members share and take pride in

¹ Magretta (1998) and Zeitlin (1976).

the tradition, identity and values drawn from this family undertaking. As such, the commitment and dedication of the family members to their business are expected to be very strong. Being members of the same (extended) family, any agency costs should be minimal even though differential distribution of ownership and managerial responsibilities among members may not totally eliminate them. Also, business-related communication will usually be facilitated smoothly due to the intimacy of their relations and frequent informal contacts outside of their offices. Thus, business decisions can be made rather quickly without much bureaucratic formalities.

However, just as good family relations can help business work, so rivalry, bitterness and other tension among family members may easily destroy good businesses. Competitiveness of businesses may deteriorate, as business decisions are compromised with family priorities and professionalism is weakened. Different roles and responsibilities of a member in the family and the business may also create confusion and frustration in the firm. However, the most difficult test of a family business is supposed to be making a leadership transition to a new successor. Picking the right successor (or a team of successors) at the right time by agreeable criteria and procedures seems to be a challenging task for large-scale family businesses. The task will usually involve the sensitive problems of redistributing business ownership (and other family wealth) as well as creating a favorable environment for the successor to firmly establish his or her leadership (without discrediting the outgoing senior CEO).²

Family-based businesses may also share many characteristics common for firms with large shareholders. Berle and Means (1932) suggest that the more concentrated a firm's ownership is, the better performance it would have. This is so, since in a firm with diffused ownership the manager's power is strong, and he may pursue his own interests with shirking, perquisite taking, empire building, and other ways, which hurt the interests of owners. Jensen and Meckling (1976) argue that firms with low equity shares for the owner-managers would result in lower firm values because of the high incentives of managers to appropriate corporate resources for themselves and the high cost of monitoring them by minority shareholders. Shleifer and Vishny (1986) also say that the presence of large outside shareholders raises expected profits of the firms and the more so the higher their equity shares thanks to their strong incentives to monitor managers. Some empirical evidence seems to support this view as they find large shareholders being associated with better performance, higher turnover of directors, higher chance of replacing managers responsible for poor performance, and lower discretionary spending of managers on such activities as advertising, R&D, and entertainment (Shleifer and Vishny, 1997).

However, it has also been noted that the strong monitoring incentives associated with large shareholders come with other incentives that may hurt corporate profitability or interests of other stakeholders. This might be particularly the case where the large shareholders control management through ownership pyramiding or cross-shareholding among subsidiaries they control. They may expropriate from other investors, managers and employees, and may exploit business relationships with other companies where

² For a discussion of challenges faced by family businesses over their life cycles of founding, growth/maturity and intergenerational succession in terms of a three dimensional (ownership development, family development, and business development) model, see Gersick, Davis, Hampton and Lansberg (1997). See also Aronoff and Ward (1966).

they have a stake.³ Large owner-managers also tend to take excessive business risk when the firms have a high debt/equity ratio, since they share the upside gains while the cost of failure is often borne mainly by the creditors. As potential outside investors are shy of buying the shares of companies with large shareholders for fear of expropriation, stock prices would be depressed and external financing through the capital market would be limited. The possibility of expropriation by large shareholders brings about further adverse effects on the incentives of managers and employees. Workers may be unwilling to heavily invest on firm-specific human capital formation, and managerial incentives may be weakened to hurt the values of their firms (Burkart, Gromb, and Panunzi, 1997).

2.2 Why Family-Based in Asia?

How can East Asian corporations be characterized in terms of family ownership and management control? Though the prevalence of family-based businesses is hardly an Asian phenomenon, East Asian countries, except for Japan, are certainly more dominated by family businesses than other parts of the world with comparable levels of development. Claessens, Djankov, and Lang (1998), investigating the ultimate control patterns of 2,980 publicly-traded companies in nine East Asian countries (Hong Kong, China; Indonesia, Japan, Korea, Malaysia, the Philippines, Singapore, Taipei, China and Thailand), find family control in more than half of the cases with particular dominance in Indonesia and Thailand. They also find that the management of two-thirds of firms that are not widely-held is related to the family of the controlling shareholder. Also noted is the size difference among East Asian business groups. Unlike Korean or pre-war Japanese counterparts, Chinese family business firms in Taipei, China and Southeastern countries have generally remained small even at their maturity stage and less inclined to create large business groups. How can we explain this distinct feature in many Chinese business firms? ⁴

Confucian culture. The dominance of family-based businesses among large enterprises or business groups in East Asia may perhaps first be explained by Confucian culture. As guiding Chinese ethical principles, Confucianism has deeply influenced social relations among Chinese societies including those found in Hong Kong, China, Singapore and parts of Southeast Asia as well as Korea and Japan. The core of Confucian teaching might be understood as having two parts: support for a hierarchical

³ Morck, Shleifer and Vishny (1988) investigate the relationship between management ownership and market valuation measured by Tobin's q to find a negative relationship between the two after the ownership reaches 5%. Beyond this level, managers are likely to command full control over the firms and be rich enough to pursue their private benefits of control that are not shared with minority shareholders.

⁴ It should also be noted that not all the business groups in Southeast Asian countries have ethnic Chinese background. Numerous indigenous business firms are owned by the Suharto family in Indonesia, and Marcos family in the Philippines is also known to have controlling stakes in many industries. In Thailand, some groups are controlled by the royal family and the military. Also, main political parties in Taipei, China and Malaysia have substantial business holdings, while large state-owned enterprises are prevalent in Singapore and Malaysia (Claessens, Djankov and Lang, 1998).

system of social relations, and emphasis on the value of family and filial piety.⁵ Of the two, the more central and more lasting moral imperative subordinating all other social relationship is supposed to be filial piety. As Fukuyama (1995, p.85-86) explains,

In the West, the father's authority has had to compete against a number of rivals, including teachers, employers, the state, and ultimately God. Rebellion against parental authority has become virtually institutionalized in a country like the United States as a coming-of-age ritual. In traditional China, this would be unthinkable. There is no counterpart to the Judeo-Christian concept of a divine source of authority or higher law that can sanction an individual's revolt against the dictates of his family. In Chinese society, obedience to paternal authority is akin to a divine act, and there is no concept of individual conscience that can lead an individual to contradict it.

The utmost importance attached to families and filial piety themselves may not fully explain the prevalence of family businesses in the Chinese culture. However, when this is combined with other aspects of families in Asia, we may find the explanations more convincing. For one thing, the family boundary in this culture usually extends well beyond nuclear families, and it might have been natural for family heads to fulfill their family obligation by themselves providing job opportunities to their family members. More important from the perspective of running a business, monitoring or agency costs would be minimized. Although this may be true for any family businesses in general, it would be all the more so in Confucian culture. The degree of hard work, dedication and willingness for personal sacrifice for business success should generally be much higher than that in other cultural environments. Any behavior pursuing personal interests at the expense of the broader family's or against the will of the founding owner is likely to face severe penalties in the forms of damaged reputation in the family, unfavorable treatment in bequest distribution, loss of managerial positions, etc.

Furthermore, Confucianism might also have helped family businesses fare better in the intergenerational transfer of the corporate leadership. As briefly mentioned above, this is believed to be one of the most challenging tasks for the longevity of family businesses. The tension, rivalry, disputes and potential destructive consequences surrounding the succession are likely to be less severe in Asian family businesses. This is so, because a decision made by a senior owner-manager would be rarely challenged by young successor candidates. The chance of a business breakup or split-up against the wishes of their father (senior chairman) due to disputes among the siblings may also be smaller.⁶

⁵ According to Fukuyama (1995), the former (political character of Confucianism and the social stratification) has largely been dismantled with the overthrow of the Chinese dynasty in the early 20th century, the revolution, and the economic success in Taipei, China. He notes "Some Chinese societies like Singapore have tried to revive a form of political Confucianism as a means of legitimizing their particular version of 'soft authoritarianism,' but these efforts have a rather artificial character to them."

⁶ In this respect, traditional China looks like an exception, as there is a noticeable tendency of business split-up as generation changes. This, however, results more from the Chinese tradition of dividing inheritance equally among sons.

However, Confucianism is far from being monolithic. Over the 25 centuries since the days of Confucius, his teaching has been interpreted, articulated and emphasized by many scholars, inevitably resulting in some variations. Moreover, as different countries introduced and earnestly practiced this philosophy at different time, it met idiosyncratic local situations so as to adapt itself somewhat differently in each one. This difference entailed some distinct characteristics in corporate organization and government-business relations in Taipei, China, Korea and Japan.

More specifically, as outlined by Morishima (1982), Confucianism in the three countries generally shares the following five values in varying degrees: loyalty and filial piety (which were already discussed), benevolence, faith, and bravery. It is generally believed, that Japanese Confucianism did not share the value of benevolence and put the highest emphasis on loyalty. Greater emphasis on benevolence as the foundation of social morality, together with harmony in extended family, in traditional China (and Korea probably in a lesser degree) might explain the lower level of institutionalizing fair rules and more widespread nepotism in these societies. Meanwhile, Japanese society (and Korean to a less degree) has been more hierarchical than China, paying higher respect to the better educated bureaucrats, allowing the government to play a more active role in guiding the private sector, and giving more attention to institutionalizing social orders. Such roles of the Japanese government as strong industrial policy, with its powerful incentives designed to upgrade industrial structure and the extensive use of 'administrative guidance' could be and were emulated by Korea with relative ease. However, more fundamental behavioral patterns of the people such as the perceived readiness to subordinate themselves in a collective activity for the common good was probably uniquely Japanese.

In Japan, even filial piety was subordinated to loyalty to the social hierarchy and state; moral obligation and concern for extended family was much weaker than in traditional China and Korea (Cho, 1991). This might have been one of the most important factors for shaping the Japanese industrial organization differently from that in Korean and Chinese societies. As one can easily anticipate, Japanese large corporations are much less family-based than Korean and Chinese counterparts. This was true for pre-war *zaibatsu* as well, where the separation of management from family ownership was not uncommon and the succession of management control by the owners to their children was rather rare.⁷ The family shareholdings in *zaibatsu* were concentrated on the holding companies and, in some groups with a long history like Mitsui, they were regarded as owned collectively by the family. This helped them keep the groups growing without being split through the succession of generations.

Lack of institutions for minimizing agency problem. The fact that large family-based businesses are not unique to East Asia certainly requires other explanations than cultural. The level of institutional development related to protection of shareholders and monitoring of the management seems to be an important factor determining the

⁷ Fukuyama (1995) also notes that Japanese families are more open to adopt outsiders than Chinese families when there is no surviving (competent) son. Because of the fear of disloyalty, adoption in traditional China was rare and, if at all possible, was usually undertaken in a secret way for infant babies within the same kinship group. One may not see any reason why this more open adoption practice in Japanese family should not easily have been extended to family businesses.

ownership structure of individual corporations as well as the whole corporate sector. When potential shareholders feel that they are poorly protected (from bad managers or expropriating controlling shareholders) by the legal and other relevant institutions, one way of securing better protection is for themselves to become a controlling shareholder with concentrated ownership (among family members). Claessens, Djankov, and Lang (1998) find a high correlation between the share of the largest 15 families in total market capitalization and the strength of relevant institutions (efficiency of the judicial system, the rule of law, and degree of corruption). La Porta, Lopez-de-Silanes, and Shleifer (1999) also observe that widely-held firms are relatively few and family-controlled firms are more common in countries with poor shareholder protection (among large corporations in wealthy economies).

Difficulties of owners in effectively monitoring and supervising the management seem to be an obvious reason for their dual role. As long as the expected loss from any managerial inefficiency (due to the combined role) is smaller than the anticipated cost of monitoring, the major shareholder will appoint themselves or one of their relatives to be the manager. Key institutions directly relevant for reducing the agency costs include basic legal framework, law acceptance and enforcement, accounting and auditing standards, and disclosure rules. Without these institutions firmly established and efficiently functioning, it can hardly be expected that business owners would feel comfortable with outsiders managing their firms.

Potential conflict of interests between owners and managers is not the only concern for the owners in sharing the management burden with non-family members. Inadequate protection of property rights might also have exerted a large effect on corporate ownership and management structure. Over the centuries, both in traditional China and Korea, peasants have been the victim of harsh and arbitrary imposition of taxes. Even in the process of rapid economic development in Korea over the past several decades, business firms have often witnessed how insecurely their wealth is protected.⁸ Many ethnic Chinese businesses in Southeast Asian economies that have experienced their political vulnerabilities in local markets, naturally seem to be extremely concerned with the protection of their interests. It is probable that the closed nature of family businesses, in terms of ownership, management and information disclosure, might have given the owners a sense of protection against outsiders including government bureaucrats.⁹

⁸ Major incidences of infringement on private property rights in Korea include: (i) agrarian land reform in the early 1950s, (ii) nationalization of banks in 1961 by the military government condemning their illicit accumulation of wealth (associated with allegedly under-priced disposal of banks by the predecessor government), (iii) the freeze, and forced readjustment of terms, of credit supplied by informal money market lenders to business firms in 1972, (iv) a series of industry rationalization programs in the second half of the 1980s for declining industries and firms or groups in financial distress, and (v) sudden introduction in 1993 of a new system requiring the identification of real names in financial transactions (together with the temporary freeze of deposits and heavy penalties imposed on financial assets withdrawn without personal identification).

⁹ Jwa (1998) presents some evidence that countries with poor protection of private property (the ratio of currency to M2 used as a proxy) tend to have more of self-employed populations and firms with a smaller size because of higher transactions costs in these economies.

Mode of inheritance and wealth accumulation. Inheritance in traditional China was shared equally among sons, which tends to fragment family wealth over generations. Under this situation, it must have been difficult to build a powerful family business empire. In contrast, a system of primogeniture was observed in Japan providing favorable environment for concentrated family wealth. However, large Japanese corporations have been less family-based than Chinese firms possibly because of weaker emphasis on filial piety or obligation to extended families in the Japanese society. The mode of inheritance in Korea lay halfway between that of traditional China and Japan: eldest son usually received much more than younger sons. The Korean system was more advantageous than the Chinese counterpart in maintaining concentrated family wealth. However, this might have played only a limited role in securing the prominent position of family-based business groups in Korea.

Actually, Korea had few capitalists on the eve of embarking on serious economic development in the early 1960s. This was largely the result of unfortunate historical disturbances, but government policies also contributed. During the Japanese colonial period of 1910-45, it was mainly Japanese capital that financed major productive activities. Soon after the liberation, the agrarian land reform, compensating poorly for the forced sale of land, dwindled the wealth of traditional landlords, and the Korean War of 1950-53 destroyed around 40% of industrial facilities. However, out of this a new group of capitalists started to grow. The most important source of capital accumulation might have been a good connection with the government: subsidized purchase of foreign aid materials or properties left behind by Japanese at the end of the war, and economic rents created by restricted licenses for trade. The new entrepreneurship was the source of capital, making the two functions inseparable from the beginning. As long as connections to policymakers remained an essential attribute of management, there was no reason to expect a divorce between ownership and management.

Limited competition and entrenched interests. The survival of the family-based governance system in large-scale business groups throughout the period of rapid economic growth should be partly attributable to limited competition in the domestic market. Even though business groups are known to have vigorously competed among themselves in Korea, they were under the generous care of the government collectively, and have largely been protected from external competition. In many of the Southeast Asian countries, major industrial powers have enjoyed monopolistic or oligopolistic market positions. This means that their profits more than compensated for the cost of inefficient management (by the owner-managers), generating little pressure for change.

Little stretch of the imagination is needed to surmise that powerful families would invest heavily out of their surplus profits to perpetuate the *status quo*. After growing powerful, large family business enterprises, both individually and collectively, are widely believed to have interfered in the political process for their interests. They must have developed a close symbiotic relationship with the political circle by giving huge political contributions in exchange for implicit promises of protection and support. The consequence was delays in putting all the necessary institutions in place, which are essential for developing an efficient capital market and allowing the separation of ownership and management through more effective corporate monitoring and

disclosure. In essence, required institution building is likely to have been impeded not only by the culture deeply imbedded in these societies but also by the conscious efforts of the vested family interests.¹⁰

2.3 Motivations for Forming Business Groups and Their Operational Objectives

Business groups may be understood as ‘coalitions of firms pursuing their common interests through a system which coordinates decisions made by member firms’ (Goto, 1982).¹¹ The system of coordination may be distinguished by the degree of hierarchy operating. It is very hierarchical for Korean *chaebols*,¹² as had been the case for Japanese *zaibatsu*, as well as most family-controlled or state-owned business groups in East Asia. In contrast, it is mainly a set of tacit, informal rules that secure coordination in contemporary Japanese *keiretsu* (Goto, 1982). Large business groups typically have the feature of both vertical and horizontal integration. Though there are evidences that members of a business group have a tendency to diversify more than stand-alone firms even at the firm level (Claessens, Djankov, Fan, and Lang, 1999a), our main interest is diversification within a group. However, the group structure facilitates not only business diversification but also pursuance of the interests of controlling families.

2.3.1 Motivations for Diversification

Vertical integration gives a firm or group much room for internal transactions. There are several explanations for vertical integration: reduction of post-contractual moral hazard in situations of asset specificity, protection from monopoly in intermediate markets and

¹⁰ Claessens, Djankov, and Lang (1998) observe that “Legal and regulatory developments may have been impeded by the concentration of corporate wealth and the tight links between corporations and government, either directly or indirectly. The endogeneity of the legal systems implies that the legal and regulatory reform in most East Asian countries will likely not be independent of changes in ownership structures and wealth concentration.”

¹¹ Leff (1978) refers to a business group as ‘a group of companies that does business in different markets under a common administrative or financial control’ where the members are ‘linked by relations of interpersonal trust, on the basis of a similar personal, ethnic or commercial background’. As noted by Khanna (2000), while economists tend to emphasize cross-shareholding pattern among member firms, sociologists, political scientists and historians tend to give more of their attention to the various formal and informal ties among the affiliated companies. Although Leff’s definition of business groups seems to be rather restrictive, since firms may still coordinate their business decisions without *common administrative or financial control*, it will still be appropriate in the context of *chaebols*, *zaibatsu* and family-based business groups in Southeast Asia.

¹² A business group as defined in Korea’s Fair Trade Act includes the companies whose voting shares are held at least 30% by an identical (natural or juridical) person, close relatives, officers of the company, or other companies or non-profit organizations effectively controlled by the identical person or those with a special relationship. Even without the 30% equity shares, a company is also considered to be a subsidiary of the business group if the identical person, together with those with a special relationship, substantially controls the management of the company through the following means: appointment/dismissal of the CEO or more than half of the officers, controlling influence over the major decision making or business operations, or close business relations with the identical person or those with a special relationship beyond a customary range (personnel exchanges such as interlocking officers; transactions of assets, goods, services, etc.; or guarantees of debt repayment or other financial transactions).

an attempt to deter new entry, better coordination and synergy between successive stages of business activities, tax saving and circumvention of price controls, and limited market size.¹³ A large portion of business groups around the world and most of those in Asia show the characteristics of conglomerates operating in diverse industries. There are several explanations (other than those specific to vertical integration) why business firms form a group and diversify their business.¹⁴ They may be falling into the following categories: exertion of market power, maximization or protection of the interests of managers and owners, creation of group-wide internal markets, utilization of common resources and economies of scope, reduction of business risk and portfolio optimization, and maximization of profit opportunities induced by government incentives or regulations (see further Box 1).

¹³ For the theories and evidences of motivations for vertical integration, see Stigler (1951), Klein, Crawford and Alchian (1978), Teece (1980), Grossman and Hart (1986), Demsetz (1988), and Milgrom and Roberts (1992).

¹⁴ For relevant arguments based on empirical evidences, see Teece (1980), Goto (1982), Montgomery (1994), Denis, Denis and Sarin (1997), Ghemawat and Khanna (1998), and Khanna (2000).

Box 1. Major Motivations for Diversification

Generation and exertion of market power. With “deep pockets” (anticipated help from other members), subsidiaries of a business group may more easily adopt predatory pricing for the purpose of driving competitors out of the market. They may also show some non-competitive behavior collectively, as they frequently confront each other in wide range of markets. For instance, they may “mutually forbear” vigorous competition among themselves for fear of retaliatory actions by other groups, while trying to foreclose markets for non-diversified firms (Bernheim and Whinston, 1990; Ordober, Saloner and Salop, 1990).

Pursuance of managers’ and owners’ interests (agency view). In large-scale firms with dispersed ownership, managers tend to pursue their own interests by diversified corporate expansion. This strategy increases not only managerial perquisites and pleasure of empire-building but also their job security, since it would require more managerial resources and might lower the business risk as well (Shleifer and Vishny, 1989; Amihud and Lev, 1981). In contrast, in business groups with concentrated ownership or pyramidal ownership structure, diversification might serve the interests of controlling owners at the expense of those of minority (outside) shareholders.

Creation of group-wide internal markets. In the early stage of development, factor markets, particularly the financial market, suffer from serious imperfections. In this situation, business groups would better be able to finance their new and existing businesses by mobilizing in-group financial resources, since information asymmetry is less of a problem within a group. Facing underdeveloped labor market, they would also attempt to develop necessary human resources themselves and allocate them in a most efficient way within the groups. Here, business groups are viewed as an organizational response to the inefficient external factor markets, which are at least partially substituted with their own internal markets.

Utilization of common resources and economies of scope. Another advantage related to the internal uses of resources is economies of scope: gains from sharing valuable assets, both tangible and intangible, within a diversified firm or group. These gains arise because, in spite of their value within a group, they either have little value or are rarely traded in the outside markets. Most important asset in this respect may be entrepreneurship, distinctively lacking in the early phase of industrialization. If entrepreneurship is indeed the key to business success, it is natural for diverse business undertakings to come under the management of a proven entrepreneurial talent.

Reduction of business risk and portfolio optimization. Business diversification means reduced risk. In the absence of a well-developed capital market and limited financial resources, portfolio diversification is inadequate for the personal wealth of controlling families, and they might want their businesses to diversify instead. Diversification also helps tide over temporary business difficulties. It enables them to aggressively enter into risky businesses with a long gestation period.

Capturing profit opportunities induced by government incentives or regulations. In many countries, business groups grew rapidly in connection with government-initiated drive for industrialization that provided a wide-range of incentives including preferential credit, tax exemptions, and exclusive licenses. Eligible for these government-administered incentives were mainly large businesses. They kept adding new businesses in an effort to secure the subsidies as much as possible often with the belief that the government would have no other choice than bailing them out in the event of financial distress.

Which motivations for diversification have been most important for Asian conglomerates is not an easy question to answer. Nevertheless, some conjectures may be made on the basis of competitive structure in the product markets, level of development of the factor markets, ownership structure of business groups, and the role of government in economic development in these economies. Market power argument should not be very convincing at least for Korea and pre-war Japan, since business groups usually competed against each other in many of product markets, making it unlikely to be tempted to adopt predatory pricing to drive competitors out of the market. It is, however, plausible that these business groups showed mutual forbearance in order to avoid retaliation in other markets. The benefits of utilizing common resources and economies of scope as well as reducing business risk might have been as important for Asian business groups as they may be for those in other parts of the world. The motivations of creating internal markets and maximizing profit opportunities induced by government incentives have also played critical roles in the formation and remarkable growth of business groups in Asia (Nam, 2001).¹⁵

The agency view seeing diversification as managers' attempt to maximize their interests is largely out of the question, since the traditional agency problem is usually absent in Asia due to the non-separation of managerial control from ownership. Another agency problem between controlling owners and outside shareholders, however, seems to be very serious in Asian business groups.

The Asian financial crisis revealed many instances of looting business groups by their controlling owners, prompting relevant theoretical works (Bebchuk, Kraakman, and Triantis, 1998; Wolfenzon, 1999; Johnson, La Porta, Lopes-de-Silanes, and Shleifer, 2000). Large family-based business groups in Asia have many firms, in which the largest owner family exercises control while retaining a relatively small fraction of the ownership. In this ownership and control structure, there is a strong incentive for the controlling owner to expropriate from outside shareholders.¹⁶

All the benefits of diversification discussed above may be realized within a multi-divisional firm, even though it may be more efficient to have a group structure as the firm enters into many different industries. However, the room for expropriating outside shareholders increases substantially in a group structure than in a multi-divisional firm. Within a firm, the controlling owner cannot expropriate outside shareholders through a resource transfer from one division to another because their ownership claim is the same across the divisions.

¹⁵ In Japan, most *zaibatsu* families accumulated their wealth as political merchants dealing in government supplies or mining ventures until the late 19th century. The key factors that prompted their diversification include the privatization of state enterprises in the Meiji period and a drive for heavy industrialization during and after World War I. In Korea, corporate growth and diversification owed much to the government sales of properties that were owned by Japanese during the colonization period, privatization of many state-owned enterprises as well as the distribution of raw materials and production facilities received as foreign aid after the Korean War. However, as was the case for many other East Asian countries, the major momentum for business diversification was generous government subsidies given in connection with its drive for export promotion and heavy/chemical industrialization since the 1960s.

¹⁶ This structure is certainly not unique to Asia. Investigating the ownership structures of large corporations in 27 wealthy economies, La Porta, Lopez-de-Silanes, and Shleifer (1999) find the same ownership and control structure, except in very few economies with good shareholder protection.

This is not the case in a business group, where the subsidiaries have their own ownership structure. The controlling owner can gain at the expense of outside shareholders by transferring resources from a subsidiary where he has a relatively small share to another subsidiary almost exclusively owned by him. The business group structure allows the group to attain all the benefits expected from diversification, at the same time, making it possible for the controlling owners to expropriate resources, property, cash and ultimately profits and dividends from outside shareholders for their benefit.

Evidences in support of this motivation are accumulating, both as the result of investigations by national fair trade agencies and more serious empirical studies. Claessens, Djankov, Fan, and Lang (1999b) report that deviations of control from cash-flow rights are associated with lower market values, especially for corporations under family control. Claessens, Djankov, Fan, and Lang (2000) further investigate the same issue with more explicit consideration of group-affiliation. They find that group-affiliation reduces corporate value, which is (more than) fully attributable to large divergence of control from cash flow rights. Bertrand, Mehta, and Mullainathan (2000) quantify the extent of resource transfer (tunnelling) in Indian business groups using a general empirical technique. By examining how various firms within an ownership pyramid respond to external shocks to their own or other firms' performance, they find evidence of considerable tunnelling. Johnson, Boone, Breach, and Friedman (2000) find that the effectiveness of protection for minority shareholders explains the extent of exchange rate depreciation and stock market decline for 25 emerging markets in 1997-98 better than do standard macroeconomic measures, and interpret this as the result of expropriation by owner-managers in times of worse economic prospects.

2.3.2 Operational Objective of Family-Controlled Groups

Given that the ownership and management are all in the hands of the controlling families, it should be natural to assume that the family-based business groups are driven by the objective of maximizing the family wealth. This objective is likely to be the very reason why they are so keen about their management control. Without much pressure to show short-run management performance, we can assume that these business groups would pursue long-run wealth maximization of the controlling families.

Unlike typical large-scale western corporations where the dispersed ownership is separated from management, the major agency problem in East Asia lies not between managers and shareholders in general, but between controlling owners and outside shareholders. In situations where management control is considered very beneficial, we may view ownership as a means of securing such control. Management control is valuable for corporate owners for the purposes of not only protecting their interests but also maximizing their benefits probably at the expense of other parties. Though the latter objective is difficult to realize where minority shareholders are given good legal protection. Then, they would not be much preoccupied with management control, neither would minority shareholders worry much about being expropriated (La Porta, Lopez-de-Silanes, and Shleifer, 1999). Thus, the non-separation of ownership and management in most East Asian countries should largely be the consequence of weak rule of law and inefficient judicial system. Once this pattern becomes dominant, the

owner-managers would effectively resist or delay the adoption of improved institutions by intervening in the policymaking process.

It has often been claimed that business groups in East Asia are not profit maximizers but show the behavior of market share or growth maximizers. This behavior is not inconsistent with profit maximization when the downside business risk is low with an expectation of bailout by the government. Business groups in high-growth East Asia with interventionist governments were also observed to have carried out national developmental goals as cooperative development partners of their governments. Business groups could secure maximum subsidy and have their downside business risk lowered (with the expected government bailout) by actively participating in the national development programs. As was the case in Korea, developmental governments in East Asia often came to rescue companies when they were in trouble carrying out “national” investment projects or the firms were subsidiaries of large business groups considered to be “too big to fail.” Though these observed behaviors are consistent with maximization of group profit or value, they are not inconsistent with our hypothesis of long-run wealth maximization of the controlling families, either.

Wealth maximization of controlling families deviates from profit or value maximization of the groups, as the latter may be sacrificed for the former, that is, minority shareholders may be exploited by the controlling families. Shleifer and Vishny (1997) stress the possibility of expropriation arguing that large shareholders, beyond a certain ownership level, gain full control and tend to generate private benefits of control that are not shared by minority shareholders. Given the concentrated ownership and control structures in most of the publicly-traded corporations in East Asian countries, they (as well as La Porta, Lopez-de-Silanes, and Shleifer, 1999; Claessens, Djankov, Fan, and Lang, 1999b) conclude that the risk of expropriation is indeed the major principal-agent problem for large publicly-held corporations.

Though we can assume that long-run family wealth maximization would be the goal of all family-based business groups in East Asia, there seem to be slight differences in their behavior across the countries. Ethnic Chinese businesses, for instance, have not had very long time horizons given their political vulnerabilities, and have been relatively less active in heavy manufacturing industries with a long gestation period.¹⁷ In the case of Japanese *zaibatsu*, there seem to have been no major divergence between the family wealth maximization and corporate profit or value maximization. It was so because the major *zaibatsu* had rather exclusive ownership structure with few minority shareholders, although late-comer *zaibatsu*, like Nissan, tended to have their ownership more open to the public by mobilizing funds in the capital market. Furthermore, with family wealth accumulated through many generations, *zaibatsu* families often limited

¹⁷ During and after the Communist Revolution of 1949, millions of Chinese people fled from Mainland China to many Southeast Asian countries. Even though most of the people came without any significant wealth, many of them managed to have remarkable business success through perseverance, frugality, and entrepreneurship. Ethnic Chinese in Singapore, Malaysia, Thailand, Indonesia, and the Philippines were estimated to represent about 70% of the total private sector not to mention Hong Kong, China and Taipei, China (Weidenbaum and Hughes, 1996). Their success often brought about jealousy in the local people, which led to violent physical assaults against ethnic Chinese in some countries. In Taipei, China growth of business groups has been constrained by political elite from the mainland who viewed the emergence of large businesses inconsistent with their ideology as well as a potential political rival.

their role as monitors rather than managers, establishing the separation of management control from ownership rather early on.¹⁸ With these features of ownership and management, the concern of controlling shareholders expropriating minority shareholders was virtually non-existent in Japan.

3. Korean *Chaebols*: Build-up of Vulnerabilities

Controlling families of business groups trying to maximize their long-run wealth are expected to show certain regularity in their behavior. We will now see whether what we have observed in the case of Korean *chaebols* before the crisis at the end of 1997 is consistent with this expected behavior. We will also examine the consequences of this behavior for their profitability.

3.1 Behavioral Characteristics

First of all, large shareholders with family wealth maximization objective would not want to give up management control in order to make sure that family interests take precedence over corporate or group interests in strategic decision-making. To maintain management control with limited family wealth, they would have no other option than relying on debt and mobilizing other subsidiaries as “friendly shareholders”. Furthermore, they would have strong incentives to diversify their businesses, particularly into the financial industry, establishing new subsidiaries. This expands the scope of group-wide internal transactions that might be used to expropriate from outside shareholders for the benefits of controlling families. The consequences would be misallocation of resources, fragile financial structure, and concentration of economic power: problems of inefficiency, instability and inequity.

3.1.1 Preoccupation with Management Control and Weak Internal Governance Mechanisms

Management control will be considered indispensable where the expected benefits from control are large. If these benefits are coming mostly from the expropriation of outside shareholders, the key factor is the adequacy of investor protection. Since Korea’s legal rules have been inadequate by any standards in protecting public investors, we can expect that large shareholders would be very keen about management control. Although the controlling family members of a group take only a few key executive positions in addition to the chairmanship or honorary chairmanship (usually given to the group founders), they seem to have no difficulty in pursuing their family interests.

¹⁸ Capable managers from the owner families were in short supply, and the families shared the belief that management control should be in the hands of those with higher education or knowledge of the West, to which Japan was newly exposed. In addition to the socio-political environments of the Meiji Restoration (emphasizing capabilities rather than social background), emerging economic opportunities and increased business risks also facilitated this transition. In some *zaibatsu*, even before World War I, the salaried managers were promoted to CEO positions. By 1930, the ratio of salaried managers among all the directors reached 45% (Morikawa, 1991). Predominantly coming from samurai classes with good education and a strong nationalistic disposition, these salaried managers prompted the family owners into charting the courses of *zaibatsu* in response to the new environments.

Most non-family CEOs have typically been with the group for decades and would usually act as faithful agents of the chairman. This is so because their promotion, tenure and other opportunities within the groups are entirely dependent on the chairman. Given that much of their human capital is group-specific, it is not as highly valued in the managerial labor market as within the group (see e.g. Table 1 for executive positions held by Hyundai group controlling family members).

Table 1. Number of Executive Officers: Controlling Family* and Others in Hyundai Group (May 1997)

| | (Honorary) Chairman | Vice Chairman or President | Other Executives |
|--------------------------------------|------------------------|----------------------------------|---------------------|
| Headquarters | 2* | 1* | 0 |
| KSE-Listed Companies | | | |
| Korea Industrial | 0 | 1 | 14 |
| Kum Kang Development Industries | 1* | 1 | 21 |
| Aluminum of Korea | 0 | 1 | 3 |
| Inchon Iron & Steel | 1* | 1 | 20 |
| Hyundai Pipe | 1* | 1 | 12 |
| Hyundai Engineering & Construction | 1* | 2 | 111 |
| Hyundai Livart | 0 | 1 | 7 |
| Hyundai Mipo Dockyard | 0 | 1 | 11 |
| Hyundai Industrial Develop. & Const. | 1* | 1 | 33 |
| Hyundai Merchant Marine | 1* | 1 | 21 |
| Hyundai Elevator | 1* | 1 | 6 |
| Hyundai Motor | 2* | 2 | 67 |
| Hyundai Motors Service | 1* | 1 | 38 |
| Hyundai Electronics Industries | 1* | 1 | 91 |
| Hyundai Precision & Industries | 1* | 2 | 45 |
| Hyundai International Merchant Bank | 1 | 1* | 6 |
| Hyundai Corporation | 1* | 1 | 34 |
| Hyundai Securities | 0 | 1 | 11 |
| Hyundai Marine & Fire Insurance | 0 | 0 | 13 |
| 28 Non-Listed Companies | 5*, 5 | 2*, 21 | 215 |

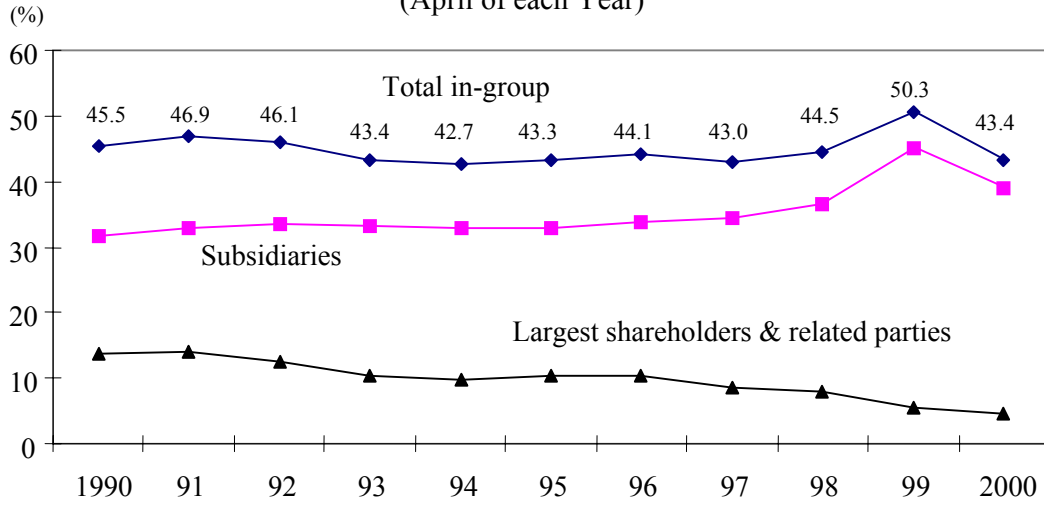
Note: * indicates controlling family members.

Source: *Hyundai 50-Year History*, 1997, pp. 1092-1095

Of course, the ultimate source of the management control is ownership. And, maintaining the ownership level high enough to keep management control of a rapid-growing business group is not an easy task even for the wealthiest family. The way Korean *chaebol* families achieved this goal was cross-shareholding among subsidiaries of a group or a form of ownership pyramiding where pure holding companies were not allowed until recently. As direct (bilateral) cross-shareholding is also prohibited, *chaebols* had either complicated circulatory cross-shareholding or pyramid-like ownership arrangement where a few key firms played a role similar to that of holding companies. During the 1990s, the total in-group ownership held by either family members or subsidiaries for the largest 30 *chaebols* was maintained at a stable ratio of

43-45%.¹⁹ As the equity share of family members showed a steady decline (to 4.5% in April 2000 from almost 14% a decade ago), it was mostly covered by increasing share of other subsidiaries including those purchased and held by own firms (which rose from 32% to 39% during the last ten years). With the in-group equity share well over 40%, it has been practically impossible for outside shareholders to challenge the management control of the major shareholders (see Figure 1 and Table 2).

Figure 1. In-Group Ownership Share: 30 Largest *Chaebols*
(April of each Year)



Source: Korea Fair Trade Commission

¹⁹ The in-group ownership ratio jumped to over 50% temporarily in 1999. This was because healthier subsidiaries of *chaebols* had to inject capital to other subsidiaries in financial distress, as they were either on the verge of bankruptcies or hard pressed for restructuring.

Table 2. Cross-Shareholding: Samsung Group (1997) (billion won, %)

| Companies Receiving Investment | Total Capital | Companies Investing | | | | | | | | | | | | | | |
|-------------------------------------|---------------|---------------------|------|------|------|------|------|------|------|------|------|------|------|-----|--------|--|
| | | SE | SLI | SC | SEM | SED | SFI | SS | SH | CI | SA | CAI | SEL | SCD | Others | |
| Samsung Electronic (SE) | 5,829.9 | • | 8.7 | 4.5 | | | 2.1 | 0.0 | | 0.6 | | 0.5 | 0.2 | | | |
| Samsung Electron Devices (SED) | 1,302.7 | 10.9 | 5.4 | | | • | 3.2 | 0.0 | | | | | 0.3 | 0.0 | | |
| Samsung Corp. (SC) | 1,098.2 | | 6.2 | • | | | | 12.6 | | 0.1 | | | | | | |
| Samsung Motor | 820.9 | 30.6 | | | 8.8 | 10.8 | | | 3.6 | | | 1.8 | | | | |
| Samsung Heavy Industry (SH) | 708.6 | 18.9 | 4.9 | | 2.6 | | | | • | 0.6 | 0.0 | | | | 0.28 | |
| Samsung Electro-Mechanics (SEM) | 692.2 | 20.3 | 6.3 | | • | | | 0.0 | | | | | | | | |
| Samsung Life Insurance (SLI) | 533.1 | | • | | | | | | | | | | 2.3 | | | |
| Samsung Aerospace (SA) | 453.7 | 8.1 | 7.8 | 10.1 | | | | | | 0.1 | • | | 0.3 | | | |
| Cheil Industry Inc. (CI) | 436.5 | | 2.2 | | | | | | | • | | | | | | |
| Samsung General Chemical | 348.6 | 3.8 | | 37.8 | 10.3 | 10.4 | | | | 0.9 | 26.0 | | | | 0.3 | |
| Samsung Coming | 232.6 | 48.4 | 1.0 | | | | | | | | | | | | | |
| Hotel Silla | 191.8 | 5.5 | 6.7 | | | | | | | | | | | | | |
| Samsung Securities (SS) | 187.0 | | 9.9 | 1.3 | | | 5.0 | • | | | | | 5.2 | 2.3 | | |
| Samsung Engineering | 178.7 | | 6.5 | | | 6.2 | 1.4 | 10.0 | | 16 | | | | 1.4 | | |
| Samsung Card (SCD) | 161.0 | 54.4 | | 14.4 | 21.5 | | | | | | | | | • | | |
| S1 Corp. | 154.6 | | 10.0 | 11.4 | | | 1.0 | 0.1 | | | | | | | | |
| Samsung Everland (SEL) | 143.8 | | | 1.8 | | | | | | 5.0 | | 17.1 | • | | | |
| Samsung Capital | 121.0 | 74.7 | | 25.0 | | | | | 0.3 | | | | | | | |
| ChoongAng Ilbo (CAI) | 118.2 | | | 3.9 | 2.5 | | | | | 8.5 | | • | | | | |
| Samsung Petrochemical | 108.2 | 9.9 | | 10 | | | | | | 16.4 | | | | | | |
| Samsung Commercial Vehicles | 100.1 | | | | | | | | 100 | | | | | | | |
| Samsung SDS | 78.7 | 29.9 | | 25.3 | 11.7 | | | | | | | | | | | |
| Samsung Fire/Marine Insurance (SFI) | 60.0 | | 10.0 | | | | | • | | | | | | 1.7 | | |
| Samsung Kwangju Electronic | 43.7 | 95.0 | | | | | | | | 5.0 | | | | | | |
| Pohang Steel | 36.3 | | | | 38.0 | | | | 3.0 | | | | | | | |
| Samsung Invest. Trust Management | 28.9 | | 10.0 | | | | | 3.3 | 16.7 | | | | | | | |
| Cheil Comm. Inc. | 26.6 | 5.1 | 1.4 | 2.6 | | | | | | 2.8 | | 1.6 | | | | |
| Steco | 24.5 | 51.0 | | | | | | | | | | | | | | |
| Daehan Fine Chemical | 21.6 | | | | | 50.0 | | | | | | | | | | |
| Daeyoung Building | 21.3 | | | 43.6 | | 6.4 | | | | | | | | | | |
| Stemco | 20.7 | | | | 50.0 | | | | | | | | | | | |
| Samsung GE Medical Systems | 19.7 | 34.0 | | | 10.0 | | | | | | | | | | | |
| Samsung SM | 16.0 | | | | | | | | | | | | | | 80.0 | |
| Seoul Comm. Technology | 13.5 | 33.3 | | | | | | | | | | | | | | |
| Korea DNS | 10.7 | 43.7 | | | | | | | | | | | | | | |
| Samsung Futures | 10.4 | | 80.0 | 10.0 | | | 10.0 | | | | | | | | | |
| Bokwang Family Mart | 10.3 | | | | | | | | | | | | | | 3.0 | |
| Bokwang Investment Corp | 10.0 | | | | | | | | | | | | | | 10.0 | |
| Bokwang | 9.9 | | | | | | | | | | | | | | | |
| Samsung Life Insurance Service | 6.1 | | 100 | | | | | | | | | | | | | |
| Seo Hae Resort | 5.9 | | | | | | | | | | | 31.7 | 68.3 | | | |
| Samsung Economic Research Institute | 5.9 | 30.0 | 30.0 | 10.0 | 10.0 | | | | 10.0 | 10.0 | | | | | | |

Note: Companies with total capital less than 5 billion won were excluded.

Source: People's Solidarity for Participatory Democracy, *White Paper on Korea's Largest Five Chaebols: 1995-97*, Nanam, 1999.

Even with their managerial control firmly secured, the major shareholders should have strong incentives to resist instituting internal governance mechanisms geared to protecting the interests of outside shareholders or other rules that might invite a threat to their management control. Korea certainly lacked, or was slow to build, these essential institutions, though it is difficult to determine who — the government or *chaebols* — should be mainly blamed for this. Typically composed of only executive directors practically appointed by the chairman, the board of directors could not play its proper role of management supervision — not to mention representation of minority shareholders' interests. The basic rights of minority shareholders have been poorly protected with fairly high threshold equity shares needed for the exercise of rights and expensive legal actions compared with the expected compensation. Government policy also discouraged any challenge to incumbent corporate management in the market. With restrictive rules for hostile takeovers, mandatory tender offers and others, mergers and acquisitions were practically absent.

The fiduciary duties of directors including duty of care and the recently introduced duty of loyalty have remained very vague in Korea without clearly defining their liabilities. Until 1998, *chaebol* chairmen typically exercised their supreme managerial power without holding a directorship, which exempted them from any fiduciary duties. Furthermore, as the maximization of family wealth may sometimes be pursued at the expense of minority shareholders or other stakeholders, the controlling owners have an incentive to keep the management non-transparent and any disclosure to outsiders inadequate. In Korea, accounting and auditing standards as well as disclosure rules have remained poor, making it difficult to grasp the accurate picture of *chaebols* including their internal transactions among subsidiaries. As observed by Khanna and Palepu (1999), family-based groups suffer from a greater lack of transparency than stand-alone firms and are difficult to monitor.

This lack of transparency generally is related to the extensive and frequently abusive internal transactions among subsidiaries of a group including many closely-held firms. And being better linked to the domestic political apparatus, the *chaebol* families also tend to engage in rent-seeking behavior to maintain the *status quo* of non-transparency.

The preoccupation with management control of *chaebol* families has also been manifested in the process of succession of the chairmanship — the ultimate management authority. Obviously, the obligation of maximizing family wealth (as well as allocating any augmentation fairly among the extended family) could not be given to an outsider, however capable and faithful he might have been to the owner family. This was borne out by the evidence on the succession of chairmanship for Korean *chaebols*. There were 23 cases of succession among the 50 *chaebols* before 1990. Out of the 23, there was only one case of succession (Kia Motor that went bankrupt in 1997) to a non-family member. In 14 out of the remaining 22 cases, the chairmanship was succeeded by the eldest son, while the remaining cases mostly included succession by other children, sometimes divided between themselves or with the partner of the previous chairman. There were additional 12 cases of succession between 1990 and 1996 among the 30 largest *chaebols*. In all of the 12 cases, the chairmanship was transferred to other family members: the eldest son in six cases, younger brother in four cases, and other son and son-in-law in one case each (see Table 3).

Table 3. Succession Pattern for *Chaebol* Chairmanship

| | Before 1990 ¹ | 1990-96 ² | Total |
|---|--------------------------|----------------------|-----------|
| Succession to Family Members | 22 | 12 | 34 |
| - Intra-Generation | 1 | 4 | 5 |
| - Inter-Generation | 21 | 8 | 29 |
| • Eldest Son | 14 | 6 | 20 |
| • Other Child | 3 | 1 | 4 |
| • Division between Children | 2 | 0 | 2 |
| • Division between Child & Partner | 1 | 0 | 1 |
| • Son-in-Law | 1 | 1 | 2 |
| Succession to Professional Manager | 1 | 0 | 1 |
| Total | 23 | 12 | 35 |

Notes: 1. Cases among the 50 largest *chaebols*.

2. Cases among the 30 largest *chaebols*. The second son was counted as the eldest where the first-born son had died.

Source: Cho (1997)

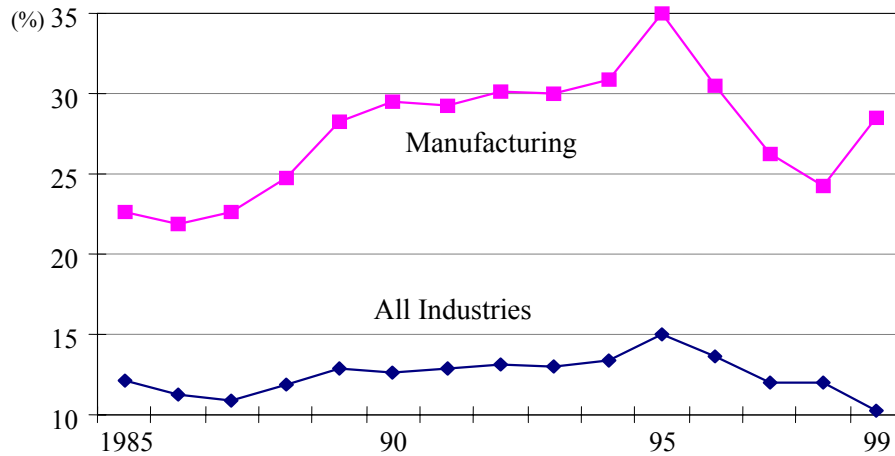
3.1.2 Aggressive Investment with Debt-Financing

Wealth maximization of owner families translates to a strategy of growth or investment maximization where the downside risk is substantially reduced by the government. This strategy would normally face constraints such as financing and investment inefficiency. Financing the rapid expansion of investment, *chaebols* definitely had to avoid the risk of losing management control resulting from ownership dilution through equity issues, leaving only the option of debt financing. The risk of investment failure has been mitigated substantially by the expectation of bailout by the government. This expectation has been held at least for government-supported projects and large *chaebols* that are perceived 'too big to fail' given the past experiences of bailouts worked out by the government for fear of the impact of a major bankruptcy on the economy. As this perception was also shared with financial institutions, *chaebols* have been little constrained in their debt-financed growth-maximization strategy.²⁰ As the result, the top 30 *chaebols* increased their share of GDP to 15% in 1995 before it dropped to almost 10% by 1999 in the wake of the financial crisis. As for manufacturing value-added, their share rose to 30% by the early 1990s (as high as 35% in 1995), but dropped significantly during the crisis period before recovering to almost 29% in 1999 (see Figure 2).

This practice resulted in unparalleled high debt-equity ratios for Korean *chaebols* and firms in general. In 1996, right before the crisis, the average debt-equity ratio of the

²⁰ Borrowings have also been encouraged or facilitated by other factors including the practice of cross-guarantees of debt repayments among *chaebol* subsidiaries, ownership and management control of financial institutions (except for nationwide city banks) by *chaebols*, repressed interest rates until the mid-1990s, and the favorable tax treatment of interest costs compared with dividends.

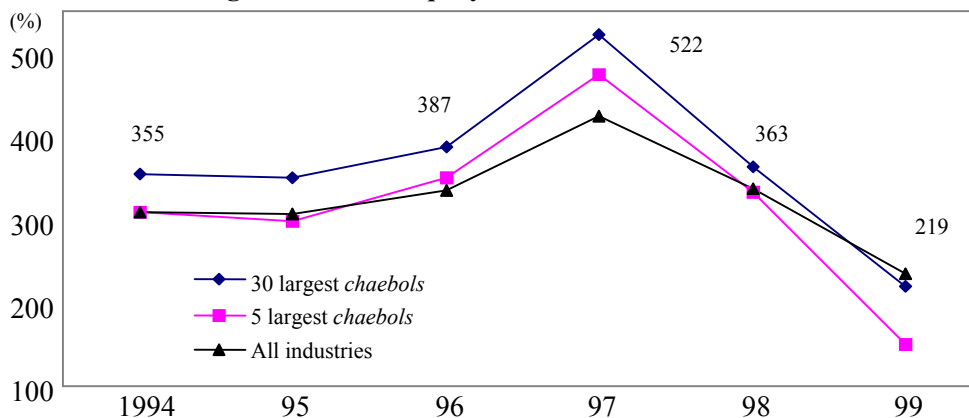
Figure 2. Share in Korea's Value-Added: 30 Largest *Chaebols*



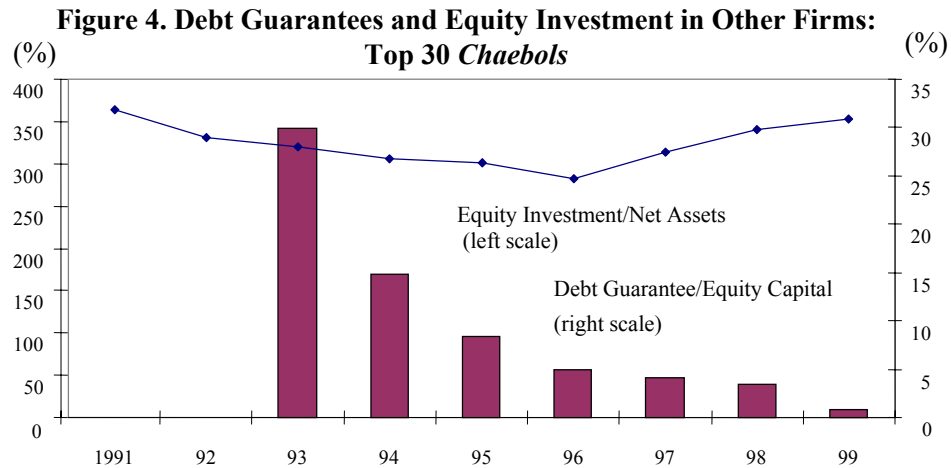
Source: Center for Free Enterprise and Bank of Korea

30 largest *chaebols* (non-financial firms) was as high as 387%. Heavy dependence on debt for *chaebols* was partly attributable to the practice of cross-guaranteeing loan repayment among subsidiaries of a group, which had been very prevalent until restrictions were first introduced in 1992. A high debt-equity ratio makes a firm or group critically vulnerable to financial and non-financial shocks. When operating profits decline due to recession or other shocks, they may easily fall short of the fixed interest burden on their debt leaving the firms in financial distress. That was exactly what happened in 1997 when the bankruptcies of several *chaebols* triggered a foreign exchange and financial crisis in Korea. Firms with a high debt-equity ratio are particularly hard hit by financial shocks such as substantial interest rate increases or currency depreciation. The increased burden of debt denominated in foreign currencies due to sharp currency depreciation (see Figures 3 and 4) was mainly responsible for the sharp rise in the average debt-equity ratio of the largest 30 *chaebols* in the crisis year of 1997 to well over 500%.

Figure 3. Debt / Equity Ratio: Non-Financial Firms



Source: Center for Free Enterprise and Bank of Korea, *Financial Statement Analysis*.



Source: Korea Fair Trade Commission.

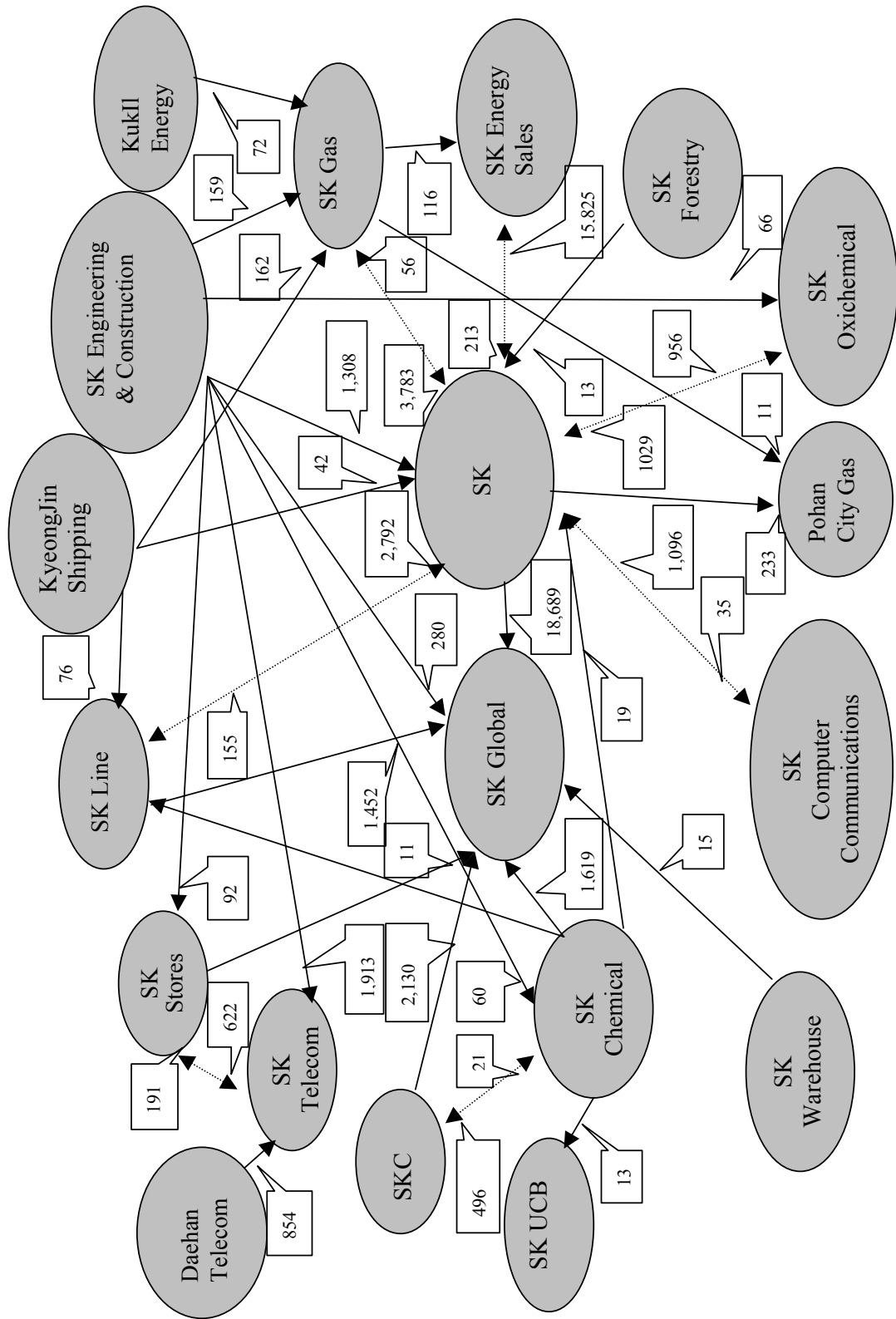
Observers have also attributed the *chaebol* bankruptcies of 1997 to the tendency of overinvestment owing to the expectation of government bailout. Hahn (1999) actually finds strong evidence of overinvestment for *chaebols* (particularly the large five) on the basis of an analysis of the investment behavior of 463 listed companies during 1992-97. He also finds that the investment of the largest five *chaebols* increases with a rise in business uncertainty measured as the coefficient of variation of the profit rate for the previous four years, while it decreases, as expected, for smaller *chaebols* and independent firms. He concludes that the risk-taking behavior of top-ranking *chaebol* firms cannot entirely be justified by the profitability of their projects, but is explainable by the hypothesis of overinvestment with the expectation of government bailout.

3.1.3 Extensive Diversification and Group-Wide Internal Transactions

We have discussed various motivations of diversification for benefits to the business. Business groups attempting to maximize the family wealth of controlling owners (with the downside risk substantially shared with the government) have added incentives to diversify their businesses. Diversification resulting in establishment or purchase of subsidiaries expands the room for intra-group transactions, which are often misused to contribute to the wealth maximization of the controlling families.²¹ Internal transactions for the largest five *chaebols* in 1997 amounted to over 30% of their total sales on average. The share of internal transactions for four largest (excluding the bankrupt Daewoo group) actually rose to 39% in 1999, which compares with a much lower average share of 13% for the 5th to 16th largest *chaebols*. It clearly shows that the opportunity for internal transactions generally increases faster as business groups expand their diversification. The share, of course, is high for business groups with a vertically integrated business structure and with a general trading company playing an important role for other subsidiaries of the group (see Figure 5 for the flow of internal transactions for the SK Group).

²¹ A business group increasing the number of its subsidiaries from (n-1) to n, raises the number of potential bilateral relations by (n-1), that is, the more it diversifies, the faster its opportunity for internal transactions rises at the margin.

Figure 5. Internal Transactions: SK Group (sales in 100 million won, 1997)



Source: People's Solidarity for Participatory Democracy, *White Paper on Korea's Largest Five Chaebols: 1995-97*, Nanam, 1999.

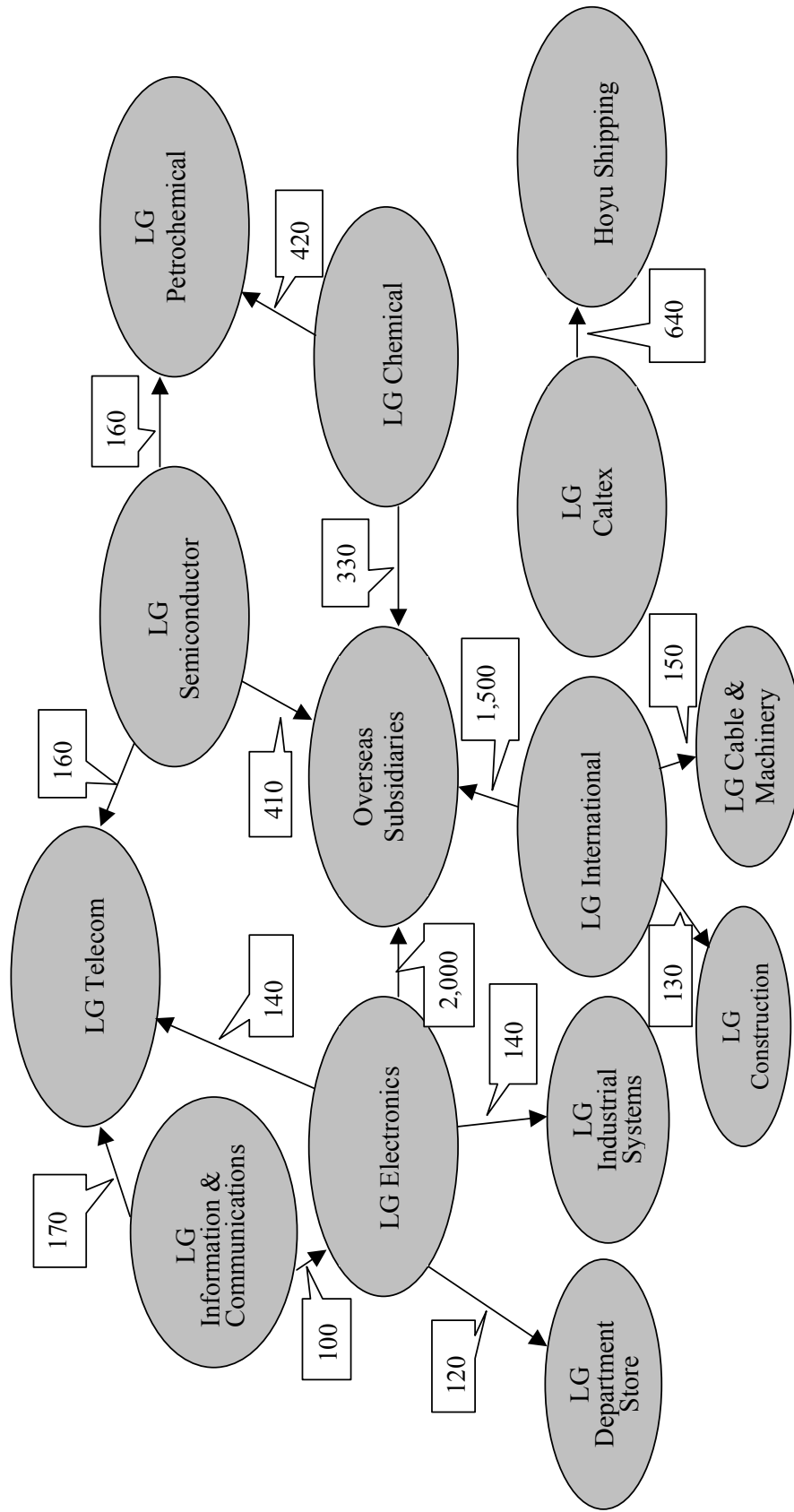
One common form of internal financial transaction is repayment guarantees among the subsidiaries of a group. Since the guarantee is a contingent liability, a cash transfer between the involved subsidiaries occurs only when the borrowing firm cannot repay its debt, and the bank asks the firm that provided the guarantee to repay on behalf of the borrower. Repayment guarantees are known to be usually given by larger and financially healthier subsidiaries to smaller and financially weaker ones. However, the guarantees might also have been used as a tool for expropriating outside shareholders by controlling families. This would particularly be the case if the guarantees were mainly given by healthy subsidiaries where the controlling family has a relatively small share to other subsidiaries in which their stake is greater and where there is a fair likelihood of the guarantees being called and paid out with nothing in return for the larger guarantor. Essentially, what is happening here is an uncreditworthy subsidiary obtaining a bank loan by relying on the strength of its stronger guarantor sister company, rather than the fundamentals of the project or business for which the loan is extended. What is more, the guarantor cannot even charge a reasonable fee for its financial favor. The data seem to show that the main beneficiaries of debt guarantees have been relatively small subsidiaries where the equity share of the controlling family is high (see Figures 6 and 7).²²

In recent years, the Korea Fair Trade Commission has conducted several rounds of investigation on illegal and unfair internal transactions among the subsidiaries of business groups. They define an illegal internal transaction as a transaction with another subsidiary or any person with special relations where advance payment, loan, manpower, real estate, securities, intangible property right, guarantees etc. are transferred free of charge or at substantially favorable conditions. The investigation results show that group companies transfer resources extensively to help financially distressed subsidiaries and to benefit the families of controlling owners. Often, family wealth of controlling owners is transferred to their children through various financial dealings in the subsidiaries at the sacrifice of minority shareholders. For instance, under-priced equity-related securities are donated or exclusively sold to the children. Their prices rise sharply later with mergers with profitable subsidiaries or through other stock price manipulation.²³ They typically fall into several categories as shown in Box 2.

²² Cross-guarantees of debt repayment among subsidiaries tend to increase concentration of bank loans on large business groups limiting credit supply available to smaller companies. Also, because of the strong financial linkage, extensive guarantees among the subsidiaries may put the whole group in distress or force chain bankruptcies when some of the subsidiaries are in trouble, which was actually witnessed during the financial crisis. This financial linkage also posed as a serious impediment to restructuring business groups. New cross-guarantees of debt repayment were prohibited starting 1999 among *chaebol* subsidiaries and existing guarantees were required to be eliminated by March 2000.

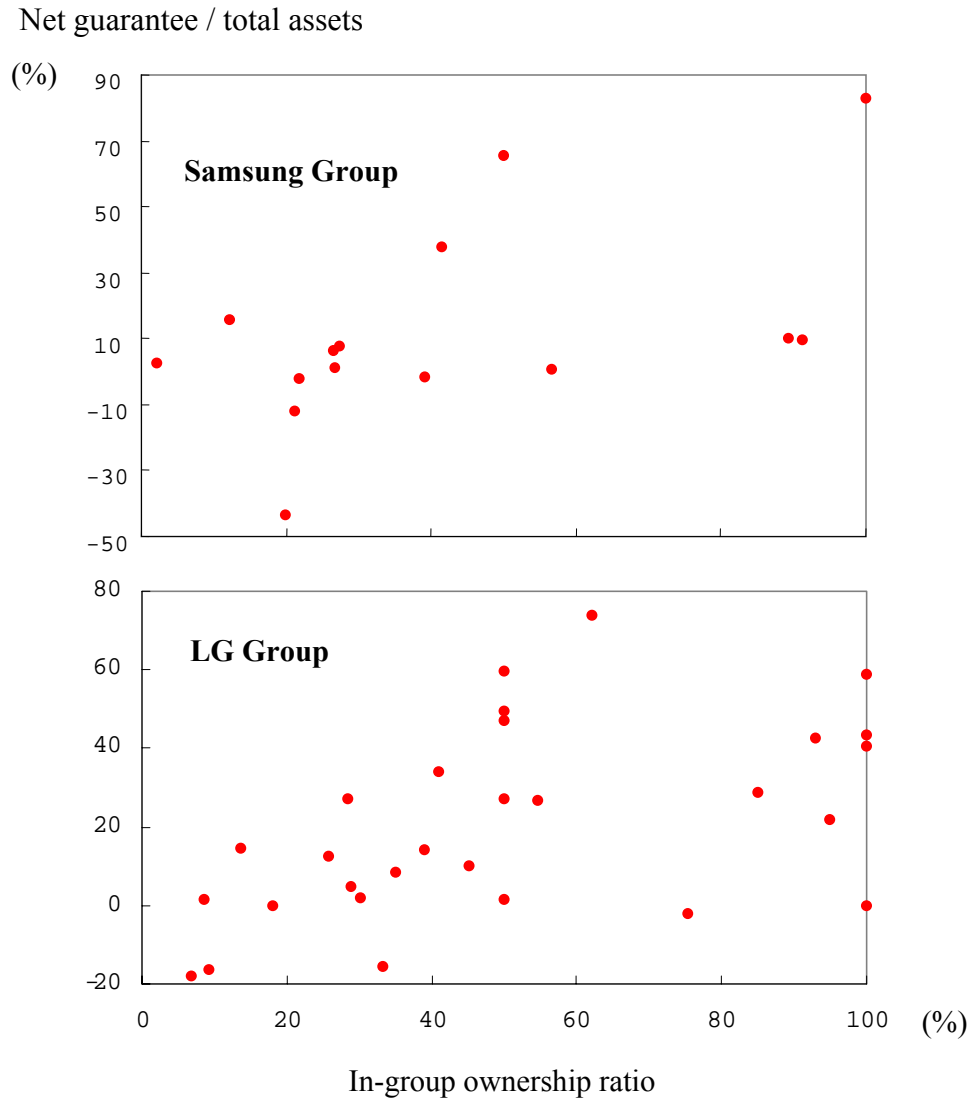
²³ Allegedly, the Samsung chairman's eldest son, a graduate student in the United States, was donated 6.1 billion won by his father in 1995, which has been snowballed to a few trillion won in a four year period through complicated financial transactions using Samsung subsidiaries (*Monthly Chosun*, February 2000).

Figure 6. Cross-Guarantees of Debt Repayment: LG Group (in billion won, 1997)



Note: Cross-guarantees of smaller amounts are excluded.
 Source: People's Solidarity for Participatory Democracy, *White Paper on Korea's Largest Five Chaebols: 1995-97*, Nanam, 1999.

Figure 7. Net Cross-Repayment Guarantee and In-Group Ownership Ratio of *Chaebol* Subsidiaries (1997)



Note: In-group ownership ratio includes the equity shares of controlling family and other subsidiaries.
 Source: Raw data from People's Solidarity for Participatory Democracy, *White Paper on Korea's Largest Five Chaebols: 1995-97*, Nanam, 1999.

A regression result for the ratio of net repayment guarantees (NRG) using total assets (TA), in-group ownership share (IO) and net profit rate (PR) as independent variables is as follows (numbers in parentheses are t-values):

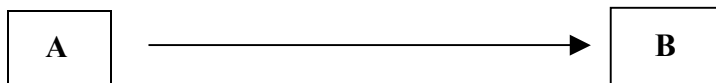
$$\text{NRG} = 74.4 - 8.11 \ln \text{TA} + 0.257 \text{ IO} - 0.032 \text{ PR}$$

(3.2) (2.3) (1.2)

Sample size = 62 (top four *chaebols*), $R^2 = 0.405$

Box 2. Modes of Unfair Financial Transfers among Subsidiaries of a Group

(1) Direct transfer of resources from subsidiary A to subsidiary B



- Purchase of high-priced commercial paper (CP) of B
- Low-interest lending
- Zero-interest advance payment, etc.

A or B may be a financial subsidiary providing/receiving low/high-priced financial services.

(2) Transfer of resource through intermediary financial institution(s)



- Deposits (trust, etc.)
- Purchase of CP or corporate bonds of financial institutions
- Debt repayment guarantee for B
- Purchase of high-priced CP or private-placed bonds of B
- Low-cost lending
- Taking over under-subscribed equity shares of B

A may be a financial subsidiary providing favors to another financial intermediary (such as subordinated lending, taking over under-subscribed equity shares of the latter) on the condition that the latter would give a roughly corresponding financial support to B.

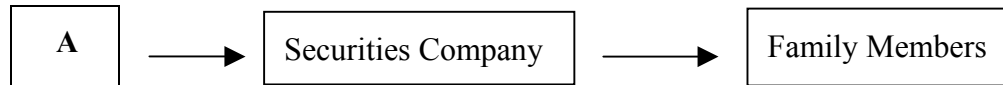
Intermediating financial institution(s) may be off-shore fund(s) established by the group.

(3) Transfer of resources through a merger



Resources are transferred from A to B (i.e. shareholders of B) by an under-valuation of subsidiary A in merging the two subsidiaries.

(4) Transfer to family members by means of under-priced securities



Typically, securities company underwrites under-priced equity-related securities (BW, CB, equity stock, etc. of non-listed subsidiary A) and sells them to controlling family members.

How extensively are Korean *chaebols* diversified? The largest five *chaebols* steadily increased the number of subsidiaries reaching over 52 on average in 1997 (27 subsidiaries for the largest 30 *chaebols*) before reducing the number significantly over the last three years in the aftermath of the crisis. As for the number of industries they are operating, the largest five *chaebols* operated in 31 industries on average, more than half of the total 60 industries of 2-digit Korean Standard Industrial Classification. As a result of corporate restructuring efforts following the crisis, the number dropped to 25 in 2000 (partly reflecting the dropout of some of the more diversified *chaebols* from the list due to failure). A similar trend has been shown for the smaller *chaebols* as well (see Table 4).

Table 4. Average Number of Subsidiaries and Industries Operating: Korean *Chaebols*

| | | 1987 ² | 1990 | 1993 | 1995 | 1997 | 1999 | 2000 ³ |
|--|------------------------------------|-------------------|------|------|------|------|------|-------------------|
| Number of Subsidiaries (April each year) | Largest 5 | 35.2 | 37.2 | 41.6 | 41.4 | 52.4 | 46.8 | 36.0 |
| | 6 th – 30 th | 12.7 | 14.8 | 15.8 | 16.6 | 22.3 | 18.1 | 14.6 |
| | Largest 30 | 16.4 | 18.6 | 20.1 | 20.8 | 27.3 | 22.9 | 18.1 |
| Number of Industries Operating ¹ (end of business year) | Largest 5 | 17.6 | 18.0 | 30.4 | 30.6 | 30.8 | 29.8 | 25.4 |
| | 6 th – 30 th | 8.2 | 10.8 | 16.8 | 17.4 | 15.8 | 16.2 | 13.3 |
| | Largest 30 | 9.7 | 12.0 | 19.1 | 19.6 | 18.3 | 18.4 | 15.3 |

Notes: 1 Based on the 2-digit Korean Standard Industrial Classification (KSIC). Because of change in the KSIC in 1992, there is a discontinuity in the data between 1990 and 1993.

2 As of the end of 1986 for number of industries operating.

3 As of April 2000 for number of industries operating.

Source: Korea Fair Trade Commission

Simple counting of industries may not be a good way of measuring the degree of diversification given the substantial difference in size across subsidiaries in a group. The Berry-Herfindahl diversification index shows that diversification of *chaebols* actually peaked in 1994-95 before the crisis, which should partly be due to government efforts to induce them to specialize in a few areas of competence. Smaller *chaebols* below the largest 30 are on the average much more focused in their business. The extent *chaebols* have diversified into related industries can be evaluated by the Entropy Index of related diversification. The estimated index shows that the largest five *chaebols* are diversified more into unrelated businesses than smaller *chaebols* as expected, but the level of relatedness in their diversification increased up to 1992-93 before it started to decline. The lion's share of value-added generated by the major *chaebols* is in manufacturing, particularly electronics, motor vehicles, and petroleum refineries. They are also active in such services industries as trade, finance, and construction (see Tables 4 and 5).²⁴

Table 5. Trend of Diversification for Korean *Chaebols*

| | <i>Chaebols</i> by size | 1985 | 1988 | 1991 | 1994 | 1997 |
|--|-------------------------------------|-------|-------|-------|-------|-------|
| Berry-Herfindahl Diversification Index ^{1,3} | Largest 5 | 0.743 | 0.766 | 0.803 | 0.810 | 0.797 |
| | 6 th – 30 th | 0.724 | 0.716 | 0.741 | 0.752 | 0.736 |
| | 31 st – 72 nd | 0.401 | 0.471 | 0.488 | 0.510 | 0.509 |
| Entropy Index of Related Diversification ^{2, 3} (%) | Largest 5 | 16.7 | 17.7 | 18.8 | 20.5 | 19.4 |
| | 6 th – 30 th | 21.7 | 22.2 | 24.8 | 25.7 | 24.8 |
| | 31 st – 72 nd | 19.0 | 29.0 | 29.7 | 32.7 | 24.6 |

Notes: 1 Berry–Herfindahl Diversification Index = $1 - \sum s_i^2$

2 Entropy Index of Related Diversification = $\sum s_j [\sum s_{ji} \cdot \ln(1/s_{ji})]$, where s_i : share of sales for industry i ; s_j : share of sales for industry group j (which is unrelated each other); and s_{ji} : sales share of industry i in industry group j .

3 Weighted average of individual group's index by sales.

Source: Hwang (1999)

Another area which Korean *chaebols* have been particularly keen about gaining entry was the financial sector. The financial sector has been heavily controlled by the government, which has constrained business operation but substantially reduced the business risk. In addition to the purposes of profit-making and business diversification in all major industries, there seem to have been several reasons why they have been eager to own and control financial intermediaries. First, financial services might differ from most other businesses in that every company needs them. This means that a financial subsidiary of the group may have substantial externality, or it may provide important “common

²⁴ In manufacturing, *chaebols*' market shares are fairly high in petroleum products, where the top 10 *chaebols* accounted for almost 100%, and also in electronics, automobiles and transportation equipment, where the market shares of the top 10 groups were over 70% in 1995.

resources” to other group subsidiaries. For example, information on financial markets, industries and customers obtained in doing business in the financial sector should be valuable for many of the group subsidiaries.

Table 6. Share of Value-Added by Industry: 5 Largest *Chaebols* (1998)

| | Hyundai | Daewoo | Samsung | LG | SK |
|---|----------------|---------------|----------------|-----------|-----------|
| Manufacturing | 68.6 (15) | 59.8 (16) | 89.8 (24) | 86.3 (16) | 45.6 (9) |
| Textiles & wearing apparel | – | – | 2.6 (1) | – | 5.5 (1) |
| Petroleum refineries | 4.2 (1) | – | – | 14.9 (1) | 34.0 (1) |
| Chemical and chemical products | 3.2 (1) | 0.1 (2) | 5.6 (5) | 15.8 (4) | 6.1 (6) |
| Non-metallic mineral products | – | 2.8 (1) | 3.8 (2) | – | – |
| Basic metals | 3.0 (3) | 0.3 (1) | – | 4.9 (1) | – |
| Fabricated metals & machinery | 0.5 (1) | 31.2 (1) | 0.6 (3) | 0.0 (1) | – |
| Electronics, electrical & precision machinery | 20.5 (1) | 11.7 (6) | 60.2 (9) | 60.4 (9) | 0.0 (1) |
| Motor vehicles & transport equipment | 37.2 (8) | 13.7 (5) | 17.0 (4) | – | – |
| Electricity, gas & water | 0.0 (1) | – | – | 1.3 (2) | 3.8 (8) |
| Constructions | 15.1 (5) | 1.4 (1) | – | 2.0 (2) | 6.7 (5) |
| Wholesale and retail trade | 4.3 (5) | 37.0 (4) | 2.3 (3) | 4.9 (4) | 9.1 (4) |
| Hotels & restaurants | – | 0.7 (1) | 1.2 (1) | 0.1 (1) | 1.1 (1) |
| Transport, storage & communication | 11.4 (5) | – | – | 2.1 (3) | 33.4 (6) |
| Information processing & others | 0.5 (6) | 1.0 (8) | 6.7 (11) | 3.3 (9) | 0.2 (1) |
| Financial intermediation & insurance | N.A. (8) | N.A. (5) | N.A. (12) | N.A. (8) | N.A. (4) |

Notes: Numbers in parentheses are the number of subsidiaries operating. A few subsidiaries are excluded in calculating the share of value-added.

Sources: Center for Free Enterprise and Bank of Korea

Second, a financial subsidiary could mitigate the problem of imperfect financial markets for group subsidiaries that had huge financing needs for their ambitious investment projects. More importantly, a financial subsidiary could serve as an effective means of reallocating resources among the subsidiaries and the family of controlling owners. Faced with an underdeveloped financial market, *chaebols* have operated a group-wide, non-arm’s length internal capital market, and the headquarters reallocated financial resources among alternative uses. A financial subsidiary has greatly facilitated the operation of the internal capital market. Most of the types of illegal and/or unfavorable internal transactions presented above actually have financial intermediaries in the middle, indicating their

critical role in this respect. Even in cases where ceilings or bans are imposed on direct support of other group companies by the financial subsidiary (as in the provision of credit and some securities underwriting), they always had ways to circumvent the regulations.²⁵

As of 1997, the five largest *chaebols* controlled 7.2 financial intermediaries on average mostly in the nonbank financial sector. Basic ownership ceiling for any individual or a business group is set at 4% for nationwide commercial banks and at 15% for provincial banks. But there are no such ownership ceilings for most nonbank financial institutions except for some restrictions in the cases of securities investment trust companies and life insurance companies. As a result, the market share of *chaebols* in nonbank financial business is rather high. In March 1999, the top five *chaebols* had a combined market share (based on assets) of more than 40% in such nonbank financial institutions as securities, life insurance, non-life insurance, and credit card. After the crisis, their market share has increased, since many stand-alone financial intermediaries went bankrupt and people had relatively higher confidence in *chaebol*-affiliated intermediaries (see Tables 6 and 7).

Table 7. Number of Financial Subsidiaries Held by Top 5 *Chaebols* (1997)

| | Hyundai | Samsung | Daewoo | LG | SK | Total |
|-----------------------------|---------|---------|--------|----|----|-------|
| Banks | 1 | 0 | 0 | 0 | 0 | 1 |
| Securities Companies | 2 | 1 | 1 | 1 | 1 | 6 |
| Securities Investment Trust | 1 | 1 | 0 | 1 | 1 | 4 |
| Merchant Banking Corp. | 2 | 1* | 0 | 1 | 0 | 4 |
| Life Insurance Companies | 0 | 1 | 0 | 0 | 1 | 2 |
| Non-Life Insurance Co. | 1 | 1 | 0 | 1 | 0 | 3 |
| Installment Finance | 1 | 1 | 1 | 1 | 0 | 4 |
| Credit Card | 0 | 1 | 1 | 1 | 0 | 3 |
| Others | 3 | 1 | 2 | 2 | 1 | 9 |
| Total | 11 | 8 | 5 | 8 | 4 | 36 |

Note: * Separated from Samsung Group in April 1997

Source: Ministry of Finance

²⁵ Faced with bans or ceilings on directly supporting other subsidiaries of the group, they used such tactics as “cross-financing” among *chaebols* or “circuitous lending”. The former involves two financial intermediaries of different groups mutually supporting the subsidiaries of the other group. The latter is an arrangement where another financial intermediary (not belong to the group) supports group subsidiaries in exchange for deposits or other financial transfers from the group.

Table 8. Market Share of Top 5 *Chaebols* in the Nonbank Financial Industry

(% based on assets)

| | March 1997 | March 1999 |
|-------------------------------|------------|------------|
| Securities Companies | 29.6 | 54.6 |
| Securities Investment Trusts | 5.3 | 30.2 |
| Merchant Banking Corporations | 12.9 | 24.8 |
| Life Insurance Companies | 34.9 | 40.3 |
| Non-Life Insurance Companies | 44.7 | 47.3 |
| Credit Card | 46.7 | 52.2 |
| Total Nonbank Finance | 22.5 | 34.7 |

Source: Financial Supervisory Commission

Many *chaebols* in recent years newly established investment management companies, which have been widely suspected of channeling investment funds to the securities issued by their member subsidiaries, thereby continuing to support some of their non-viable businesses rather than undertaking urgent restructuring. With several financial institutions under a *chaebol* umbrella providing many different financial services including investment trusts, consulting, underwriting or trading of securities, the room for abusing conflicts of interest is actually large. The securities companies of the five largest *chaebols* on average underwrote two-thirds of the corporate bonds issued by the subsidiaries of their group in 1996, which was equivalent to almost half of all their underwriting of corporate bonds. The financial subsidiaries of *chaebols* are also known to be involved in managing the stock prices of their subsidiaries or the equity shares held by the owner-families, often interfering in the management of investment trusts causing losses to other client investors.

3.2. Profit Performance

As the overriding objective of *chaebols* is to pursue the accumulation of wealth for the controlling families, they are not necessarily interested in maximizing the profits of their groups or the constituent subsidiaries. Since these profits are to be divided with outside shareholders according to their ownership shares, controlling families tend to be keener on transactions that would predominantly benefit themselves. This would usually be pursued at the expense of profits for some subsidiaries and the group as a whole.

Consequently, in spite of many potential benefits for the organizational structure of business groups, they are likely to show rather poor profitability. The sources of the inefficiencies that might be responsible for the poor profit of family-based business groups have already been discussed above. To recap:

- The *managerial capacity* of these groups may be weak, since the key CEO positions are filled with the members of the extended families not to mention the chairmanship. Even

the appointment of non-family members to CEO positions might be based more on their loyalty to, and lack of questioning of, the chairman than on their managerial capability.

-
- Their *investment decisions* might have been primarily driven for growth (thus, family wealth) maximization with the expectation of risk sharing by the government. The consequences might be overinvestment, poorly-evaluated, inefficient investment, and undertakings of wasteful pet projects of the controlling owners.
-
- They may *over-diversify* beyond the level justifiable in terms of profit or value maximization with a view to maximizing business growth as well as creating an organizational structure that can increase the opportunities for family wealth augmentation. The results for the groups are increased costs of internal communication, monitoring and coordination.
-
- *Internal transactions* within a group may well be driven by the motivation of maximizing the family wealth of the controlling owner or of supporting weak (inefficient) subsidiaries. This represents a gross misallocation of resources within the group that leads to poor profits.

In recent years, profits of *chaebols* have not been very impressive. The average rate of ordinary profit on total capital of the largest 30 *chaebols* was lower than that of all corporations or manufacturing firms. For the three years before the crisis (i.e. 1994-96), the average rate for the largest 30 *chaebols* remained at 1.98% compared with 2.33% and 2.39% for all corporations and manufacturing firms, respectively. Particularly noteworthy is the very weak profit performance of smaller *chaebols* (other than the largest five), whose collective ordinary profits were almost zero during the 1994-96 period (see Table 9).²⁶ Joh (1999) estimates corporate profit rates using more than 6,000 Korean firm data for the period of 1992-97. Controlling other variables affecting profits, she finds that *chaebol*-affiliated or exchange-listed firms have lower profits. Also found is that investment in affiliated firms lower their profits, particularly so when made by listed firms, where equity shares of the controlling owners are usually low. These findings are consistent with our argument of family wealth maximization by the controlling owners of business groups at the expense of corporate profits and the interests of minority shareholders.

²⁶ There seem to be at least two explanations. First, the profit performance of the largest five *chaebols* was greatly helped by the semiconductor boom during the period. Second, the motivation to maximize family wealth of the controlling owners by the sacrifice of minority shareholders might have been stronger for smaller *chaebols*. Even though the moral hazard ('too big to fail') effect might have been smaller, the smaller *chaebols*, by their nature of being less exposed to public sentiment and having less transparent management, might have been less inhibited in pursuing family interests through profit or value-reducing internal transactions.

Table 9. Rate of Ordinary Profit to Total Capital: Korea (%)

| | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 |
|-------------------------------------|----------------|----------------|----------------|------------------|------------------|----------------|
| Top 30 <i>Chaebols</i> | 2.19 | 3.15 | 0.60 | -0.71 | -1.96 | -0.71 |
| Top 5 | 3.54 | 5.27 | 1.22 | 0.34 | -1.40 | 4.50 |
| 6 th – 10 th | 1.17 | 1.04 | -0.65 | -2.33 | -0.53 | -24.51 |
| 11 th – 30 th | -0.06 | -0.08 | 0.08 | -2.43 | -4.80 | -0.29 |
| All Industries | 2.83 | 3.08 | 1.08 | -0.22 | -1.15 | -0.26 |
| Manufacturing (Large firms) | 2.64 (2.68) | 3.59 (4.02) | 0.93 (0.85) | -0.30 (-0.55) | -1.52 (-2.12) | 1.38 (0.72) |
| Listed Companies | 2.94 | 3.27 | 1.27 | 0.15 | 0.90 | 3.97 |

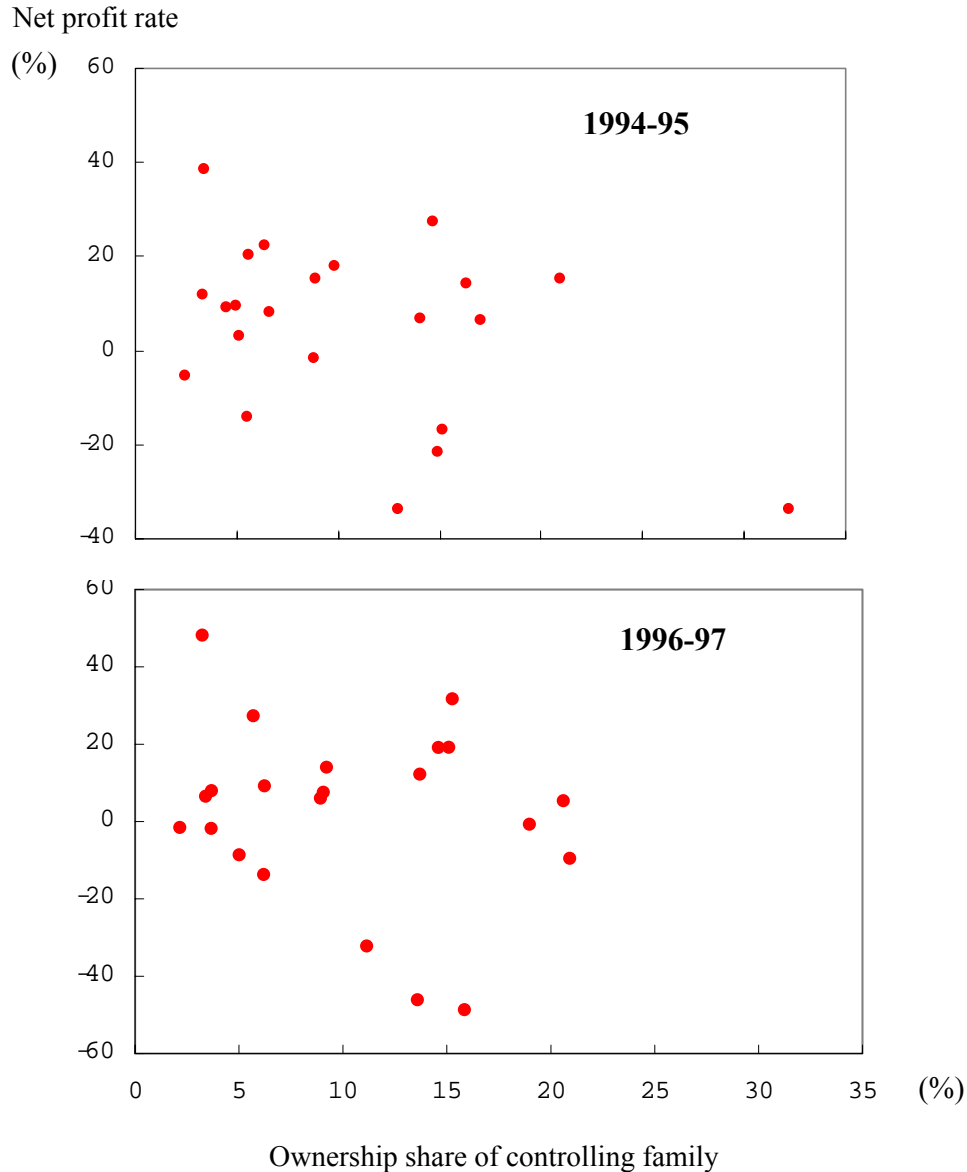
Note: The financial sector is excluded.

Sources: Center for Free Enterprise, Bank of Korea, *Financial Statement Analysis*, and Korea Listed Companies Association.

Difference in profitability among *chaebols* may be partly explainable by the shares of equity ownership or control rights for the controlling family to the extent that these shares have any impact on the strength of their incentives to expropriate from outside shareholders. A high equity share for the controlling family in the group may mean that they have a relatively stronger base of wealth in the group to arrange internal transactions and to obtain private benefits for themselves. Or, as is generally believed, the incentives to expropriate and, thus, the profitability of business groups may be more affected by the difference between the equity share (cash flow right) and control/voting right (approximated by the total in-group equity share) of the controlling family. Actually, the profitability of *chaebols* shows a discernible negative relationship with the equity share for the controlling family (see Figure 8).²⁷

²⁷ The gap between cash flow and control rights for the controlling family shows a weakly positive relationship with the profit rate of *chaebols*, while a negative relation is expected. Controlling family with a relatively high equity share in the group (thus, a smaller gap between cash flow and control rights) may be more aggressive and unscrupulous in expropriating from outside shareholders. With a low perceived risk of losing management control (coming from their high equity share), they are less likely to be concerned with their reputation that might be damaged by their expropriation behavior. A similar result is reported in Hwang (2001), where a pyramid multiplier (the ratio of total asset value of *chaebol* to equity value of the controlling family) is used instead of the gap between cash flow and control rights.

Figure 8. Relation between *Chaebol* Profit and Ownership Share of Controlling Family



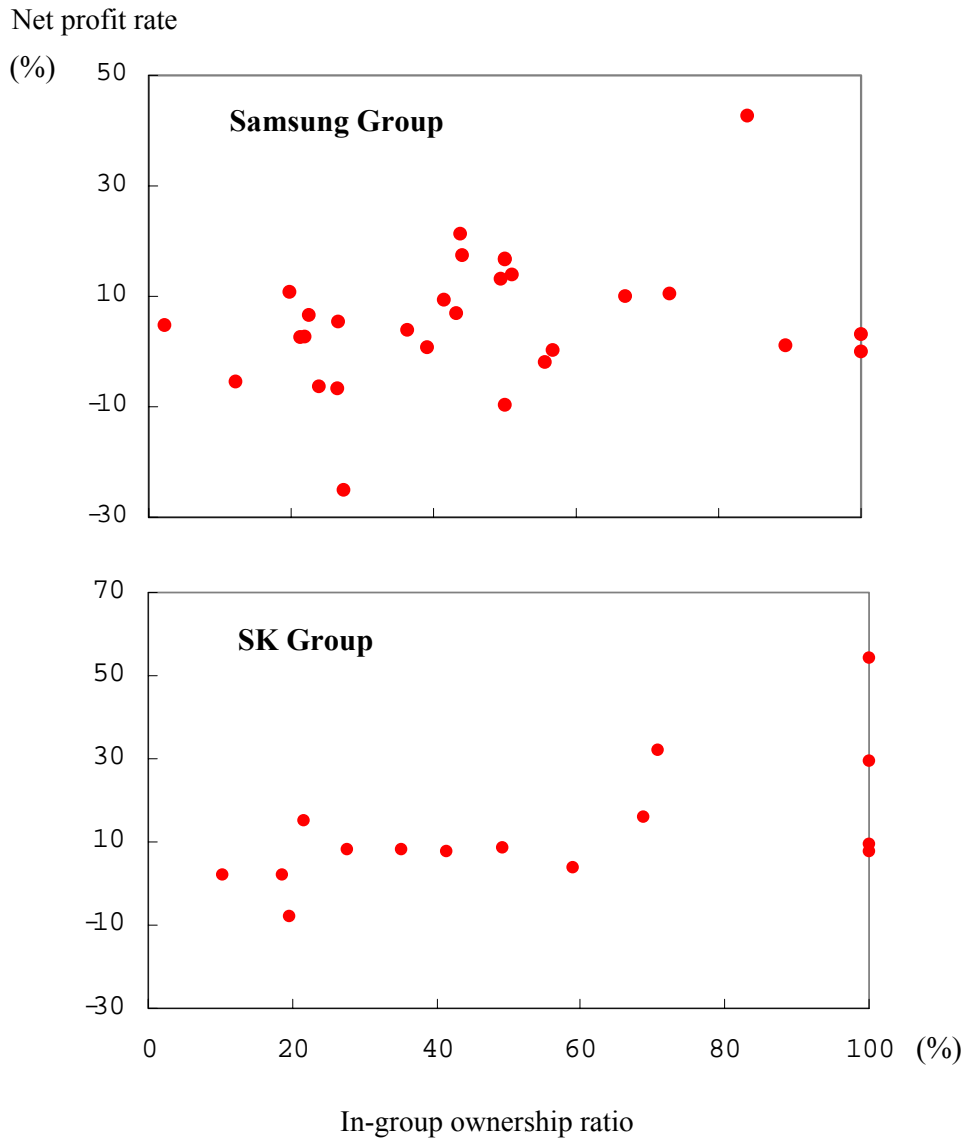
Note: Samples include 30 largest *chaebols* except for those where data are incomplete. Net profit rate is percent of equity capital.

Source: Raw data from Korea Fair Trade Commission.

If this relationship is the result of expropriation by the controlling family, it should also be reflected in the profits of individual subsidiaries. Controlling families, with the objective of family wealth maximization, will tend to transfer resources to subsidiaries in which they have a relatively larger stake (high ultimate ownership share that may be approximated either by their own equity share or total in-group equity share) through

group-wide internal transactions. As a consequence, these subsidiaries in which the controlling family has a high level of ultimate ownership are likely to have a higher profit rate (as is shown in Figure 9).

Figure 9. Relation between Profit Rate and In-Group Ownership Ratio of *Chaebol* Subsidiaries (1997)



Note: Net profit rate is percent of equity capital (average of 1996 and 1997).
 Source: Raw data from People's Solidarity for Participatory Democracy, *White Paper on Korea's Largest Five Chaebols: 1995-97*, Nanam, 1999.

Poor profitability due to the controlling shareholders deviating from the interests of shareholders as a whole should be reflected in share prices as well. La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1997 and 1998) argue that, in countries where minority shareholders are poorly protected from the risk of expropriation, share prices would be depressed and controlling owners would try to avoid any significant reduction of their equity shares that might lead to the loss of management control, resulting in a vicious circle of concentrated ownership and depressed share prices. Also, as noted by Jensen and Meckling (1976), the smaller the cash-flow rights a controlling shareholder has, the stronger his incentive is to expropriate from minority shareholders, and therefore the lower the share price would be. Given that this is exactly the case for the controlling families of *chaebols*, we expect the share prices of *chaebol* subsidiaries would be much depressed compared with their earnings prospects. Claessens, Djankov, Fan, and Lang (1999b) actually find that lower market prices are associated with lower cash-flow rights as well as larger deviations between cash-flow and control rights (particularly in family-controlled firms) that result from ownership pyramiding, cross-shareholdings, or dual-class shares. Fan and Wong (2001) find that the informativeness of reported earnings to outside investors is weakened for firms with high ownership concentration and a large gap between ownership and control rights for the controlling shareholder.

4. Conclusions

To what extent is the strategy of high-leveraged expansion and deliberate weak governance employed by large business groups responsible for the Asian crisis? The crisis was like the collapse of a bridge in a heavy rain-storm. One might reasonably blame the rain rather than the shaky foundation of the bridge. Indeed the rain was heavy!

Since the 1980s, East Asian enterprises have faced two major changes that have made their strategy all the more vulnerable. One important trend is globalization: deepening integration into the world market for both products and productive factors, particularly, capital market opening. Another is progress in political democracy, which has triggered increasing demand for the same democratic principles in corporate management as well. The failure of big businesses and the authorities in East Asia to be more responsive to these developments played a major role in the outbreak of the crisis.

While globalization has brought new opportunities, the economies have also been under increasing competitive pressure, more overseas vigilance and transparency expectations, higher business uncertainty, increased vulnerability to external shocks, and higher instability in the financial market. It has left the national authorities with limited room for giving assistance or protection to businesses and for managing the economy. The implications were the urgent need to improve fragile corporate financial structure, streamline their businesses and strengthen basic financial market infrastructure including prudential regulations, all of which had been seriously neglected. Political democratization in some of the East Asian economies has also meant that big businesses could no longer rely on a corrupt symbiosis with the government that effectively protected the interests of controlling families from being challenged. With such democratic principles as trans-

parency, accountability and participation also increasingly called for in the socio-economic sphere, big businesses should have paid more attention to minority shareholders and other stakeholders.²⁸

Probably the most critical environmental change was the external liberalization of capital transactions. The global financial market, to which domestic firms and financial institutions are now fully exposed, has been merciless with the occasional sound judgement, but also unreasoning whims and herding behavior.²⁹ One may ask why these economies could not “grow out” of the financial distress as they had done in the past by a large-scale bailout in the hope that rapid economic growth would keep the banking and corporate sectors viable. Though the authorities must have been tempted to turn to this approach once again, it was less feasible and very costly under the changed environment. They include the changing nature of the government–business relationship in a more deregulated and democratic policy regime, increased scale of rescue operation required, and the reduced willingness of close allies to come to the rescue in the new post-Cold War geo-political situation.

Business groups in East Asia are predominantly family-based both in ownership and management control. Confucian culture in traditional China, Korea and Japan with its emphasis on the value of (extended) family and filial piety seems to have played an important role. But, more generally, the lack of legal and other institutions, required for minimizing agency problems in corporate management, might also be responsible. These explanations depict family-based groups as an organization with a strong familial hierarchy, which tends to mitigate agency problems and the costs of monitoring. The modes of inheritance and wealth accumulation also had impacts on the size and other corporate characteristics. However, family-based groups have their own weaknesses and inefficiencies resulting from limited entrepreneurial and managerial capacity and interference of family concerns in business operation. Part of the explanation of how they could survive and prosper for decades may be found in their entrenched interests under government patronage and protection particularly when they formed close partnerships for national development.

²⁸ In Korea, after an interruption of more than 15 years, the presidential nominee pledged a direct presidential election in 1987, which was followed by revision of labor laws to acknowledge workers’ right to organize and strike. In more recent years, the civil society gained new strength and became increasingly vocal for the rights of minority shareholders and other measures geared to improving corporate governance. Although democracy can serve as a powerful check of the collusive symbiosis between the state and big businesses, that does not seem to be always the case. In Taipei, China, the progress in democratization, triggered by the death of their powerful leader in 1988, created a pro-business climate in the political circles and bureaucracy (Woo-Cummings, 1999; and Chu, 1999).

²⁹ Korea’s capital market opening was accelerated with its entry into the OECD in 1996 and a policy-induced bias for short-term external borrowing resulted in its short-term external debt balance amounting to three times the foreign exchange reserve before the crisis. In Thailand, motivation to boost the Bangkok International Banking Facilities overly encouraged the Thai financial sector to raise short-term external funds, while the early capital market opening in Indonesia in the 1970s led to continued reliance on offshore financial markets.

It seems a reasonable approximation to view family-based business groups in East Asia as an organization through which the controlling owners have pursued long-run family wealth maximization. This business objective has not been incompatible with those of growth or market share maximization or serving as development partners of the government that was willing to share the risk of major development investments. As such, it is understandable that the owner families have been extremely preoccupied with maintaining management control and very reluctant to introduce sound corporate governance mechanisms. With the expectation of their downside risk partly assumed by the government, large business groups have been engaged in aggressive debt-financed investment, bringing about highly leveraged financial structures. They have also tended to diversify their businesses beyond the level justifiable on an efficiency ground. Diversification not only allowed the groups to capture newly emerging business opportunities including attendant government subsidies but also facilitated internal transactions among the subsidiaries for the benefits of controlling families. The consequences were deteriorated competitiveness, poor corporate profits and a financially very fragile corporate sector.

The Asian crisis revealed that the group structure, in spite of its potential organizational advantages, had facilitated plundering of firms by controlling shareholders in a poor institutional environment of investor protection. As the result, the East Asian corporate and financial sectors showed fundamental weaknesses, which have been the target for post-crisis reform efforts. The immediate task was to address the extreme vulnerability of highly leveraged financial structures and close financial linkages among the subsidiaries of business groups. Reducing the high leverage requires ownership dilution or scaling-down of business operations. In either case, the family-based ownership and management structure of business groups is likely to undergo a substantial change. In the area of corporate governance, much effort has been directed toward protecting minority shareholders and disciplining poor management. It includes reshaping of the board of directors, making basic shareholder rights easier to exercise, and exposing management control to be challenged in the market. Though it would take some time, these measures should go a long way toward restraining controlling shareholders from expropriating from outside shareholders and, thus, reducing the private gains expected from management control.

Government reform efforts have often gone beyond instituting proper governance mechanisms to interfere in the organizational structure of business groups or impose certain rules geared to protecting minority shareholders. In Korea, for instance, the concern over excess capacity and diversification led to the government-prodded “big deals” among *chaebols* for the consolidation or swap of overlapping businesses. The planning and coordination office (or chairman’s office) of *chaebols*, blamed for their major concern about the interests for controlling families, had to be closed down. Cross-guarantees of debt repayment among *chaebol* subsidiaries have been banned. The Fair Trade Commission has strengthened its investigations on illegal internal transactions among the subsidiaries resulting in the levy of substantial administrative fines.

Though some of these measures may be justified for the fast improvement of the situation, they might well have bypassed solid market solutions or constrained the proper development and workings of grass-roots governance systems. Most crucial is putting effective corporate governance mechanisms in place and improving transparency that would reorient the operational objectives of business groups more toward efficiency and profitability by way of protecting the interests of outside shareholders from expropriation by controlling families.

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