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Public Enterprise Reform and Privatization in Korea: Lessons for Developing Countries

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**Public Enterprise Reform and Privatization in Korea:
Lessons for Developing Countries**

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A shorter version of this paper was presented at the International Workshop on Management of State Ownership in China's SOEs: Reform Agenda after the 16th Party Congress, jointly organized by the World Bank and Development Research Center of the State Council, China (Beijing, 14 January 2003). The author would like to thank Bill Mako of the World Bank and seminar participants at the Development Strategy Institute (Hanoi, 28 May 2002) for helpful comments on earlier drafts. Jina Yu provided excellent research assistance.

Foreword

Since the 1970s, the focus of public enterprise reform around the world has increasingly shifted from efficiency improvement under continued state control to full-fledged privatization. International experiences show that the efficiency effect of privatization crucially depends on the existence of efficient and competitive markets. Yet most developing and transition economies have a deficient institutional infrastructure to support privatization, as evidenced by weak shareholder rights, limited competition, and moral hazard. Moreover, privatization may even have the perverse effect of perpetuating these problems if it aggravates the distribution of property rights and political power. For developing and transition economies, it is indeed a challenge to reform public enterprises while avoiding these pitfalls.

This study looks at Korea's experience with public enterprise reform and privatization, and draws useful lessons for developing and transition economies. In Korea, a major reform in 1983 sharply reduced political appointments at public enterprises, gave managers greater autonomy, and introduced incentives based on a rigorous system of performance evaluation. The reform was widely regarded as a success, and with the subsequent strengthening of market-based sanctions and incentives, Korea took the next step and pushed ahead with a full-fledged privatization program in the wake of the 1997 economic crisis. The author, Dr. Wonhyuk Lim of the Law and Economics Division, argues that for developing and transition economies, there is room for public enterprise reform under continued state control while the institutional infrastructure to support privatization is shored up. He emphasizes that if privatization is to lead to increased efficiency, it must be a part of a comprehensive reform program designed to improve corporate governance in the broad sense of the term.

I believe that both policymakers and academics grappling with the problem of public enterprise reform in such countries as China and Vietnam will find this study very useful.

Choongsoo Kim
President
Korea Development Institute

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Summary

A Corporate Governance Perspective on Public Enterprises

In its broad sense, corporate governance may be defined as the entire set of institutions, both inside and outside the firm, through which the objectives of the company are set and executed and the performance of the firm is monitored. From a corporate governance perspective, incentive schemes and objectives under public vs. private provision may be analyzed as follows. For public provision, the objective is “public interest,” defined through a political process; whereas, for private provision, the objective is profit. However, for both public and private provision, the most effective incentive mechanism for managers is to link managerial rewards to performance, based on clearly defined objectives.

The essence of public enterprise reform prior to privatization is to establish this type of effective incentive mechanism by implementing the following set of actions: (1) Minimize political interference, especially in personnel and pricing decisions; (2) Clarify the firm’s objectives, using performance indicators whenever possible; (3) Increase managerial autonomy to meet these objectives; (4) Evaluate managerial performance; (5) Link reward to performance.

Privatization makes a fundamental break from this approach and changes the objective of the firm from “public interest” to “profit.” As such, a decision to privatize a public enterprise should be based on a judgement that the firm’s “public interest” function has been exhausted or can be replaced by other means such as direct fiscal subsidies. There should also be an additional judgment that the introduction of the profit motive through privatization is likely to lead to increased consumer welfare through substantive competition and regulation. Privatization will risk a serious backlash if it leads to a destruction of firm value through “tunneling” or other acts of malfeasance, or gives rise to monopoly rent due to the lack of competition or the capture of regulatory bodies. As the effectiveness of privatization crucially depends on the existence of competitive and efficient markets, privatization should be part of a comprehensive program of market-oriented reform.

Public Enterprise Reform and Corporate Governance Improvement

In Korea, the most important reform measure adopted before the full-fledged privatization of public enterprises was the Government-Invested Enterprise (GIE) Administration Basic Act of 1983. Through this Act, the government introduced a German-type dual board at each GIE, establishing

a supervisory board made up of non-standing directors (except the CEO) and a virtual executive board staffed with internally promoted executive officers. The supervisory board included representatives from the supervisory ministry and the Economic Planning Board. The separation of internally promoted executive officers and non-standing outside directors was designed to reduce the “parachute appointment” of outsiders to executive positions, which had weakened the morale of employees at public enterprises. In addition, the 1983 Act streamlined various controls to increase managerial autonomy, and established an inter-ministerial council to evaluate public enterprise performance and link reward to performance. Based on the efficiency principle, a set of performance indicators devised by experts had the effect of checking managers as well as bureaucrats and politicians from pursuing their narrowly defined private interests. This reform was widely regarded as a success (Shirley 1989).

As the Korean economy was progressively liberalized and the “public interest” argument for public enterprises was weakened, privatization began to surface as a realistic policy option in the late 1980s. Yet due to bureaucratic inertia as well as general concern about the increasing concentration of economic power in the hands of the chaebol, or Korea’s family-based business groups, the government exercised a great deal of caution in pushing ahead with privatization prior to the 1997 economic crisis. The government took measures to improve the corporate governance of public enterprises, and partially sold its shares in public enterprises while retaining control.

Representative of the government’s cautious approach was the 1997 Act on the Managerial Structure Improvement and Privatization of Public Enterprises. This Act aimed at improving managerial efficiency and pushing ahead with privatization while preventing further concentration of economic power. It imposed a shareholding cap of 7 percent to prevent the chaebol from acquiring controlling interests, and envisioned an Anglo-Saxon style corporate governance structure, involving active participation by institutional investors with significant but non-controlling interests. Although the 1997 Act provided an alternative to chaebol-dominated privatization, it had serious shortcomings as it was accompanied neither by a credible program to sell government shares nor by a plan to separate regulatory and industrial policy objectives from the business objectives of public enterprises. In fact, Korea implemented a comprehensive program of privatization only after the outbreak of the economic crisis at the end of 1997.

Privatization and Remaining Challenges

The economic crisis added a new sense of urgency to privatization policy, as the sale of highly regarded public enterprises was viewed as a means of generating hard currency and securing foreign investors’

confidence in Korea. The implementation of institutional reforms to reduce moral hazard, improve corporate governance, and enhance competition also supported the privatization drive.

As the crisis put a serious dent in the *chaebol's* claim for superior efficiency, most of the privatization plans for large-scale public enterprises were drafted with a view toward establishing Anglo-Saxon style corporate governance. In fact, the privatization of POSCO, KT, and KT&G proceeded along this line.

In addition, there was an increased awareness of the importance of competition and regulation in the process of privatization. In particular, the sale of co-generation facilities in Anyang and Bucheon without an appropriate transformation of regulatory policy led to significant hikes in heating bills and subsequent consumer complaints. Through this experience, the government learned an expensive lesson that the introduction of the profit motive through privatization should be accompanied by substantive competition or regulation if it is to lead to improved consumer welfare.

This lesson should not be lost on policymakers. Of the eleven public enterprises targeted for privatization in 1998, only three remain public enterprises, in electric power, gas, and district heating sectors— all network industries where competitive market design and regulation are of crucial importance. In order for privatization to improve efficiency and consumer welfare, it should be a component of a comprehensive program to enhance the operation of market forces.

CHAPTER 1

Introduction

Since the postwar welfare state began to unravel in advanced industrial countries in the 1970s, the focus of public enterprise reform has increasingly shifted from efficiency improvement under continued state control to full-fledged privatization.¹ Margaret Thatcher and her followers were early advocates of this sea change. In the late 1970s, when some policy study groups said state-owned enterprises (SOEs) should be “commercialized” and made to operate more like private companies, Thatcherites argued that getting an SOE to “imitate” a private firm was much like trying “to make a mule into a zebra by painting stripes on its back.”²

In response to this colorful analogy, a skeptical observer might have asked whether a mule could run faster just because its ownership was transferred from the government to private hands. A cynic might have gone further and said a mule could never become a zebra—there would be little point in trying to change SOEs, and it would be better to start from scratch and encourage the growth of companies subject to market discipline from their birth. Yet this kind of concern about the effectiveness of privatization was largely overlooked, and it became increasingly fashionable to propose privatization as a solution to inefficiency in the public sector. Part of the reason for this oversight was that advanced industrial countries on the leading edge of the privatization wave had a well-developed institutional infrastructure to support privatization. They had relatively efficient and competitive markets to make market-based sanctions and incentives effective.³

In contrast, under the current institutional environment in most

¹ A “public enterprise” may be defined as a state-owned or state-controlled economic entity that generates the bulk of its revenue from selling goods and services. This definition encompasses enterprises directly operated by a government ministry (e.g., Post Office in most countries) and stand-alone business enterprises of which the government is the controlling shareholder. It excludes much state-sponsored activity that is usually financed from the government’s general revenue (e.g., education and health services). The term “state-owned enterprise” (SOE) is also widely used, even in cases where the state has less than a majority stake.

² Re-cited from Yergin, Daniel and Joseph Stanislaw (1998), *The Commanding Heights: The Battle Between Government and the Marketplace That is Remaking the World* (New York: Simon & Schuster), p.114.

³ For a discussion of public enterprise reform from advanced industrial countries’ perspectives, see OECD (1998), *Corporate Governance, State-Owned Enterprises and Privatisation* (Paris: OECD).

developing countries, the efficiency effect of privatization may not be as great as is often claimed due to weak shareholder rights, limited competition, and soft budget constraints or moral hazard. In fact, in many transition economies, privatization involving a scale beyond that of small shops and farms has frequently led to unsatisfactory results.⁴ For small shops and farms, owners typically double up as managers, and there is little corporate governance problem that arises from the separation of ownership and control. Moreover, such small-scale enterprises typically face intense competition, and this intense competition tends to promote efficiency. As a result, placing the ownership and control of small shops and farms in private hands typically leads to significant efficiency gains, as witnessed in many transition economies. By contrast, for large-scale firms, institutional requirements for efficiency improvement through privatization are much more complex. If privatization is to lead to increased efficiency, it must be part of a comprehensive reform program designed to remove various entry and exit barriers and enhance the operation of market forces.

In developing countries, there is room for a traditional type of public enterprise reform under continued state control while the institutional infrastructure to support privatization is shored up. Such a reform program requires a political economy environment that places priority on economic efficiency, even though markets may be underdeveloped, as posited by the “developmental state” model. Of course, an alternative approach is to implement a “big-bang” program of privatization and hope that such a move will spur market-oriented reform. However, if anything, privatization carried out in the absence of effective competition and investor protection is likely to create vested interests determined to impede such reform, as demonstrated by oligarchs in Russia.

Korea’s experience with public enterprises offers valuable lessons in this regard. As in many other developing countries, SOEs have been important actors in the Korean economy, especially in network industries and the banking sector. Since the late 1960s, the government ruled out privatization except in limited cases, and instead sought to improve the performance of public enterprises while retaining control. A major reform in 1983 sharply reduced political appointments at SOEs, gave managers greater autonomy, and introduced incentives based on a rigorous system of performance evaluation. The reform was based on five principles: (1) Minimize political interference, especially in personnel and pricing decisions; (2) Clarify the firm’s objectives using performance indicators; (3) Increase managerial autonomy to meet these objectives; (4) Evaluate managerial performance; (5) Link reward to performance. The 1983 reform was widely regarded as a success,⁵ but with the increasing

⁴ See Nellis, John (1999), “Time to Rethink Privatization in Transition Economies?,” Discussion Paper No. 38 (Washington, D.C.: International Finance Corporation).

⁵ See, for instance, Shirley, Mary M. (1989), “Improving Public Enterprise Performance:

liberalization of the economy since the mid-1980s, Korea took the next step and pushed ahead with a full-fledged privatization program.

This paper looks at Korea's experience with public enterprise reform and draws lessons for developing countries. This paper is organized as follows. Chapter 2 introduces a corporate governance perspective on public vs. private provision. This chapter emphasizes that the introduction of the profit motive through privatization should be accompanied by substantive competition or regulation if it is to lead to improved consumer welfare. Chapter 3 presents a brief overview of Korea's public enterprises as of end-2002, unless otherwise noted. Chapter 4 looks at the evolution of public enterprise policy since 1945. Breaking up the postwar era into four periods, this chapter shows how the government established the institutional framework for setting managerial objectives, providing incentives, and evaluating performance for public enterprises in each period. The corporate governance reform of 1983 and 1997 is highlighted. This chapter also looks at the government's privatization drive in the wake of the 1997 economic crisis. Chapter 5 presents case studies on six of Korea's largest public enterprises, the last four of which have been completely privatized: KEPCO (Korea Electric Power Corporation), KOGAS (Korea Gas Corporation), KT&G (Korea Tobacco & Ginseng Corporation), KT (formerly Korea Telecom Corporation), POSCO (formerly Pohang Iron & Steel Company), and Doosan Heavy Industries & Construction Company (formerly Hanjung or Korea Heavy Industries & Construction Company). The aim of this chapter is to highlight critical factors that have influenced the privatization decisions rather than to give an extensive chronological account of each of the corporations.

Chapter 6 concludes, with lessons on public enterprise reform and privatization. For public enterprise reform to be successful, the political leadership must make a credible commitment to minimize undue interference and have technocrats and experts evaluate the performance of public enterprises after giving their managers autonomy to meet clearly defined objectives. While reforming the internal operation of public enterprises, the government should also make efforts to build market institutions and expose public enterprises to real or yardstick competition. In order for privatization to improve efficiency and consumer welfare, it should be a component of a comprehensive program to enhance the operation of market forces.

CHEPTER 2

Public versus Private Provision: A Corporate Governance Perspective

What kinds of goods and services are better provided by the private sector than by the public sector? Under what conditions is the existence of state-owned enterprises justified and when should they be privatized?

In order to address these questions, it may be useful to adopt a corporate governance perspective and focus on problems arising from incomplete contracts and information asymmetry between the principal and the agent. This approach will compare the operation of state-owned enterprises versus private-sector firms and clarify conditions under which private provision may be superior to public provision-- and vice versa. In particular, it will be useful to separate incentives from objectives, or means from ends, and compare the two modes of provision.

2.1. The Problem of Corporate Governance

The problem of corporate governance becomes interesting when ownership and control are separated, as in a firm owned by shareholders and controlled by managers. When the same person has both ownership and control, as in the case of a firm directly managed by its owner, there is no meaningful corporate governance problem: Presumably, the owner-manager can perfectly monitor his or her own performance.

When ownership and control are separated, however, it is important to devise an incentive and monitoring scheme to make sure that the managers work in the interest of the owners rather than their own. It is not difficult to imagine cases in which managers sacrifice the interests of shareholders for the gratification of their own interests, through pay raises, empire-building, and so on.⁶

It is important to note that this problem of corporate governance arises from three factors: (1) The owner (the principal) and the manager (the agent) have different objectives; (2) The owner cannot perfectly monitor the

⁶ For a general discussion on the problem of corporate governance, see Hart, Oliver (1995), *Firms, Contracts and Financial Structure* (Oxford: Oxford University Press).

behavior and decision of the manager; (3) The owner cannot anticipate and specify all contingencies in the contract with the manager. The problem of corporate governance in both public and private firms would disappear under complete contracts and symmetric information. The principal and the agent originally may have different interests, but the principal could use complete contracts and perfect monitoring to make sure that the agent's interests are brought in line with those of the principal's. In reality, however, the principal cannot anticipate and specify all contingencies, the agent will look for loopholes in the contract, and the principal cannot perfectly monitor the agent's performance.

This problem of corporate governance exists in both public and private firms as long as ownership and control are separated. After all, most large private firms are owned by shareholders and controlled by professional managers. While shareholders presumably want to maximize profit, managers may pursue their own agenda. In order to have managers pursue profit maximization, an appropriate incentive compensation scheme must be devised. As risk-averse managers with superior information have to be paid risk premium and information rent, however, firm performance may still deviate from the objective of profit maximization.

It is simply wrong to assume that the divergence of their interests is smaller than that between the owners and managers of public enterprises. Now, if the basic nature of the corporate governance problem in both private and public firms is identical, any difference in performance between public and private firms must arise either from differences in objectives or differences in incentives schemes. Otherwise, it should be possible for the government to make public managers to pursue profit maximization and eliminate the differences between public and private ownership regimes—without resorting to privatization.

This may sound obvious once explained, but it is a point often missed in the debate on privatization. For instance, Stephen P. King (1998: 8) writes: "A key difference between ownership regimes is the beneficiary of increases in the value of the assets that underlie the business. A public sector manager ... has no claims on these assets. The assets belong to the government. In contrast, a private owner retains the assets and has the right to sell them and receive the value of the assets through this sale." King implicitly assumes that the private manager and the private owner are one and the same person and in effect eliminates the principal-agent problem under private ownership. However, a private sector manager hired by a private owner has no claims on the assets that underlie the business as does a public sector manager.

2.2. Incentive Schemes Under Public versus Private Provision

What are the differences in incentive schemes between public and private provision? The standard answer is that public firms are shielded from market forces. For instance, OECD(1998: 7) argues:

The weaknesses of governance in state-owned enterprises stem from insufficient market incentives and disciplines. There is no market for corporate control, e.g. no threat of take-over and replacement of incumbent management, shareholder exit is not possible and monitoring of performance by the state equity-holder is weak mainly due to the lack of economic motivation. Corporate governance is exercised by a chain of agents without identifiable principals. There is no credible threat of bankruptcy as SOEs are frequently bailed out.

In general, for listed firms, there are four types of incentives and sanctions that can be used to influence managers' performance and induce them to maximize profit: (1) threat of shareholder exit (i.e., selling shares of a poorly performing firm), (2) threat of takeover or replacement of incumbent management, (3) threat of bankruptcy, and (4) performance-related pay (e.g., stock options). In contrast, it is argued, civil servants—who are not entitled to the gains from improved efficiency—have no financial incentive to monitor public firms. It is also generally argued that members of the public do not have the possibility of shifting their assets away from unprofitable SOEs, lowering share prices and informing potential bidders that the companies' assets are not earning the maximum possible return.⁷ Thus, the standard case for the superiority of private provision is based on the effectiveness of market-based incentives and the inapplicability of these incentives to the public sector.

At this point, it may be useful to raise two points related to the argument above: (1) The superiority of private provision crucially depends on capital market efficiency and product market competition—privatization, by itself, is not sufficient to guarantee improved performance; (2) Public enterprises have much room to adopt market-based incentives without resorting to complete privatization—the listing of SOEs on the stock market through partial privatization can have a significant effect on their performance. Many countries, including some in the developed world, lack meaningful competition in the market for corporate control; hostile takeovers are virtually impossible. Moreover, in some countries, product market

⁷ See Estrin, Saul (1998), "State Ownership, Corporate Governance and Privatisation," in OECD, *Corporate Governance, State-Owned Enterprises and Privatisation* (Paris: OECD), pp.11-31.

competition is less than effective due to various entry barriers, and gigantic private firms, comparable in size to prominent SOEs, are widely believed to be shielded from the threat of bankruptcy due to the "too big to fail" problem. For such private firms protected from the threat of takeover and bankruptcy, the alleged effectiveness of market-based incentives is greatly weakened.

Also, with diffuse ownership, it may be too costly for a small shareholder to collect enough information to convince others of dismissing managers perceived to have unsatisfactory performance. Although mass privatization or "people's share" programs are often used as a means of reinforcing popular support for democratic capitalism, these schemes may result in ineffective monitoring of corporate performance due to the collective action problem. At the same time, however, this observation does not necessarily imply that the sale of a controlling stake to a single strategic investor is the only effective means of privatization. What is needed is large shareholders who have enough stake in the firm willing to collect information, discipline management, and raise capital if needed. The problem of collecting necessary information presents particular challenges in highly concentrated industries, where comparison with other companies in the same sector becomes more uncertain and the informational advantage to management greater. This problem is particularly acute in natural monopoly industries. Performance benchmarks derived from the operation of natural monopoly firms in other countries may provide the only means of comparison, but it may be very difficult to control for other factors that complicate international comparison. Indeed, it is not difficult to imagine circumstances in many developing countries where the government may have access to more information and stronger powers to discipline firms than private shareholders.

In short, privatization without capital market efficiency and product market competition will not necessarily improve economic performance and may actually lead to efficiency loss. It may be a good idea to remove entry and exit barriers in the product and corporate control market before public enterprises are sold off. Under the current institutional arrangement in most developing countries, the difference between private and public incentive schemes may not be as great as is often claimed. In particular, in many institutionally-weak transition economies, ownership change through privatization has led to stagnation and decapitalization rather than efficiency improvement.

The listing of SOEs on the stock market is also likely to narrow the gap between private and public incentive schemes. For the managers of unlisted SOEs, a typical incentive and discipline mechanism involves promotion and demotion and possible publicity in the case of exceptionally good or bad performance. In practice, however, public managers tend to play it safe and try to hold on to their jobs. The trading of SOE shares will make it possible for shareholders to exit from badly performing SOEs and

allow the government to devise various performance-related pay schemes for public managers. In practice, civil service rules, legal restrictions on compensation of public managers, and so on may limit the extent to which performance-based pay schemes can be introduced. It is, however, important to note that these limitations do not arise from the alleged inefficiency of the public sector per se, but rather from preconceptions about what "public" managers should receive. In a sense, they are closely related with various administrative checks and screens to prevent the use of public office for private gain. As long as policymaking and management are separated, however, there should be no presumption of conflict of interest.

More generally, one approach to improving the efficiency of SOEs is to emulate the private sector incentives. This includes corporatization of SOEs, i.e., their constitution as private law commercial entities, and creating transparency in the relationship between the state and the board of directors of the SOE, including a clear set of rules for the appointment of directors and a clear definition of the corporate goals. Performance contracts between SOEs and the state are another way to exercise governance, especially in industries that are monopolistic.

The threat of takeover and bankruptcy can be effectively emulated through the threat of replacing incumbent public managers if they do not meet the objectives of consistent profitability and performance close to benchmarks. Since pursuit of maximum profit by SOEs through exploitation of their market power goes against the public interest, the objective of consistent profitability should be interpreted as consistent ability to self-finance operations. Benchmarking world leaders is designed to improve the operating efficiency of SOEs through "virtual" competition and limit their exercise of market power. In particular, exposing SOEs to international competition is likely to have a significant effect on their performance. Singapore's Singapore Airlines and Korea's POSCO are two prominent examples of SOEs hardened through international competition. Once internationally competitive, however, SOEs usually come to appreciate that privatization is a critical component of their regionalization or globalization strategy.

2.3. Objectives Under Public versus Private Provision

If the difference between private and public incentives may not be as great as is often claimed and can be substantially reduced through emulation, what remains of the "efficiency" argument that favors private provision over public provision? To address this question, it is now time to examine the difference in objectives under the two modes of provision.

What are the objectives of the owners of public enterprises? This

question may have to be preceded by another one: Who are the owners of public enterprises? Since voters-taxpayers in effect provide capital for public enterprises in the first place, they may be regarded as the ultimate owners of these firms. In practice, however, politicians and bureaucrats behave as if they were the effective owners of public enterprises rather than the agents of voters-taxpayers.⁸ The objectives of politicians and bureaucrats may deviate significantly from those of voters-taxpayers. It may be much more difficult to address this problem of state governance than that of corporate governance. Voter-taxpayer exit is basically impossible unless he or she is willing to emigrate, and at any rate poses little threat to politicians and bureaucrats; elections, the only formal incentive mechanism for state governance, are frequently affected by factors other than the performance of politicians and bureaucrats and are shielded from international competition; and performance-based pay schemes are non-existent.

In order to examine the objectives of voters-taxpayers, recall that the postwar proliferation of SOEs was justified on the grounds of social welfare: (1) improving efficiency through scale economies, (2) correcting for actual or potential market failures, and (3) facilitating economic development. Political leaders made SOEs part of their agenda, and, in most countries, the establishment of SOEs was approved through a political process involving voters-taxpayers. Therefore, it may be argued that the social welfare objectives of SOEs generally correspond to the objectives of voters-taxpayers.

The objectives of politicians and bureaucrats may be very different. While claiming to serve the public, they may actually advance the interest of themselves and their supporters. Politicians and bureaucrats may well use their control of SOEs as a means of channeling benefits to their supporters. A deliberate policy of transferring public resources will amount to more than simple redistribution if it involves distortions, say, in the form of above-market wages or subsidies to nonviable firms. In particular, if there are powerful labor unions that demand resource transfers to SOEs in exchange for their political support, serious allocative inefficiency may result in addition to operating inefficiency (X-inefficiency) which stems from the lack of financial incentives. Also, outright corruption is a major source of inefficiency, as it typically involves above-market procurement prices. In addition, politicians and bureaucrats might use SOEs to undertake "monumental projects" for their personal grandeur. SOE employees, for their part, might not object to these projects if they mean more positions and greater power.

⁸ In theory, managers of SOEs are agents of politicians and bureaucrats, who are in turn agents of voters-taxpayers. Some economists call this a double agency problem. There may be a similar problem in the private sector if *de facto* CEOs are largely shielded from shareholder pressure and have control over professional managers. Korea's *chaebol* may be a case in point.

As the objectives of politicians and bureaucrats clash with those of voters-taxpayers, it may become very difficult to define clear managerial objectives for SOEs. Moreover, changes in short-term political needs may lead to abrupt changes in managerial objectives. As managerial objectives become downright confusing, it will become increasingly difficult to monitor and evaluate the performance of SOEs. In the end, the government may be tempted to specify actions rather than results, further distancing SOEs from market-based performance criteria.

In short, unless politicians and bureaucrats stop treating SOEs as vehicles of their private interest, managerial objectives imposed on SOEs are likely to lead to serious inefficiency. While it may not be too difficult for SOEs to emulate private incentive schemes through corporatization and partial privatization, these incentives will become largely meaningless unless distortionary objectives are removed. If a privatization program can be somehow implemented over the resistance of politicians and bureaucrats, it will at least have the effect of removing these distortionary objectives. Of course, for this program to be effective, policy measures to improve capital market efficiency and product market competition must be also implemented.

On the possibility of implementing privatization in corruption-prone countries, Shleifer(1998: 17-18) argues: "In practice, ...it is generally easier for reformers in a government to design a relatively corruption-free privatization program, which relies on the effectiveness of a relatively small agency, than to fight corruption inside state firms and agencies. Moreover, once an activity is privatized, the scope of government control and regulation over its delivery generally falls, and so do the opportunities for corruption." Russia's experience with privatization, however, seems to show that it is very difficult to implement a corruption-free privatization program in a corruption-prone country because politicians and bureaucrats naturally demand "a piece of the action" in exchange for their approval of privatization.⁹ A nation's general social capabilities seem to matter much more than the mode of ownership.

At any rate, if appropriate market institutions can be established, removing potentially distortionary objectives through privatization will typically lead to improved performance. It is, however, not the case that replacing genuine "social welfare" objectives with commercial objectives always results in increased efficiency. Asymmetric information and incomplete contracts again play a critical role here.

In contrast to public owners, the objective of private owners is relatively clear. Although there is some room for debate, profit maximization is usually accepted as the objective of private shareholders. Now suppose that owners have successfully imposed their objective on managers through

⁹ On the political economy of privatization, see Perotti, Enrico C.(1995), "Credible Privatization," *American Economic Review* 85: 847-59.

appropriate incentive schemes so that "private firms" can be regarded as monolithic entities.

Under the objective of profit maximization, private firms will try to employ the least-cost method of producing goods and services and may look for ways to "cut corners" whenever possible. Cost-reducing effort is certainly an important source of innovation, but under the conditions of asymmetric information and incomplete contracts, this effort may not always have a positive effect on social welfare. For instance, suppose that the government contracts out some service to a private firm. Because the government cannot observe costs, the government can specify only price and some measure of output in the contract. Moreover, because the government cannot anticipate all contingencies, the government will wind up leaving unspecified some important component of quality. Under these conditions, a profit-maximizing firm may well attempt to degrade this unspecified component of quality in its effort to reduce cost.

Disposal of medical waste provides a case in point. In 1996, the City of Los Angeles employed private firms to dispose of medical waste, probably expecting them to use the standard method of high-temperature incineration. To minimize costs, however, these private firms simply dumped the waste at sea. When the waste began to wash up on local beaches, questions were raised about the desirability of contracting out this kind of service to private firms.¹⁰ Certainly, the city government could have specified the method of disposal as well as price and output in the original contract, but the point is that it cannot possibly specify all components of quality under all contingencies. As the profit motive drives private firms to look for loopholes whenever possible, the private objective of profit maximization can generate serious negative externalities.

Certainly, there are some moderating factors, such as competition and reputation effect, which prevent private firms from engaging in quality-degrading cost reduction activities. When such factors have a limited effect and opportunities for quality-degrading cost reduction are significant, however, public provision is likely to be superior to private provision.

Public managers are not likely to engage in quality-degrading cost reduction effort for two reasons. Public managers' effort to reduce cost typically goes unrewarded. Moreover, since the objective of SOEs is supposed to be social welfare rather than profit maximization, quality-degrading cost reduction may lead to a political uproar and threaten the job security of public managers— even though there are no explicit "contracts" to speak of for such contingencies. In other words, SOEs are likely to be much more conscious of externalities than private firms.

¹⁰ See King(1998), who cites Shelby Grad, "Medical-waste mess leads to fees for health professionals," *The Los Angeles Times*, December 29, 1996.

2.4. Summary

This chapter has looked at public enterprise reform and privatization from a corporate governance or principal-agent perspective, focusing on the problems of asymmetric information and incomplete contracts. When incentive schemes and objectives are examined separately under public vs. private provision, it seems clear that the case for the superiority of private provision comes from the objective side, rather than the incentive side. Through corporatization and listing of shares on the stock market, public enterprises can adopt much of market-based sanctions and incentives— i.e., the threat of shareholder exit, takeover, and bankruptcy as well as the reward of performance-based pay.

What public enterprises cannot easily imitate is private firms' focus on the objective of profit maximization. While voters-taxpayers want SOEs to correct for market failures and promote social welfare, politicians and bureaucrats may use SOEs to pursue their private objectives by undertaking monumental projects, transferring public resources to win support, and engaging in outright corruption. The distortionary objectives of politicians and bureaucrats are likely to lead to serious inefficiency, especially if there are powerful public-sector labor unions or there is widespread corruption in society. Privatization can serve as a means of removing these potentially distortionary objectives. In a corruption-prone country, however, it is not clear whether privatization will necessarily improve social welfare; for the well-connected and resourceful are more than likely to benefit disproportionately from privatization. In institutionally-weak countries, privatization is not likely to increase efficiency. General social capability matters much more than the mode of ownership.

It is perhaps worthwhile to elaborate on this point, for much of the discussion on privatization nowadays seems to proceed from the presumed efficiency of private provision. The superiority of private provision over public provision, however, crucially depends on capital market efficiency and competition in corporate control as well as product market. Market-based sanctions and incentives lose much of their effectiveness under diffuse ownership, overprotected management, soft budget constraints, and limited market competition. If privatization is to lead to increased efficiency, it must be a part of a comprehensive package involving the participation of at least some large shareholders who have enough stake in the firm to monitor management as well as concomitant improvements in market institutions. In short, market liberalization must be accorded priority if privatization is to prove effective.

Moreover, it is important to note that in some cases, public provision may be superior to private provision. Under the objective of profit maximization, private firms may look for ways to "cut corners" if possible, degrading the unspecified component of quality and potentially generating

negative externalities. When competition and reputation have a limited effect and opportunities for quality-degrading cost reduction are significant, public provision is likely to be superior to private provision. Due to the "social welfare" objectives of SOEs, public managers are likely to be more conscious of externalities.

CHAPTER 3

An Overview of Korea's Public Enterprises

Public enterprises (*kong-kieop*) have been important players in the Korean economy. Some of these enterprises trace their origins to the Japanese colonial period (1910-1945), including KEPCO, but a majority of them are products of Korea's state-led economic development strategy, which had its golden age in the 1960s and 1970s.

According to one estimate, the value-added contributed by Korea's public enterprises, including financial institutions, accounted for 8.3 percent of GDP in 1975 and 9.4 percent in 1990. Meanwhile, the share of public enterprises in fixed capital formation declined from 27.6 percent in 1980 to 8.9 percent in 1990. By contrast, the direct contribution of public enterprises to total employment was only around 2.5 percent in the same period.¹¹

SOEs, including those that have been privatized in recent years, comprise some of the largest business groups in Korea. Measured by the sum of the total assets of non-financial member firms and the total equity of financial member firms at the end of 2002, KEPCO is Korea's largest business group, ahead of Samsung. KT comes in at No. 6, right after Hyundai Motor Co.; Korea Highway Corporation, No. 7; POSCO, No. 10; Korea National Housing Corporation, No. 11; Korea Land Corporation, No. 12; Korea Water Resources Corporation, No. 16; KOGAS, No. 18; KT&G, No. 27; and Korea Agricultural & Rural Infrastructure Corporation, No. 28.¹² In all, ten of the 30 largest business groups in Korea are public enterprises or recently privatized public enterprises—namely, KT, POSCO, and KT&G.

As Table 1 shows, compared with privately owned business groups of comparable size, SOEs tend to have a less number of subsidiaries (more business focus), a lower debt-equity ratio (better financial stability), and a comparable level of profitability.¹³ On average, SOEs have 5.3 member

¹¹ See Song, Dae-Hee (1994), "Policy Directions for Improving the Monitoring of Management and Privatizing Korea's Public Enterprise Sector" (Seoul: Korea Development Institute), pp.13-14 [in Korean].

¹² After acquiring Hanjung, Doosan comes in at No. 19. Renamed Doosan Heavy Industries and Construction Co., Hanjung accounts for approximately 30 percent of the Doosan Group's total assets.

¹³ In 2001, when the Korean economy was affected by a global slowdown, the business performance of SOEs was actually better than privately owned business groups. For the 2001 cohort, the weighted average ROA and ROE for SOEs were 2.65 percent and 5.15 percent, respectively, while the comparable figures for their privately owned counterparts were 1.69 percent and 4.12 percent. Presumably, SOEs, concentrated as they are in infrastructure industries, are less vulnerable to cyclical factors. The business focus and

Table 1. Korea's Largest Business Groups in 2002

(unit: billion won, 1200 won/US\$)

	Business Group (number of member firms)	Non-Financial Firms Only				
		Assets	Equity	Liabilities	Sales	Net Income
1	KEPCO (13)*	92,094	55,988	36,106	35,801	5,049
2	Samsung (63)	71,904	42,840	29,064	108,068	9,029
3	LG (50)	55,200	21,901	33,300	78,237	2,418
4	SK (60)	46,315	16,594	29,721	51,801	1,856
5	Hyundai Motor Co. (25)	42,877	19,535	23,343	53,516	2,950
6	KT (10)**	30,815	10,916	19,899	17,834	2,499
7	Korea Highway Corp. (3)*	28,257	14,424	13,833	2,478	47
8	Hanjin (23)	20,764	6,3075	14,457	13,778	225
9	Lotte (35)	20,289	11,659	8,630	18,632	9571
10	POSCO (15)**	20,499	13,258	7,241	16,986	1,199
11	Korea National Housing Corp. (2)*	15,529	5,647	9,882	3,272	134
12	Korea Land Corp. (2)*	14,654	3,520	11,134	4,933	372
13	Hanhwa (33)	10,318	3,366	6,952	7,560	-69
14	Hyundai Heavy Industries (6)	12,193	3,420	8,773	10,253	-246
15	Hyundai (12)	7,667	1,661	6,006	23,768	-14
16	Korea Water Resources Corp. (2)*	9,725	8,069	1,656	1,544	292
17	Kumho (15)	9,340	1,989	7,352	6,848	54
18	Korea Gas Corp. (2)*	9,361	2,844	6,517	7,358	300
19	Doosan (22)	8,434	2,904	5,530	6,891	-439
20	Dongbu (23)	6,676	2,701	3,975	3,991	-184
21	Hyosung (15)	4,915	1,901	3,014	4,512	64
22	Shinsegye (12)	4,689	1,845	2,844	7,637	316
23	Daelim (15)	4,593	2,214	2,379	5,362	213
24	CJ (33)	4,213	2,077	2,136	5,770	240
25	Tongyang (15)	3,283	717	2,566	1,501	-4
26	Kolon (32)	4,334	1,780	2,554	3,891	40
27	Korea Tobacco & Ginseng Corp. (2)**	4,242	2,275	1,967	5,095	385
28	Korea Agr. & Rural Infra. Corp. (2)*	4,231	1,252	2,979	2,328	7
29	Hanaro Telecom (8)	4,206	1,595	2,611	1,647	-132
30	Dongkuk Steel (7)	4,079	1,708	2,370	3,026	49

Note: An asterisk (*) marks an SOE while a double asterisk (**) denotes a recently privatized SOE. (KT, POSCO, and KT&G were completely privatized in May 2002, Oct. 2000, and Oct. 2002, respectively.)

Source: Fair Trade Commission (2002)

financial stability of SOEs were superior to privately owned business groups, as usual. In 2001, on average, SOEs had 5.4 member firms in a group while privately owned business groups had 22.1. The weighted average debt-equity ratio for SOEs was 94.3 percent while the comparable figure was 143.9 percent for privately owned business groups.

firms in a group while privately owned business groups have 25.2. The weighted average debt-equity ratio for SOEs (i.e., total debt of the ten SOEs divided by their total shareholder equity) is 94.1 percent while the comparable figure is 132.9 percent for privately owned business groups. The weighted average ROA and ROE for SOEs are 4.48 percent and 8.70 percent, respectively, while the comparable figures for their privately owned counterparts are 5.00 percent and 11.65 percent.¹⁴ Korea's SOEs have typically funded their own business activities and caused no drain on public finance.

3. 1. Classification Based on Corporate Form

As in other countries, public enterprises in Korea may be classified into three broad categories based on their corporate form: government enterprise (GE), public corporation, and joint-stock company. Each type has a different legal basis. Accordingly, they exhibit significant differences in (1) ownership and control structure (including the extent of parliamentary involvement), (2) budget, accounting, and audit rules, (3) employee status and labor rights, and (4) organizational flexibility.

Government enterprises (GEs) are government departments subject to government organization laws. The government is fully liable for their performance, and the parliament reviews and approves their budget. GEs are typically subject to the same set of budget, accounting, and audit rules that apply to general administrative bodies in the government. The employees of government enterprises are public employees, and to change the number of employees or the structure of the organization, relevant government regulations must be amended. Such rigidities constrain the ability of GEs to adapt to changing business conditions. Moreover, direct parliamentary involvement may aggravate the risks of political interference in the operation of these public enterprises.¹⁵

In Korea, there are four government enterprises (jeongbu-kieop): the Korean National Railroad,¹⁶ the Post Office, the Public Procurement Service,

¹⁴ This respectable business performance of SOEs does not seem to be driven by high prices they charge. In fact, one of the biggest worries about privatization in Korea is the possibility of price hikes after privatization.

¹⁵ The case of the Japanese National Railways (JNR) shows how the management of public enterprises may be compromised due to politicization. JNR's labor unions with the political power to deliver the votes formed a *de facto* coalition with members of the Diet who were interested in consolidating their political base by having railway lines built and public works provided to local construction companies in their districts. The softening of the budget constraint through cross-subsidization and government subsidies turned JNR into a black hole. In 1987, the Japanese government hardened the budget constraint by splitting JNR into 7 companies (thus blocking cross-subsidization) and reducing government subsidies. See Fukui, Koichiro (1992), "Japanese National Railways Privatization Study: The Experience of Japan and Lessons for Developing Countries" (Washington, D.C.: World Bank).

¹⁶ In 2003, the Korean National Railroad was transformed from a government enterprise to a

and the grain management “enterprise” (network of officials at the Ministry of Agriculture and Forestry and local governments, responsible for the Special Account on Grain Management).

Public corporations have more flexibility than government enterprises, as they are judicial persons separate from the government. They have their legal basis in individual acts of establishment. In general, public corporations are not subject to budget, accounting, and audit rules that apply to administrative bodies. The employees of public corporations are not public employees, although senior-level employees may be regarded as such in the application of the criminal law. The government has the ultimate responsibility for the operation of public corporations. It may have public corporations transfer their surpluses to the government, and, conversely, make up for their losses. In principle, the government should have complete ownership of public corporations, but this principle obviously breaks down in the process of gradual privatization. The distinction between public corporations and joint-stock companies gets blurred as a result as well.

In Korea, most of the remaining public enterprises are public corporations (*kongsa*). In the 1980s, two of Korea’s largest government enterprises were transformed into public corporations to give them more operational flexibility. The Telecommunications Authority was separated from the Ministry of Communication and was converted into a public corporation in 1981. It subsequently became KT. The Office of Monopoly became a public corporation in 1987, later renamed Korea Tobacco & Ginseng (KT & G).

Public enterprises that are established as joint-stock companies have their legal basis in the commercial code, not individual acts of establishment. The government has only limited liability commensurate with its equity stake, and its control over this type of public enterprises is also constrained by its ownership share. Unless the government as the controlling shareholder imposes undue constraints through special laws and regulations, public enterprises belonging to this category should closely resemble private joint-stock companies in operational flexibility. In Korea, POSCO was established as a joint-stock company. As the sale of government shares progressed, such firms as KEPCO and KT became hybrids combining the features of public corporations with joint-stock companies.

more business-oriented entity when its physical infrastructure and operating segments were vertically separated. The physical infrastructure segment became a publicly dedicated corporate entity (*kongdan*) while the operating segment became a public corporation (*kongsa*).

3.2. Classification Based on Legal Status

Korea's public enterprises may also be classified according to the degree of government ownership and the applicability of specific laws. Since government enterprises are departmental agencies belonging to the government, there is little sense in talking about the government's ownership stake in them. As for public corporations and joint-stock companies, however, the classification based on the degree of government ownership and the applicability of specific laws is quite relevant. There are three main categories in Korea: Government Invested Enterprise (GIE), Government Backed Enterprise (GBE), and Indirectly Invested Enterprise (IIE). The Treasury Bureau of the Ministry of Finance and Economy (MOFE) holds the government's shares in GIEs and GBEs. The supervisory ministry has the authority to exercise the government's shareholder rights in consultation with MOFE (See Tables 2 and 3).

In principle, Government Invested Enterprises or Institutions (*jeongbu-tuja-kigwan*) are public corporations or joint-stock companies in which the government has a direct majority ownership stake. The GIE Budget and Accounting Act of 1962 first established their legal basis. They are now governed by the GIE Administration Basic Act of 1983 (*jeongbu-tuja-kigwan kwanri-kibonbeop*, also translated as the GIE Management Act or Framework Act on the Administration of GIEs), a comprehensive law that defines the corporate governance structure of GIEs and imposes a rigorous system of performance evaluation.¹⁷

There had been as many as 26 GIEs in the late 1980s, including 13 commercially oriented firms, 8 promotional enterprises, and 5 financial institutions.¹⁸ Financial institutions and some of the commercially oriented public enterprises were, however, subsequently dropped from the list, even though the government continued to have majority ownership in some of these cases. As a result, they were exempted from the GIE Administration Basic Act. As Table 2 shows, there are now only 13 GIEs.

Government Backed Enterprises or Institutions (*jeongbu-chulja-kigwan*) were originally defined as public corporations or joint-stock companies in which the government directly had less than a majority stake. With the change in the definition of GIEs, however, GBEs have in effect become public enterprises with a direct government ownership stake that are exempted from the GIE Administration Basic Act. In other words, the applicability of the GIE Administration Basic Act rather than the extent of government ownership is the decisive criterion that distinguishes GBEs from GIEs. As Table 3 shows, there are now 17 GBEs in Korea.

¹⁷ This Act is explained in detail in Section 4.3.1.

¹⁸ See Shirley (1989), pp.42-44 for a list of Korea's public enterprises in 1986. The list of GEs, GIEs, and GBEs in 1986 is reproduced in Appendix 1.

Table 2. Korea's Government Invested Enterprises (GIEs) in 2002

GIE	Primary Roles and Responsibilities	Supervisory Ministry (Government Share, %)
Korea Minting and Security Printing Corporation	- Mint and print Korean currency and securities	MOFE (100.0)
Agricultural & Fishery Marketing Corporation	- Promote the agro-processing industry - Operate the government's price stabilization program	MAF (100.0)
Korea Agricultural & Rural Infrastructure Corporation	- Undertake large-scale agricultural development projects (reclamation, etc.)	MAF (100.0)
Korea Electric Power Corporation*	- Generate, transmit, and distribute electric power	MOCIE (32.4)
Korea Coal Corporation	- Develop and operate coal mines - Sell coal and its by-products	MOCIE (100.0)
Korea Resources Corporation	- Support the mining industry - Secure the stable supply of overseas mineral resources	MOCIE (98.6)
Korea National Oil Corporation	- Explore and develop oil resources - Export, import, store, transport, lease and sell crude oil and petroleum products	MOCIE (100.0)
Korea Trade Investment Promotion Agency	- Collect and disseminate information on global markets - Promote international investment	MOCIE (100.0)
Korea National Housing Corporation	- Construct and supply housing for lower-income groups	MOCT (76.0)
Korea Highway Corporation	- Construct and maintain expressways	MOCT (85.7)
Korea Water Resources Corporation	- Construct and manage multi-purpose dams - Construct and manage multi-regional water supply systems	MOCT (80.6)
Korea Land Corporation	- Acquire, develop and supply land for housing complexes, industrial complexes, and distribution centers	MOCT (72.9)
Korea National Tourism Organization	- Promote tourism in Korea - Develop tourist resorts	MCT (55.9)

Notes: MOFE: Ministry of Finance and Economy

MAF: Ministry of Agriculture and Forestry

MOCIE: Ministry of Commerce, Industry, and Energy

MOCT: Ministry of Construction and Transportation

MCT: Ministry of Culture and Tourism

*Although the government's direct ownership share in KEPCO is less than 50 percent after the government made in-kind investment in the Korea Development Bank with its KEPCO shares, the company is still classified as a GIE.

Source: Treasury Bureau, Ministry of Finance and Economy (2002)

Table 3. Korea's Government-Backed Enterprises (GBEs) in 2002

GBE	Primary Roles and Responsibilities	Supervisory Ministry (Government Share, %)
Korea Development Bank	- Furnish and administer funds for the financing of major industrial projects	MOFE (100.0)
Industrial Bank of Korea	- Promote the independent economic activity of small and medium-sized enterprises (SMEs)	MOFE (51.0)
Kookmin Bank	- Improve the financial status of citizens and SMEs by providing them with effective financial facilities	MOFE (9.6)
Korea Export-Import Bank	- Extend financial support for export and import transactions and overseas investment projects	MOFE (50.7)
Korea First Bank	* Commercial bank with the government holding a non-controlling stake	MOFE (3.1)
Korea Asset Management Corp.	- Manage and dispose of non-performing assets (NPAs) of the financial sector and state-owned properties.	MOFE (42.8)
Korea Investment Trust Co.	- Engage in fund products distribution, equity and fixed income brokerage and trading, corporate and project finance and asset management	MOFE (12.1)
Daehan Investment Trust Co.	- Engage in investment trust businesses	MOFE (10.4)
Korea Daily News (Daehan Maeil)	* Newspaper publishing house with the government holding a non-controlling stake	MCT (30.5)
Korean Broadcasting System	- Provide public broadcasting with the highest priority on the public interest	MCT (100.0)
Korea Gas Corp.	- Import and transport natural gas to local distributors through trunk pipelines it operates	MOCIE (26.9)
Daehan Oil Pipeline Corp.	* Pipeline construction and operating company with the government holding a non-controlling stake	MOCIE (9.8)
Korea Appraisal Board	- Provide valuation services	MOFE (49.4)
Korea District Heating Corp.	- Promote energy conservation and improve citizens' welfare by efficiently providing district heating	MOCIE (46.1)
Incheon Int'l Airport Corp.	- Develop, promote and manage airports, the seaport and business, and leisure infrastructure	MOCT (100.0)
Korea Educational Broadcasting System	- Provide educational and cultural programming	MCT (100.0)
Korea Airports Corp.	- Facilitate air transportation through efficient construction, management and operation of airport facilities	MOCT (100.0)

Source: Treasury Bureau, Ministry of Finance and Economy (2002)

Indirectly Invested Enterprises or Institutions (*kanjeob-tuja-kigwan*) are basically subsidiaries of GIEs or GBEs, with no direct government ownership stake. They are also exempted from the GIE Administration Basic Act. Most of them are small companies carrying out specialized functions for their parents. Exceptions are KEPCO's six power-generating subsidiaries (gencos), each of which has assets in excess of one billion dollars.

CHAPTER 4

The Evolution of Korea's Public Enterprise Policy

The evolution of public enterprise policy in Korea has closely paralleled the evolution of general economic policy. The post-1945 history of Korea's economic policy may be divided into four periods as follows.¹⁹

In the first period (1945-1960), Korea struggled to cope with post-colonial challenges, including the national division and war (1950-1953), and depended on foreign aid to survive. Instead of formulating a coherent economic development program, the Syngman Rhee government created various distortions in the economy to produce arbitrage opportunities, and used the discretionary allocation of state-controlled resources to sustain its political supporters. The Student Revolution of 1960 that toppled the corrupt Rhee regime marked the end of this period. The second period (1961-1979) saw Korea adopt an outward-looking state-led development strategy. Park Chung Hee, a military general who took power through a coup, established a government-business risk partnership, combining state protection and control with private entrepreneurship. Although this system contributed to rapid capital accumulation and economic growth, it also led to excessive government intervention and weakened investment discipline.

The policy of liberalization and deregulation adopted in the third period (1980-1997) was born out of the excesses created by the state-led economic development strategy. Yet this policy of loosening, fine-tuning, and ultimately eliminating direct government intervention contained a fundamental flaw: Although the government gradually lifted controls, it failed to remove implicit guarantees that were thought to shield large business groups from the threat of bankruptcy. This policy of de-control without de-protection served as the background of the 1997 crisis, as large business groups freely and aggressively entered into new business lines while discounting downside risks. The fourth period (1998-present) has seen dramatic changes in the assessment of risks in the wake of massive bankruptcies. Korea has finally taken a decisive step toward a full-fledged market economy.

¹⁹ For details, see Lim, Wonhyuk (2000), "The Origin and Evolution of the Korean Economic System," Policy Study 2000-03 (Seoul: Korea Development Institute).

4.1. Colonial Legacy, Crony Capitalism, and General Neglect (1945-60)

In the first period, the government took over a number of formerly Japanese owned enterprises as vested properties.²⁰ Syngman Rhee, Korea's first President, could have used these new SOEs as vehicles for economic development, as in many "mixed economies" around the world at the time. Alternatively, he could have privatized these properties through a competitive bidding process, laying the groundwork for a market economy while maximizing government proceeds from the sale. Rhee's political interest in cementing a close relationship with businessmen, however, precluded either approach. The government instead lowered the requirements for the sale of SOEs to facilitate privatization in favor of the interim plant managers as well as politically well-connected,²¹ and in return for their windfall gains, businessmen made kickbacks to the ruling Liberal Party. The Rhee government typically set the assessed value of the SOEs at 25 to 30 percent of the market value. Moreover, it offered the new owners of these properties generous installment plans when the annual rate of inflation hovered around 30 percent.²² In particular, the sale of banks to industrial capitalists at favorable terms had serious repercussions as the share of loans subsequently extended to the controlling shareholder of these privatized banks exceeded 50 percent.²³

While many SOEs were sold off at generous terms, some remained in government hands. Government enterprises continued to carry out the operation of railroads and communications (mail, telephone, and telegraph), and also collected revenues from the monopoly sale of tobacco, salt, and ginseng. In the banking sector, the Korea Development Bank became the successor to a similar development bank during the Japanese colonial period. In the electric power sector, the Chosun Electric Power Co., Kyung-sung Electric Co., and Namsun Electric Co. took care of generation, transmission, and distribution. Precursors to KEPCO, they were organized as joint-stock companies. In the mining sector, the Daehan Coal Corporation was established in 1950 to manage coal mines that had been taken over by the government as vested properties. SOEs in charge of extracting tungsten, iron, gold and silver also traced their origins to vested enterprises. The same is true of SOEs in the shipbuilding, iron-making,

²⁰ For a detailed account, see Kim, Ky Won (1990), *The Structure of the Economy During the U.S. Military Government Era—with a Focus on the Disposal of Vested Enterprises and Workers' Self-Management Movement* (Seoul: Pureunsan) [in Korean].

²¹ Some of Korea's largest business groups today, including SK and Hanhwa, started out by acquiring vested properties.

²² See Kim (1990), pp.170-174.

²³ Ahn, Dong-won (1993), "The Structure and Characteristics of Financial Capital," in Ki-tae Kim et al., eds., *The Structure of the Korean Economy* (Seoul: Hanul Academy), p.272 [in Korean].

and machinery industries as well as the transportation sector. In fact, the only notable SOEs that were in the process of being newly established during this first period (1945-1960) were chemical fertilizer companies, but due to financing problems, their plants were not completed until the early 1960s.²⁴

Korea's SOE policy in this period was marked by general neglect, much like economic development policy as a whole. Although the government did separate the budget of government enterprises from the general account in February 1950 and established special accounts for transportation, communications, and monopoly (tobacco, salt, and ginseng), few efforts were made to improve the efficiency of SOEs. In fact, in this period, there were no laws and regulations controlling SOEs other than their individual acts of establishment. There was no centralized control (for instance, by the Ministry of Finance), and line ministries were delegated with the task of supervising SOEs. The approval by the supervisory ministry finalized the budget of SOEs. The line ministry, together with the Board of Audit and Inspection, audited the operation of SOEs. Even this ministerial control tended to be on the loose side, although there were variations. Moreover, as there was no performance evaluation mechanism, it was difficult to hold the managers of SOEs accountable for their performance.²⁵ Many of them were making losses, and the three electric power companies, in particular, were on the verge of bankruptcy by the end of the 1950s.²⁶

4.2. Centralized Control by Technocrats (1961-79)

In the second period, the military government led by Park Chung Hee viewed SOEs as important vehicles in carrying out its state-led development strategy. Park's conflict with the United States over the general direction of economic policy as well as his pragmatism, however, prevented him from overly relying on SOEs. In fact, while the Park government had re-nationalized the banks, it did not take over the manufacturing industries. Instead, the government decided to use its credibility to raise capital on the international market and allocate financial resources to private firms contingent on their performance in the global market. As a result, industrial capitalists became agents of the state in carrying out its economic development plans, engaging in a government-monitored contest to secure

²⁴ For an overview of Korea's SOEs prior to the 1960s, see Yu, Hoon (2000), *A Theory of Public Enterprises*, Fifth Edition (Seoul: Beopmunsa), pp.298-328 [in Korean].

²⁵ See Yu (2000), p.472.

²⁶ See Korea Development Bank (1955), *A Ten-Year History of the Korean Industrial Economy* (Seoul: Korea Development Bank) [in Korean]. See also Park, Chung Hee (1963), *The Country, The Revolution and I* (Seoul: Hollym Corporation), pp.46-48.

loans guaranteed by the state. Although they were not formally owned by the government, Korea's largest family-based business groups, or the chaebol, operated like quasi-SOEs in this period under a strong government-business risk partnership.

The Park government established a number of new SOEs in this period, especially in heavy and chemical industries as well as the banking and infrastructure-related sectors.²⁷ Construction work on the chemical fertilizer plants that had started in the 1950s was completed in the early 1960s, and they were reorganized as the Korea General Chemical Company in 1973. In the heavy industry, Pohang Iron & Steel Company was set up in 1968. In the infrastructure-related sectors, the government established the Korea Water Resource Development Corporation in 1967, the Korea Highway Corporation in 1969, and the Korea Land Development Corporation in 1979.

The most significant changes took place in the banking sector, as the government sought to centralize the financial resource allocation mechanism. Besides taking over the commercial banks that had been privatized in the 1950s, it established a number of specialized banks: the Small and Medium-Size Enterprise Bank (Industrial Bank) in 1961, the Kookmin Bank (Citizens Bank) in 1962, the Housing and Commercial Bank and the Korea Exchange Bank in 1967, the Korea Trust Bank in 1968, and the Korea Export-Import Bank in 1969.²⁸

In addition, the legal basis for the holding company function of the Korea Development Bank (KDB) was firmly established with the enactment of the Act on the Administration of the Invested Enterprises of the Korea Development Bank in 1969. The 1969 Act covered those enterprises in which KDB had majority interests, but it did not provide KDB with strong shareholder rights. The Act stipulated that the Invested Enterprise Administration Council, consisting of EPB Deputy Prime Minister, five Supervisory Ministers, KDB Governor, and two civilian experts, make major decisions regarding business and budget plans. Other than sending one or two directors to the board of an invested enterprise, KDB itself had little power over the appointment of directors. Moreover, as KDB subsequently took over a number of distressed companies through debt-equity swaps in different sectors, its effectiveness as a holding company was compromised.²⁹

²⁷ See Kim, Ik-Soo (1984), "The Improvement of the Administration System for Government Invested Enterprises," in *The National Budget and Policy Priorities*, 1984 Edition (Seoul: Korea Development Institute), pp.386-434 [in Korean].

²⁸ For a discussion of changes in Korea's financial system in the 1960s, see Yoon, Seok-beom et al. (1996), *A Study of Korea's Modern Financial History* (Seoul: Sekyungsa), esp., pp.365-380 [in Korean].

²⁹ KDB remains a *de facto* holding company. As of December 2001, included in its consolidated subsidiaries is Daewoo Shipbuilding & Marine Engineering, in which it has a 40.82 percent stake. KDB also has significant equity investments in Daewoo Heavy Industries & Machinery (21.91 percent) and Korea Electric Power Corporation (21.59 percent).

Making a major break from the 1950s, Korea's SOE policy in this period was characterized by its focus on economic development and centralized control, especially by the technocratic, administrative branch of the government. As early as December 1961, the Government Enterprise Budget and Accounting Act was promulgated to have government enterprises adopt modified corporate accounting standards with income statements and balance sheets. Prior to this act, special accounts on government enterprises had basically recorded only cash inflows and outflows with no provisions for changes in asset values (through depreciation, for instance). The government also de-politicized the SOEs' pricing decisions by making it unnecessary to go through the National Assembly. Instead, these prices were determined upon the President's approval after a cabinet review.

In August 1962, the GIE Budget and Accounting Act was enacted, imposing centralized control on government invested enterprises by the Economic Planning Board (EPB). Established a couple of months after Park's coup in 1961, EPB was a super-ministry that took over the budgetary function from the Ministry of Finance and the collection and evaluation of national statistics from the Ministry of Internal Affairs. Staffed with well-educated technocrats, it was in charge of formulating and implementing five-year economic development plans. Under the 1962 GIE Budget and Accounting Act, EPB prepared a common set of budget planning guidelines for GIEs and required them to submit their budget plans to their supervisory ministries, which in turn had to consult with EPB before a cabinet review.

Partly out of inter-ministry rivalry, the Ministry of Finance (MOF) took the initiative in introducing the GIE Administration Act of 1973. The Act included a provision for the Government Investment Administration Committee at MOF. It also specified what had to be included in the articles of association for GIEs and provided a common set of guidelines for the designation, appointment, tenure, and qualification of officers (*imwon*). Moreover, the Act provided a legal basis for MOF to conduct an annual performance evaluation of GIEs.

In short, Korea's SOE policy in this period was marked by strong government intervention. Even procurement and contracting decisions were centralized and handled by the Office of Supply (later renamed the Public Procurement Service). This preoccupation with centralized control by technocrats was partly a response to the general neglect of SOEs in the previous period. Yet intervention by various government ministries severely constrained managerial autonomy and compromised the efficiency of SOEs. In particular, EPB and MOF as well as the Board of Audit and Inspection and supervisory ministries were involved in the external audit of SOEs, forcing their employees to expend an enormous amount of time and energy on paperwork. Also, although a performance evaluation mechanism had been first introduced in 1968 and strengthened in 1973, it

was largely ineffective in this period due to the lack of pre-requisite managerial autonomy on the part of SOEs. Last but not least, retired military officers and bureaucrats were frequently “parachuted” into public enterprises based on political reasons. The recognition of these problems led to significant changes in SOE policy in the next period.

4.3. Liberalization and Deregulation (1980-97)

Korea’s general economic policy of reducing direct government intervention in this period was reflected in its SOE policy as well. The highlight of this period was the enactment of the GIE Administration Basic Act in 1983, which addressed the problems arising from excessive government intervention into the operation of GIEs. The 1997 Act on the Management Structure Improvement and Privatization of Public Enterprises marked the culmination of the trend toward reducing direct government intervention in this period. Yet the government retained its ultimate controlling powers even after the passage of this Act.

4.3.1. Public Enterprise Reform in 1983

Prior to December 1983, a host of laws and regulations had governed GIEs: the 1962 GIE Budget and Accounting Act, the 1973 GIE Administration Act, the Board of Audit and Inspection Act, the Procurement Fund Act, individual company acts of establishment and a number of other acts and regulations affecting business supervision. The 1983 GIE Administration Basic Act consolidated and repealed the first two acts and changed the way GIEs were governed by the others.³⁰ Incorporating the principles of autonomy, accountability, and efficiency, the Act introduced major changes in nearly all aspects of GIE internal management as well as the external supervision of GIEs.³¹

³⁰ See Shirley (1989) and Song, Dae-Hee (1988), “New Korean Public Enterprise Policy and Efficiency Improvement,” Working Paper (Seoul: Korea Development Institute). For a more comprehensive account, see Song, Dae-Hee (1989), *Korea’s Public Enterprise Management Policy* (Seoul: Korea Development Institute) [in Korean].

³¹ In 1979, while many other SOEs were showing poor performance, KEPCO recorded a net income of 130 billion won (approximately 270 million U.S. dollars at the prevailing exchange rate), almost three times the average annual net income of the previous three years. Encouraged by this improved performance, KEPCO made a request to the government for a special bonus. The government was very much interested in using performance-based incentives, but it realized that for such an incentive scheme to work, pricing decisions and other idiosyncratic factors affecting the financial performance of SOEs had to be separated from genuine efficiency gains. Moreover, it felt that KEPCO’s performance should not be an isolated case and the efficiency of SOEs as a whole had to be improved. Prompted by

A. Reducing "Parachute Appointments": Changing the Board Structure

The proponents of the 1983 Basic Act felt that "parachute appointments," combined with multi-layered control by technocrats, presented the biggest obstacle to the performance of public enterprises. Many executives of SOEs at the time were recruited from the outside of the firms based on political reasons rather than managerial skills. In fact, 88 out of 166 officers at 24 GIEs in 1983 had been recruited from the outside.³² These "parachute appointments" lowered the morale of SOE employees, who saw only limited opportunities for promotion and had to begin to look for other jobs once they reached a certain level in the organization.

Article 15 of the 1983 Basic Act required the appointment of executive officers at GIEs be made from employees within the organization. The only exception to this internal promotion rule was the Chief Executive Officer (CEO), who, as before, was appointed for a three-year term by the President at the recommendation of the Supervisory Minister. In other words, the law categorically prohibited outsiders from "parachuting" into GIEs as executive officers below the CEO level (*jiphaeng-kanbu*). This drastic measure blocked the possibility of recruiting capable executives from the outside, but previous experiences with "parachute appointments" under the open system led the government to embrace internal promotion as the lesser of evils.

The government's commitment to a reduction of "parachute appointments" was laudable, but the interests of retired military officers and bureaucrats could not be ignored altogether. The 1983 Act adopted a compromise solution by introducing significant changes in the board structure.

In general, there are two board types. Under the functional-board structure, all members of the board serve as executive officers on a standing basis; whereas, under the policy-board structure, members of the board generally do not hold executive positions at the same time. Prior to the enactment of the 1983 Basic Act, standing, executive boards had formed the basis of the internal corporate governance structure of GIEs. The new law replaced this functional-board structure with a policy-board type, separating the policymaking functions of boards from the implementation responsibility of management.³³

Each GIE board was to consist of no more than 10 members, including the Chairman (*isajang*), the CEO, one representative each from EPB and the

these concerns, the government directed the Korea Development Institute (KDI) to conduct a comprehensive study in 1981. The 1983 Basic Act was born out of this work. Author's interviews with Il SaKong, Dae-Hee Song, and Hoon Yu.

³² See Kim (1984), p.406.

³³ According to Article 9 of the 1983 Act, the new board had the authority to deliberate and resolve matters regarding budget and financing plans, including capital-raising decisions; acquisition or disposition of basic assets and investment in other companies; use of reserve and disposition of surplus; and revision of by-laws and internal regulations.

supervisory ministry, and civilians with expertise in public enterprise management or consumer protection. Like the CEO, the Chairman was appointed by the President. The other board members were appointed by the Supervisory Minister at the recommendation of the Chairman, except for the two government representatives who were automatically appointed. All board members except the CEO were to serve on a non-standing basis. These non-standing board members were to receive neither fixed salaries nor performance-based incentives, but were to be reimbursed only for the actual expenses of carrying out their duties. By reducing pecuniary incentives, this measure sought to discourage “parachute” types from seeking director positions.

The GIE board may be compared with the better-known international benchmarks as follows. In the Anglo-Saxon system, there is a single board of standing and non-standing directors; whereas, in the German dual-board system, there is a management board of standing directors overseen by a supervisory board of non-standing directors. Prior to the enactment of the 1983 Basic Act, the GIE board had fitted neither type, consisting entirely of standing, executive directors. By contrast, the new board resembled the supervisory board in the German system; in that, it consisted entirely of non-standing directors (except for the CEO) and that the CEO and internally promoted executive officers formed a *de facto* management board.

The transformation of the board structure had the effect of separating internally promoted executive officers from non-executive board members, who could be recruited from the outside with much lowered risks for damaging the performance of GIEs.³⁴ In addition, direct government representation on the board had the effect of reducing transaction costs between GIEs and relevant ministries. At board meetings, the government representatives could communicate their concerns directly with the other board members including the CEO.³⁵

Combined with a performance evaluation system focusing on efficiency, this automatic government representation on the board had the effect of making the GIE board similar to the supervisory board in the dual-board

³⁴ The post of the Chairman in particular was subsequently filled with retired military generals and bureaucrats. In fact, the first Chairmen heading the boards at 25 GIEs included: 13 former high-level public officials (Ministers and Vice Ministers, who might also have had a military background), 6 retired military generals, 3 former members of the National Assembly, and 3 former CEOs. See Song (1989), p. 229.

³⁵ Since the government is the controlling shareholder of SOEs, it is entitled to set their managerial objectives and evaluate their performance. In this regard, government intervention in SOE management is inevitable, and it may actually make more sense to reduce transaction costs by having government officials represented on the board instead of having them wield influence from behind the scenes. Of course, far more important than the *mode* of government intervention is its *content*. The key is to have government officials or their agents set managerial objectives based on efficiency considerations rather than political or personal interests. A performance evaluation system mandated by an inter-ministerial council and put into operation by experts may be able to play an important role in this regard.

system. Although these measures to reduce and fine-tune outside influences on GIE management were halfway solutions to the problem, they marked significant progress over the past practices.

B. Streamlining the Budget Planning, Procurement, and Audit Procedure

The 1983 Act also streamlined multi-layered controls by technocrats and gave GIE managers greater autonomy.³⁶ While the government set the objectives for GIEs and rigorously evaluated their performance, it began to refrain from controlling the means through which these objectives were attained.

Prior to the 1983 reform, EPB had announced annual budget guidelines by June 30. Each GIE formulated its budget plan by August 31 and submitted the plan to its supervisory ministry. Although the supervisory ministry was supposed to submit the reviewed budget plan to EPB by September 30, it was typically late and EPB began to inspect the budget plan only after November. Since the GIE budget had to be finalized by the President by December 31 after a cabinet approval, EPB had on average one working day for inspecting the budget plan of each of 24 GIEs. This budget planning procedure was time-consuming and duplicative in many ways. The 1983 Basic Act entrusted GIEs with the authority to finalize their budget plans, subject only to common budget guidelines that were released by October 31. Direct government representation on GIE boards facilitated this change.

The new law also decentralized the procurement procedure. Prior to the 1983 Act, the Office of Supply had handled the procurement and contracting decisions for GIEs. For domestically produced goods, the Procurement Fund Act stipulated that the Office of Supply procure any item over 5 million won (approximately 10,000 dollars at the prevailing exchange rate); for foreign goods, the Office of Supply in principle made all purchases for GIEs. This third-party procurement procedure was rigid and time-consuming. For instance, in 1980, it took more than four months for the Korea Coal Corporation to purchase transformers as it had to respond to the Office of Supply's request to adjust the budget and procurement date.³⁷ The 1983 Act allowed the CEO of a GIE to exercise discretion in purchasing goods, making it optional to turn to the Office of Supply in procurement and contracting decisions.

Prior to 1983, the external audit of GIEs had been conducted by a host of government agencies, forcing GIEs to expend enormous manpower and time in preparing paperwork and responding to questions. KEPCO, for instance, had undergone eight government inspections in 1981 alone, for a total of 108 days. These inspections had induced GIE management to take

³⁶ See Song (1989), pp.114-121 and pp.136-142 for a "before" and "after" comparison.

³⁷ See Song (1989), p.121.

a negative style and play it “safe.” The 1983 Act designated the Board of Audit and Inspection as the sole authorized audit agency. If necessary, the Supervisory Minister was allowed to conduct an audit but only after consultation with the head of the Board of Audit and Inspection. This centralized audit system was in effect until the parliamentary inspection was re-introduced following Korea’s democratization in 1987.

C. Clarifying Managerial Objectives and Linking Incentives to Performance

The 1983 Basic Act established the GIE Management Evaluation Council (MEC), replacing the defunct Government Investment Administration Committee. A ministerial-level council, it was empowered to coordinate major issues, such as guidelines for managerial objectives, budget preparation, performance evaluation, and other matters. Headed by the Deputy Prime Minister, it had representatives from supervisory ministries and civilian experts.

This new umbrella organization significantly strengthened the GIE performance evaluation system.³⁸ The system was similar to those used by large private companies to manage their subsidiaries.³⁹ Outside experts, working with the Performance Evaluation Division of EPB and the GIEs themselves, developed performance indicators that were designed to assess managerial performance by linking them to managerial objectives and by controlling for external factors that management could only take as given. All financial indicators, for instance, were put into constant prices so as to account for the effect of pricing decisions by the government. Public profitability in constant prices was the basic concept on which the performance evaluation system was based.⁴⁰ Standard financial indicators such as ROE were considered inappropriate for public enterprises because

³⁸ For details, see Song, Dae-Hee (1986), “The Performance Evaluation of Korean Public Enterprises: Policy, Practice and Experience,” Working Paper (Seoul: Korea Development Institute).

³⁹ Although many proponents of privatization argue that performance contracts do not work, they should look at the details of contracts see what the real problem is. After all, large private companies use performance contracts to control their subsidiaries. The principal-agent problem that exists in large public and private enterprises is basically the same. If public enterprises can get around the performance evaluation system imposed by the government, private subsidiaries should also be able to get around the system imposed by their parent companies. For a large collection of dysfunctional performance contracts (mostly from less developed countries), see World Bank, 1995, *Bureaucrats in Business: The Economics and Politics of Government Ownership* (Oxford: Oxford University Press).

⁴⁰ Public profit is an indicator that is supposed to increase only when society as a whole is better off. It excludes transfer payments such as taxes and focuses on operating efficiency. To calculate public profit from private profit, taxes, interest expenses, and depreciation charges should be added back to private profit and non-operating income and an opportunity cost of working capital should be subtracted. Public profit is then converted to constant prices using a Divisia index.

they were not profit maximizers.⁴¹

Performance indicators that defined managerial objectives for GIEs consisted of three main categories.⁴² First, General Indicators included some quantitative measures of productivity (or social return on investment) and qualitative indicators of managerial efficiency such as efforts for responsible management. For KEPCO, public profit divided by fixed operating capital was employed as a productivity measure; whereas, for the Korea National Housing Corp., sales divided by operating expenses was used.

Second, Criteria for Carrying Out Establishment Purposes included a number of enterprise-specific, technical indicators that measured operating efficiency. For KEPCO, they included: power plant construction progress rate, utilization ratio of atomic power plants, loss ratio of transmission and distribution, and power failure rate. For the Korea National Housing Corp., the technical indicators included: public housing construction progress rate, share of rental housing in total construction, and housing sales administration rate (i.e., housing units actually sold divided by housing units up for sale). Most of these indicators were evaluated on a target vs. performance basis, with the target value determined through a multi-year time-trend analysis. These enterprise-specific indicators gave the government the means to expose public enterprises to yardstick competition, if needed.

Third, Business Administration Criteria consisted of common indicators on long-term business administration, improvement in administration system, substantiality in internal evaluation, service improvement, and R&D. They were mostly qualitative indicators such as responsiveness to changing business conditions, efficient operation of the board of directors, appropriateness of internal targets, customer satisfaction, and contribution of R&D to performance. In all, qualitative indicators in the three major categories accounted for 30 to 50 percent of the GIE score in the 1980s.⁴³

Interestingly, GIE managers requested the inclusion of a number of specific performance indicators so as to make these targets credible in the eyes of their employees. These targets mostly belonged to Criteria for Carrying Out Establishment Purposes. The result was a proliferation of performance indicators adapted to enterprise-specific conditions. In fact, it

⁴¹ In recent years, the government has increasingly adopted economic value-added (EVA) as a relevant concept in developing performance indicators. In 2001, for instance, the labor productivity of the Korea Minting and Security Printing Corp. was defined as EVA divided by the number of employees.

⁴² See performance indicators for KEPCO in 2001 in Appendix 2.

⁴³ An important part of the grade was based on the experts' qualitative evaluation because it was feared that management, the better-informed party, could achieve a high score by manipulating the quantitative results. Of course, the experts' qualitative evaluation involves subjective judgement and may create its own set of problems. Nevertheless, the weight of qualitative indicators in GIE performance evaluation has been increasing, and is now greater than 60 percent.

was not uncommon for a GIE to have 30 or 40 performance indicators applied to them. Most GIEs established a performance evaluation division to monitor progress in meeting managerial objectives.

Typically, the satisfactory grade for a quantitative indicator was set on the basis of past performance (using a multi-year regression trend or a multi-year Beta-weighted distribution). The bounds on the upper (excellent or good) and lower (poor or deteriorating) grades were defined by historical standard deviations. In other words, if the GIE did what it had done in the past it got the satisfactory grade; if it did better (or worse) by more than could be explained by random luck it got an upper (or lower) grade. By contrast, a simple grade evaluation scheme (e.g., A to E) was used for qualitative indicators. All indicators were weighted and GIEs could receive a total score of up to 100.

The evaluation score for each GIE was then linked to its special annual bonus, which was distributed to all staff. Table 4 shows how much special annual bonus was paid out to GIE employees as a percentage of their monthly salary. The bonus difference between the top and bottom performer was typically equivalent to a month's salary.

Under the new system, the CEO of each GIE submitted the annual report on the previous year's performance to EPB by March 20. The report was to be intensively reviewed by an ad hoc Performance Evaluation Task Force, consisting of academics, researchers, lawyers, and certified public accountants. The Task Force then submitted its final review of the performance report to the MEC by early June. Deputy Prime Minister reported the final result to the President by June 20.

The subsequent release of the GIE Management Performance Evaluation Report received a great deal of publicity, and acted as an additional incentive for managers. In fact, compared with special annual bonus, the loss of face resulting from bad publicity may have been a greater concern for top managers at GIEs.

D. Assessment of the 1983 Reform

Although it is difficult to isolate the impact of institutional changes and control for all other factors, comparative studies and regression tests suggest that the 1983 reform had a positive effect on the performance of GIEs. A study comparing the actual and expected ratio of cost of sales to total revenues in constant prices found that the actual cost ratio was below its expected value (based on regression tests using past averages and trends) in the three years after the new regime was introduced. In 1986, for example, costs were 67.7 percent of revenues for all the GIEs, well below an expected ratio of 73.1 percent based on past performance.⁴⁴ Opinion surveys also showed wide support for the reform. Interestingly, the group

⁴⁴ See Song (1989), pp.175-186. These results are cited in Shirley (1989), pp.29-30.

Table 4. Special Bonus Based on GIE Performance Evaluation (1984-2001)

(unit: percentage of monthly salary)

	'84	'85	'86	'87	'88	'89	'90	'91	'92	'93	'94	'95	'96	'97	'98	'99	'00	'01
Korea Development Bank	250	240	250	240	270	245	240	265	255	255	305	395	375	-	-	-	-	-
Industrial Bank of Korea	250	250	250	270	250	255	230	235	215	275	335	385	345	-	-	-	-	-
Korea Tobacco & Ginseng Corp.	-	-	-	260	260	265	270	275	255	255	295	355	375	-	-	-	-	-
Korea Minting & Security Printing Corp.	250	250	280	220	260	255	220	235	245	235	285	285	395	188	67	209	334	229
Korea Electric Power Corp.	250	250	280	270	260	255	260	285	295	305	335	395	385	325	350	344	358	304
Korea Coal Corp.	250	250	260	220	250	215	190	245	135	265	295	315	295	175	220	240	265	186
Korea Resources Corp.	250	250	250	260	240	245	230	255	265	265	315	395	365	288	302	265	288	245
Korea National Oil Corp.	250	230	250	240	240	255	240	265	275	275	315	385	365	313	290	297	317	254
Korea Gas Corp.	150	270	240	260	270	265	270	265	275	265	275	315	321	-	-	-	-	-
Korea Trade Investment Promotion Agency	200	270	290	290	300	275	280	285	295	295	335	395	349	313	302	294	347	343
Korea Highway Corp.	250	250	240	250	270	275	270	285	275	255	275	265	315	300	299	357	353	343
Korea National Housing Corp.	150	250	280	290	270	275	280	285	295	255	295	345	325	238	229	235	311	342
Korea Water Resources Corp.	250	270	260	280	230	275	250	295	255	255	315	345	345	275	357	357	336	320
Korea Land Corp.	250	280	190	230	220	245	250	225	245	235	295	345	335	288	235	302	355	268
Korea Agr. & Rural Infrastructure Corp.	250	270	270	270	220	235	250	295	295	285	325	385	375	325	310	325	330	309
Agricultural & Fishery Marketing Corp.	200	210	260	250	240	235	240	285	265	275	285	345	335	288	286	258	321	279
Korea Telecom Corp. (KT)	250	250	290	260	250	275	280	275	295	275	305	365	385	-	-	-	-	-
Korea National Tourism Organization	200	240	270	240	250	255	250	285	265	245	275	325	277	250	237	208	323	266
Average	229	252	259	256	253	256	250	269	267	265	330	352	347	344	268	284	326	284
Top - Bottom Difference	100	70	100	70	80	40	90	70	80	70	60	130	100	150	290	149	93	157

Source: Ministry of Planning and Budget (2002)

that expressed the greatest degree of reservation was bureaucrats from supervisory ministries.⁴⁵

4.3.2. Corporate Governance Reform in 1997

Although the 1983 Basic Act represented substantial progress over its predecessors, the corporate governance structure it imposed on GIEs became a subject of increasing criticism. In particular, the largely ceremonial post of the Chairman (*isajang*) came under attack. Moreover, having witnessed other countries privatize their SOEs since the 1980s, some began to call for privatization as the ultimate reform program for Korea's SOEs.⁴⁶ As a result, a couple of notable changes in the corporate governance structure of SOEs were introduced in 1997, near the end of the term for the Kim Young Sam government.

First, the 1983 Basic Act was amended in August to eliminate the separate post of the Chairman. The CEO took over the Chairman's role. The 1983 Basic Act had established the Chairman's post as a compromise solution to deal with "parachute appointments." Since Korea's democratization in 1987, support for its abolition had been gaining ground.

Second, the Act on the Managerial Structure Improvement and Privatization of Public Enterprises was introduced in August as well.⁴⁷ It covered four public enterprises: Korea Telecom (KT), Korea Tobacco & Ginseng (KT&G), Hanjung, and KOGAS. The new law essentially sought to transform more business-oriented public enterprises into ready-for-privatization companies operating on commercial principles.⁴⁸ It changed the legal status of KT and KT&G from public corporation to joint-stock company, abolished their individual acts of establishment, and exempted them from the 1983 GIE Administration Basic Act. Hanjung's legal status did not need to change as it had been a joint-stock company all along, and KOGAS was to remain a public corporation until the completion of the national gas pipeline network.

According to Article 1 of the 1997 Privatization Act, the new law aimed at improving managerial efficiency and pushing ahead with privatization while preventing further concentration of economic power. The concern with the concentration of economic power was prompted by the negative

⁴⁵ See Song (1989), pp.186-202. Asked about the extent of improvement in GIE management, 19.0 percent and 45.4 percent of employees said "by a great deal" and "to a fair degree," respectively, while 28.3 percent responded "so-so" and 4.7 percent and 2.6 percent said "not much" and "not at all."

⁴⁶ See Song (1994) and Samsung Economic Research Institute (1997), *Privatization and the Korean Economy* (Seoul: Samsung Economic Research Institute) [in Korean].

⁴⁷ For a discussion of the background of its enactment, see Nam, Il Chong (2001), "Recent Developments in the Public Enterprise Sector of Korea," Working Paper (Seoul: Korea Development Institute).

⁴⁸ The exclusion of KEPCO and POSCO was rather surprising in this regard.

public attitude toward the *chaebol*, family-based business groups that relied on a controlled pyramid structure to expand rapidly with little capital of their own.⁴⁹ The Privatization Act imposed an ownership ceiling of 7 percent to prevent the *chaebol* from acquiring controlling interests in the public enterprises subject to the Act.

It envisioned an Anglo-Saxon style corporate governance structure, involving active participation by institutional investors with significant but non-controlling interests. Unlike the 1983 Basic Act, the 1997 Privatization Act did not include provisions for automatic government representation on the board by the supervisory ministry and EPB, which had merged with MOF to become the Ministry of Finance and Economy (MOFE) in 1994. The board was to consist of standing and non-standing directors, with a majority of non-standing directors. The Privatization Act also created at each public enterprise a CEO recommendation committee dominated by non-standing directors at each of the public enterprises, which had the authority to draft a management contract for the CEO.

Although the Privatization Act contained a number of detailed provisions to introduce an Anglo-Saxon style corporate governance structure, it had only limited effects on actual practice. The Act covered only four public enterprises. Moreover, it was accompanied neither by a credible program to sell government shares nor by a comprehensive plan to separate regulatory and industrial policy objectives from the business objectives of public enterprises. In fact, the privatization of KOGAS and Hanjung was not to begin until 2003 according to the Act.

Obviously, as long as the government retains a controlling stake, public enterprises remain public enterprises. The supervisory ministry continues to exercise the government's shareholder rights in consultation with MOFE, and unless the attitude of the ministries changes, all the detailed provisions contained in the Privatization Act are unlikely to produce real changes. After all, directors are appointed by shareholders in joint-stock companies, and the government is the controlling shareholder in this case.

4.4. Economic Crisis and Privatization Drive (1998-Present)

The outbreak of the economic crisis at the end of 1997 brought about real changes in Korea's general economic policy. Public enterprise reform and

⁴⁹ For a discussion of the *chaebol* as a corporate form, see Lim, Wonhyuk, Stephan Haggard, and Euysung Kim (2003), "Introduction: The Political Economy of Corporate Restructuring in Korea," in Stephan Haggard, Wonhyuk Lim, Euysung Kim, eds., *Economic Crisis and Corporate Restructuring in Korea: Reforming the Chaebol* (Cambridge: Cambridge University Press).

privatization policy was no exception.⁵⁰ The crisis added a new sense of urgency to privatization policy, as the sale of highly regarded public enterprises was viewed as a way of generating hard currency to service foreign debt. The crisis also led the government to expand unemployment insurance, and made it possible for public enterprises to address overstaffing problems.⁵¹

4.4.1. The 1998 Privatization Plan

The new government headed by Kim Dae-jung drafted a comprehensive privatization plan in the summer of 1998. This plan differed from previous privatization efforts in its ambitious scope and its determination to transfer the control of public enterprises to the private sector, instead of stopping at a partial sale of government shares.⁵²

Table 5. The 1998 Privatization Plan and Its Outcome

Plan	Targeted Public Enterprises	Outcome (as of end-2002)
Early Privatization (5)	Pohang Iron and Steel Co., Ltd. Hanjung Co., Ltd. Korea General Chemical Co., Ltd. Korea Technology Banking Corp. National Textbook Co., Ltd.	sale of state shares completed (Nov. 2000) trade sale to Doosan (Dec. 2000) liquidated (Apr. 2001) trade sale to Mirae & Saram (Jan. 1999) trade sale to Daehan Textbook (Nov. 1998)
Privatization in Stages (6)	Korea Telecom Corp. Korea Tobacco & Ginseng Corp. Korea Electric Power Corp. Korea Gas Corp. Korea Oil Pipeline Corp. Korea District Heating Corp.	sale of state shares completed (May 2002) sale of state shares completed (Oct. 2002) vertical separation in progress listed on the stock exchange (Dec. 1999) sold to an oil consortium (Apr. 2000) Anyang-Bucheon facilities sold (Aug. 2000)

⁵⁰ See Lim, Wonhyuk, Il Chong Nam, and Hyecheon Lee (2000), *Privatization and Combined Heat and Power* (Seoul: Korea Development Institute), pp.21-73 [in Korean].

⁵¹ Between March 1998 and January 2000, the total number of employees at SOEs was reduced from 166,415 to 138,596, or by 19.4 percent, without causing any serious problems.

⁵² In Korea, the government has minority blocking rights through the Securities and Exchange Act. The Enforcement Decree of the Act gives the Finance and Economy Minister the authority to designate as "public-natured corporations" (*konggongjeok-beobin*) those corporations engaging "in an important industry for the national economy" as long as the government has at least a 15 percent equity stake. For such corporations, Article 199 of the Act restricts proxy voting, and Article 200 makes it possible to limit the voting rights of other shareholders to a cap of 3 percent in the articles of incorporation.

As Table 5 shows, the government's plan designated a total of 11 public enterprises for privatization and divided them into two groups depending on the ease with which it was thought they could be privatized. The privatization of public enterprises in network industries such as KT, KEPCO, and KOGAS required accompanying changes in the regulatory system, while KT&G had vested agricultural interests that posed a major obstacle to privatization. These public enterprises were to be privatized in stages. The others were to be privatized as early as possible.

While the government generally sold off smaller public enterprises to private companies in a trade sale, it took various approaches in disposing of government shares in larger ones. For POSCO, the government imposed an ownership ceiling of 3 percent for some time and sold government shares in several tranches, so as to produce a corporate governance structure dominated by institutional investors and strategic partners. The cap on shareholdings was subsequently lifted. State shares in KT and KT&G were similarly sold in tranches but without an explicit ownership ceiling. In the case of Hanjung, however, the ownership ceiling of 15 percent (raised from 7 percent through a 1999 amendment of the Privatization Act) was lifted to allow Doosan to acquire a controlling stake. One of the prominent *chaebol* in Korea, Doosan subsequently engaged in questionable inter-subsidary transactions apparently designed to enrich the founder's family. After Doosan's takeover, labor-management relations at Hanjung also deteriorated to such an extent that one of its workers set himself alight in protest of the company's heavy-handed tactics.

4.4.2. The 1999 Amendment of the GIE Administration Basic Act

Although the sale of government shares and various exemptions had greatly reduced the number of GIEs governed by the 1983 Basic Act, a major amendment was introduced in February 1999. The amendment replaced the GIE Management Evaluation Council with the GIE Administration Council. Headed by the Minister of Planning and Budget (MPB), a new ministry in charge of the national budget and government reform, the Council consists of vice ministers from supervisory ministries and civilian experts. In addition to evaluating the performance of GIEs, it has the authority to appoint non-standing directors and recommend the removal of CEOs and appointment of internal auditors. It also sets guidelines for the newly introduced mandatory disclosure of GIE performance and management.

The 1999 Amendment changed the structure of GIE boards along the line proposed by the 1997 Privatization Act. The board of a GIE is to consist of standing and non-standing directors, with a majority of non-standing directors. As a result, GIE boards no longer have the separation

between standing executive officers and non-standing directors. The Supervisory Minister appoints standing directors while the GIE Administration Council selects non-standing directors at the recommendation of the CEO. As in the 1997 Privatization Act, non-standing directors dominate the CEO recommendation committee, which has the authority to draft a management contract for the CEO. Separate from the performance evaluation of the GIE, its CEO is evaluated each year by the GIE Administration Council based on this management contract.

The Amendment eliminated the provision for automatic government representation on the board. It also abolished the provision for internally promoted executive officers (*jiphaeng-kanbu*), and made it possible to recruit standing directors from the outside. Whether this change represents improvement over the 1983 Act seems to depend primarily on the extent to which “parachute appointments” can be contained. As a result of this Amendment, Korea’s GIE board has become similar to the Anglo-Saxon board rather than the supervisory board of the German dual-board. The upper limit on the number of directors on the board has also been raised from 10 to 15 (including the CEO).

Box 1 shows the evolution of the legal framework for Korea’s public enterprise policy to date. The current corporate governance structure of Korea’s public enterprises may be summarized as follows. The supervisory ministry for each enterprise has the formal authority to exercise the government’s shareholder rights in consultation with the Ministry of Finance and Economy (MOFE), which actually holds the government’s shares. The Board of Audit and Inspection conducts the external audit of public enterprises, and the National Assembly also has the authority to inspect their management.

For government invested enterprises (GIEs), in which the government has a direct majority stake and to which the GIE Administration Basic Act is applied, there is a rigorous system of performance evaluation. The Ministry of Planning and Budget (MPB) heads the GIE Administration Council, consisting of representatives from supervisory ministries as well as civilian experts, which serves as an umbrella organization that coordinates policy and evaluates GIE performance. The GIE Administration Council sets managerial objectives (performance indicators) and links incentives to performance, and, for the most part, gives GIEs the autonomy to choose the best means to meet these objectives. Following the 1999 Amendment of the GIE Administration Basic Act, the board of a GIE has been changed to a type similar to the Anglo-Saxon board from a type similar to the supervisory board of the German dual-board (with automatic government representation on the board). Whether this change represents progress seems to depend on the extent to which outsiders with real managerial expertise, not political connections, can be appointed as directors.

For government enterprises (GEs), government backed enterprises (GBEs), and indirectly invested enterprises (IIEs), there is no centralized

system of performance evaluation. The supervisory ministry is primarily responsible for monitoring their performance.

<Box 1> Legal Framework of Korea's Public Enterprise Policy

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|---|
| <p>1950 Special Account Acts for Government Enterprises: accounting separation of Government Enterprises</p> <p>1961 Government Enterprise Budget and Accounting Act: introduction of corporate accounting standards</p> <p>1962 GIE Budget and Accounting Act (EPB)</p> <p>1973 GIE Administration Act (MOF)</p> <p>1983 GIE Administration Basic Act: separation of internally promoted executive officers and non-standing outside directors (somewhat similar to the German dual board), automatic government representation on the supervisory board, and performance evaluation mandated by the inter-ministerial Management Evaluation Council</p> <p>1997 Amendment of GIE Administration Basic Act: abolition of board chairman post</p> <p>1997 Act on the Management Structure Improvement and Privatization of Public Enterprises: adoption of the Anglo-Saxon board structure, abolition of automatic government representation on the board, and cap on ownership at 15 percent of voting rights for four commercially oriented GIEs</p> <p>1999 Amendment of GIE Administration Basic Act: adoption of the Anglo-Saxon board structure (outside standing directors re-allowed)</p> |
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CHAPTER 5

Case Studies: The Corporate Reform and Privatization of “the Big Six”

This section looks at the company history and corporate governance of six of Korea's commercially oriented public enterprises (“Big Six”): KEPCO, KT, POSCO, KOGAS, KT & G, and Hanjung. KT, POSCO, Hanjung, and KT&G have been privatized in the post-crisis period.

Tables 6 and 7 summarize their performance in 1990, 1995, and 2000. Typical of Korea's public enterprises, they have funded their own business activities and caused no drain on public finance. They have generally outperformed other companies listed on the Korea Stock Exchange, and have become globally competitive firms with a potential for further growth.

5.1. KEPCO

5.1.1. Overview

KEPCO (Korea Electric Power Corporation) is by far the largest electricity supplier in Korea. It accounts for 92 percent of power generation and has a monopoly on transmission and distribution. KEPCO Group, consisting of KEPCO and its subsidiaries, is also the largest business group in Korea with total assets of over 90 trillion won (approximately 75 billion U.S. dollars) on a non-combined basis at the end of 2002.

KEPCO has 12 subsidiaries in all, including six gencos after the vertical separation of its generation division from transmission and distribution division in 2001. KEPCO also has a subsidiary in data network and leased-line services. KEP Data Network Co. provides information and telecommunication services. In addition, KEPCO has an equity stake in the Korea Gas Corporation and Korea District Heating Corporation, although they are not KEPCO's consolidated subsidiaries.

KEPCO traces its origins to three electric power companies during the Japanese colonial era: Chosun Electric Power Co., Kyung-sung Electric Co., and Namsun Electric Co. On July 1, 1961, the government established the Korea Electric Company (KECO) by merging the three companies.

Table 6. Performance of the Big Six

(unit: billion won)

	Year	Assets	Debts	Sales	Op. Income	Interest Expenses	Ord. Income	Net Income
Hanjung	1990	867	819	612	25	45	0.094	-0.901
	1995	2,679	1,835	2,196	178	46	252	173
	2000	3,559	1,892	2,409	83	94	-47	-25
KEPCO	1990	13,598	6,138	5,032	1,216	302	1,017	678
	1995	27,165	14,704	10,015	1,950	621	1,472	938
	2000	64,530	32,695	18,253	3,282	1,337	2,603	1,793
KT	1990	7,776	4,789	3,445	744	0	580	345
	1995	12,334	7,311	6,362	744	40	642	418
	2000	23,233	11,806	10,322	947	332	1,261	1,010
POSCO	1990	9,765	5,196	4,805	254	218	157	161
	1995	13,315	7,254	8,219	1,356	480	1,023	841
	2000	17,767	8,337	11,692	2,099	347	1,331	1,637
KT&G	1990	2,049	290	2,481	169	0	256	199
	1995	3,459	920	3,294	252	0	349	207
	2000	3,827	1,055	1,705	426	0	391	270
KOGAS	1990	491	372	445	32	0	-3	3
	1995	2,448	1,643	1,547	298	49	258	203
	12000	8,402	6,062	6,112	529	297	147	94

Korea at the time was plagued with chronic power shortages, and the government created KECO to improve electric power resource development and to secure stable power supply. Thanks to KECO's efforts, electricity rationing that had been enforced since 1948 was finally lifted in April 1964. The company supported Korea's rapid economic growth by providing a stable supply of electricity.

In January 1982, the government acquired all outstanding stocks and converted KECO from a joint-stock company to a public corporation,

Table 7. Financial Ratios for the Big Six

	Year	D/E	ROE	ROA
Hanjung	1990	1720.8	-1.9	-0.1
	1995	217.4	22.7	7.3
	2000	113.5	-1.5	-0.7
KEPCO	1990	82.3	9.1	5.0
	1995	117.4	8.0	3.7
	2000	102.7	5.8	2.8
KT	1990	160.3	11.6	4.4
	1995	145.6	8.6	3.5
	2000	103.3	8.1	4.3
POSCO	1990	113.7	3.5	1.6
	1995	119.6	14.9	6.5
	2000	88.4	17.7	9.4
KT&G	1990	16.5	11.3	9.7
	1995	36.3	8.3	6.4
	2000	38.1	9.6	7.2
KOGAS	1990	312.1	2.4	0.6
	1995	204.1	29.1	9.4
	2000	259.0	3.9	1.2

renaming it KEPCO. It became a judicial person pursuant to the Korea Electric Power Corporation Act. The Act stipulates that the Ministry of Commerce, Industry, and Energy (MOCIE) exercises the government's shareholder rights in consultation with MOF. As a government invested enterprise (GIE), KEPCO is also subject to performance evaluation mandated by the GIE Administration Basic Act (See Appendix 2.).

In August 1989, KEPCO shares were listed on the Korea Stock Exchange. The government sold 21 percent of KEPCO's stocks to the public as part of its "people's share" (mass privatization) program. In November 1992, foreigners were allowed to acquire KEPCO shares, and in October 1994, KEPCO was listed on the New York Stock Exchange. Table 8 shows how

Table 8. KEPCO's Ownership Structure

	Government	Korea Development Bank	Other Domestic Investors	Foreign Investors
Dec. 1988	100.00	-	-	-
Dec. 1989	77.83	-	22.17	-
Dec. 1997	69.82	5.72	13.90	10.56
Dec. 1999	52.22	2.73	22.69	22.35
Dec. 2001	32.35	21.57	19.55	26.53

KEPCO's ownership structure has changed since 1988. The government and the Korea Development Bank currently have a combined majority stake in KEPCO.

5.1.2. Corporate Governance

KEPCO's corporate governance is defined by the GIE Administration Basic Act, as amended in 1999. The board consists of standing and non-standing directors, with a majority of non-standing directors. The President appoints the CEO at the recommendation of the supervisory ministry (MOCIE). The Minister of Commerce, Industry, and Energy appoints standing directors at the recommendation of the CEO after they are selected at a general shareholders' meeting, and the Minister of Planning and Budget, who heads the GIE Administration Council, appoints non-standing directors. Although the 1999 Amendment removed the provision for automatic government representation, the board consults with MOCIE, the controlling shareholder, prior to making important decisions.

As stipulated in the GIE Administration Basic Act, the board has the authority to make decisions regarding managerial objectives, budget and financing plans, and business strategies. Specifically, it deliberates and resolves matters regarding:

- (1) management objectives, budget, and financing plan;
- (2) use of reserve and budget carry-over;
- (3) settlement of accounts;
- (4) acquisition or divestiture of basic assets;
- (5) plans for acquisition of long-term loans and issuance of company debentures as well as repayment of long-term loans and redemption of company debentures;
- (6) sale price of product or service;

- (7) disposition of surplus;
- (8) investment in other companies;
- (9) revision of by-laws (articles of incorporation);
- (10) enactment or revision of internal regulations;
- (11) other matters deemed necessary by the Board of Directors.

5.1.3. Rationale for Privatization

In April 2001, as part of Korea's electric power industry restructuring program, KEPCO's generation division was vertically separated from its transmission and distribution division and split into six power generation subsidiaries. Except for the hydro and nuclear power company, the other gencos are to be privatized. In July 2002, the government designated Namdong (Southeastern) as the first genco to be sold.

The decision to privatize KEPCO was not due to some serious problems that caused a great deal of inefficiency under state ownership. Empirical studies on the efficiency of KEPCO produced mixed results, but none persuasively demonstrated that KEPCO suffered from serious productivity problems.⁵³ There was, however, some evidence of overstaffing at KEPCO.⁵⁴ A detailed study of KEPCO's management practices in 1996 pointed out internal bureaucracy and rigidity as problems, but even this study did not advocate early privatization. Instead, it suggested that privatization be preceded by industrial restructuring, with Korea's electricity demand likely to increase substantially for more than a decade.⁵⁵

The 1997 economic crisis, however, changed the whole context of the privatization debate as the sale of public enterprises to foreign companies was regarded as one of the quickest means of raising hard currency. KEPCO's increasing foreign debt became a concern, although the debt was largely a result of low electricity rates, which did not allow KEPCO to earn a reasonable rate of return on its investment. Also, the deregulation of the electric power sector in other countries such as Britain provided support to those who advocated early privatization.

⁵³ In fact, according to an empirical study that looked at the total factor productivity (TFP) of 35 major utilities around the world (including those in the U.S., Japan, France, and Italy), KEPCO came in fourth both in the absolute level and the growth rate of productivity. See Kim, Tae-Yoo et al. (1998), *International Comparison of Competitiveness of Electricity Supply Industry* (Seoul: Seoul National University) [in Korean].

⁵⁴ In a 1999 study of the world's 52 major utilities conducted by the Korea Energy Economics Institute (KEEI), KEPCO came in at no. 21 for power generation per employee; no. 27 for electricity sales per employee; and no. 34 for net income per employee. Since utilities in higher-wage countries are likely to optimize by hiring less workers compared with lower-wage countries, however, caution must be exercised in the use of per employee statistics as performance indicators. Nevertheless, KEPCO was widely regarded as having an overstaffing problem in the pre-crisis period. In fact, KEPCO's workforce was reduced from 37,827 in 1997 to 33,745 in 2000 without causing significant operating problems.

⁵⁵ See KIET (1996), *A Diagnosis of KEPCO Management* (Seoul: KIET) [in Korean].

Korea's rapid recovery from the crisis and the California power crisis of 2000, however, have again changed the context of the debate. In particular, the California crisis raised the specter of "strategic withholding" on the part of five generating companies which would control at least 60 percent of the electric power market in Korea after privatization, with little prospect for importing electricity from Russia or China in the near future. It would seem prudent for the government to digest lessons from the California crisis before going ahead with its privatization and deregulation plans and introduce real-time pricing and bilateral contracts to minimize the possibility of price spikes rather than relying on the mandatory pool.⁵⁶

5.2. KT

5.2.1. Overview

KT (formerly Korea Telecom Corporation) is the largest telecom company in Korea. It has a near monopoly on fixed line services. It handles 99 percent of local calls, 83 percent of domestic long-distance calls, and 62 percent of international calls. KT is also the leader in high-speed Internet services with a market share of 50 percent. In the mobile telecom market, however, KT trails SKT, the flagship of SK Group. KT has approximately a third of this market while SKT's market share is around 50 percent.

KT Group, consisting of KT and its 9 subsidiaries, is the sixth largest business group in Korea with total assets of more than 30 trillion won at the end of 2002. KTF (KT Freetel) is KT's mobile phone service subsidiary and is itself registered on the stock exchange (KOSDAQ).

KT started out as a division in the Ministry of Communication (now Ministry of Information and Communication, MIC). In December 1981, it was converted from a government enterprise (GE) to a public corporation and government invested enterprise (GIE). It became a judicial person pursuant to the Korea Telecom Corporation Act.

Until the end of the 1980s, KT had a monopoly in all segments of the telephone service market. In the early 1990s, the Ministry of Communication (MOC) announced plans to deregulate the telecom industry. The Ministry regulated competitive conditions so as to reduce KT's incumbent advantages and give new entrants a chance. More often than not, however, it went far beyond what might be justified as

⁵⁶ See Borenstein, Severin, James Bushnell, and Frank Wolak (2002), "Measuring Market Inefficiencies in California's Restructured Wholesale Electricity Market," *American Economic Review* 92(5): 1376-1405 and Joskow, Paul L. (2001), "California's Electricity Crisis," mimeo.

“asymmetric regulations,” placing KT at a considerable disadvantage against its competitors from the private sector and potentially harming consumer welfare as well.

As a first step, the Ministry allowed a private data service company, DACOM, to enter the international call service market on favorable terms, setting KT’s rates well above DACOM’s. Not surprisingly, DACOM’s market share soared in a relatively short period of time, from 11.9 percent in 1991 to 21.2 percent in 1992. Another firm, Onse, started its international call service in 1997.

In addition, KT was forced to dispose of its mobile phone and paging (beeper) subsidiary, Korea Mobile Telecom (KMT), in 1994. KT had established the subsidiary in 1984 and was getting ready to expand its mobile phone services. SK, one of the largest chaebol in Korea, acquired KMT and turned it into SKT. More scandalously, KT was barred from the then-burgeoning paging market, and was prohibited from re-entering the mobile telecom market until it obtained a PCS license in 1996. The government in effect had clipped the wings of one of Korea’s largest public enterprises in favor of the chaebol.

KT had to start over again and set up another mobile phone subsidiary, KT Freetel, in December 1996. It was faced with brutal competition in a crowded market. Earlier, Shinsegi Telecom had obtained a cellular phone service license, and LG and Hansol obtained PCS licenses in 1996 as well. KT and these three companies were, however, placed at a disadvantage because they had to use CDMA (code-division multiple access) technology, which had not been fully developed, while SKT could use either the old analog standard or CDMA technology.

These experiences led KT employees to wonder about the prospects of the company under continued state ownership. Their change in attitude toward privatization provided support for the move to exempt KT from the GIE Administration Basic Act and place it under the jurisdiction of the 1997 Privatization Act. A sense of crisis among KT employees as well as KT’s good reputation among customers, allowed it to expand its share of the mobile telecom market. In July 2000, KT acquired Hansol’s PCS subsidiary and strengthened its market position.

As Table 9 shows, KT’s ownership structure has drastically changed in recent years. In December 1999, KT shares were listed on the Korea Stock Exchange. In May 1999, KT was listed on the New York and London Stock Exchanges. The government aggressively sold its KT shares in the post-crisis period, and finally in May 2002, completely divested itself of KT. Immediately after KT’s complete privatization, SKT became its largest shareholder with an equity stake of 11.34 percent. The employee stock ownership program (5.67 percent) and Templeton Fund (4.38 percent) were next in line. SKT subsequently sold its stake in exchange for KT’s divestiture from SKT. Their mutual stock ownership had raised antitrust issues.

Table 9. KT's Ownership Structure

	Government	Other Domestic Investors	Foreign Investors
Dec. 1992	100.00	-	-
Dec. 1998	71.20	23.80	5.00
Dec. 1999	58.99	22.30	18.71
Dec. 2001	40.15	22.65	37.20
May 2002	-	51.00	49.00

5.2.2. Corporate Governance

Prior to the 1997 Privatization Act, KT was subject to the GIE Administration Basic Act, and, like other GIEs, its corporate governance was defined by the Basic Act. Under the Privatization Act, KT adopted an Anglo-Saxon type board. The board consists of 7 non-standing directors and 6 standing directors. Non-standing directors includes an industrial engineer, two electrical engineers, two lawyers, a former KT CEO, and a former Vice Minister of Information and Communication. The board has the authority to call general shareholders' meetings, approve the budget and its settlement, effect major changes in the organization (e.g., merger and acquisition); and enact or amend the articles of incorporation and internal regulations.

5.2.3. Rationale for Privatization

Changing competitive conditions in the telecom market had a significant effect on the decision to privatize KT. As long as KT remained a monopoly under state ownership, its employees were not interested in changing the status quo. Customers, for their part, did not complain as long as KT delivered satisfactory services.

The introduction of competition, however, disturbed this equilibrium. To make matters worse for KT, it was placed at a serious disadvantage against new entrants as its ability to set rates and enter emerging market segments was severely constrained. Cream skimming was the result.

KT employees began to regard privatization as a means of putting them on a level playing ground with powerful competitors from the private sector. Rapid changes in information technology (IT) also increased the need to make quick decisions and reduce bureaucracy. The privatization

drive of the Kim Dae-jung government in the wake of the crisis added further momentum.

As a result, KT, which had a market capitalization of more than 13.5 trillion won (approximately 11 billion U.S. dollars), was completely privatized less than three years after its listing on the stock exchange.

5.3. POSCO

5.3.1. Overview

POSCO (formerly Pohang Iron & Steel Co.) is one of the largest steel producers in the world. In Korea, it has approximately 60 percent of the market. Unlike KEPCO and KT, which were essentially state monopolies in network industries, POSCO was exposed to the rigors of global competition from its start.

POSCO Group, consisting of POSCO and its 14 subsidiaries, is the tenth largest business group in Korea with a total asset size of more than 20 trillion won as of end-2002. Compared with KEPCO and KT, POSCO Group is more diversified. The subsidiaries include a construction company, a data-service company, a research institute, and a venture capital fund.

The manner in which POSCO was established as a public enterprise in April 1968 was quite remarkable for a couple of reasons.⁵⁷ First, the investment capital for POSCO's integrated steel mill came from reparations that Japan had agreed to pay in 1965 as a gesture of goodwill for its previous colonial occupation of Korea. POSCO received \$77.2 million from the reparations fund (\$30.8 million without interest and \$46.4 million with an interest of 3.5 percent over 20 years with a grace period of 7 years). The injection of reparations not only helped to reduce POSCO's financial costs, but it also served as a reminder that POSCO was truly a national company built on the past pain and suffering of the Korean people.

Second, the government established POSCO as a joint-stock company rather than a public corporation, and appointed Park Tae Joon, President Park Chung Hee's right-hand man, as its CEO. The government felt that the joint-stock company form offered a degree of flexibility that was needed in a competitive industry like steel. POSCO was subsequently designated as a government backed enterprise (GBE) rather than a GIE. The appointment of Park Tae Joon as CEO signaled that the President himself

⁵⁷ For details on credit policies toward POSCO during its formative years, see Cho, Yoon Je, and Joon Kyung Kim (1997), *Credit Policies and the Industrialization of Korea* (Seoul: Korea Development Institute), pp.118-127.

was paying a great deal of personal attention to POSCO. It was a stern warning for “vultures” to stay away from this treasured enterprise whose success would be essential to the national economy. In fact, for the next 24 years, Park managed POSCO with a single-minded focus on efficiency.

The first phase of Pohang Works was completed in July 1973 with an annual crude steel capacity of 1.0 million tons. When the fourth and final phase was completed in May 1983, Pohang Works had a total capacity of 9.1 million tons. The first phase of Gwangyang Works, another integrated steel mill, began in March 1985, and when its fourth phase was completed in October 1992, POSCO had a total capacity of 20.8 million tons. As of end-2002, POSCO has an annual crude steel capacity of 28.1 million tons.

In June 1988, the government launched its “people’s share” program by publicly offering POSCO’s stocks on the Korea Stock Exchange. Given POSCO’s origins, it was perhaps fitting that the company was designated as the first public enterprise to be offered to the general public. In October 1994 and October 1995, POSCO was listed on the New York and London Stock Exchanges, respectively. POSCO quickly became a very popular stock among foreign investors.

Although the combined equity stake of the government and state-owned banks subsequently fell below 50 percent, the government retained effective blocking rights through the Securities and Exchange Act by designating POSCO as a “public-natured corporation” (*konggonjeok-beobin*). In accordance with Article 200 of this Act, POSCO’s articles of incorporation capped non-government shareholders’ voting rights at 3 percent.

As in the case of other public enterprises, however, the government’s strategy of selling shares but retaining control changed in the post-crisis period. The government pursued privatization as a means of generating hard currency, promoting efficiency, and signaling its commitment to economic reform. POSCO’s privatization was completed in October 2000. Table 10 shows how POSCO’s ownership structure has changed over time. POSCO currently has dispersed ownership with Postech (Pohang University of Science & Technology) as its largest shareholder.

5.3.2. Corporate Governance

Thanks to Park Tae Joon’s special relationship with Park Chung Hee, POSCO enjoyed a degree of autonomy that was rare among Korea’s public enterprises. At the same time, it was subject to global competition, the ultimate form of performance evaluation. These conditions made POSCO very different from GIEs whose corporate governance was defined by the 1983 Basic Act and whose performance was evaluated by the experts.

As long as Park Tae Joon was the CEO, he essentially defined POSCO’s corporate governance no matter what the formal board structure was. His decision to enter politics in the early 1990s, however, shook the foundation

Table 10. POSCO's Ownership Structure

	Gov't	KDB	Other Banks	Korea Tungsten	Postech	Employee Stock Ownership	Other Domestic Investors	Foreign Investors
Dec. 1968	56.2			43.8	-	-	-	-
Dec. 1987	32.3	36.8	25.3	2.4	-	-	-	-
Jun. 1988	20.0	15.0	25.3	2.4	-	10.0	27.3	-
Dec. 1992	20.0	15.0	14.3	0.8	-	8.1	33.8	8.0
Dec. 1997	19.6	14.1	7.7	0.8	-	0.6	32.1	25.1
Dec. 1999	-	9.96	7.90	-	-	-	39.16	42.98
Dec. 2001	-	-	6.73	-	3.24	-	28.02	62.01

of POSCO's management. Following Park's 24-year tenure that ended in 1992, four different CEOs took office within a course of the next six years. More importantly, as Park's political fortunes rose and fell, the fortunes of executives who were thought to be close to him also rose and fell. The least politicized of Korea's public enterprises had become a victim of politics. Eventually, privatization was viewed as a means of de-politicizing POSCO management.⁵⁸

Currently, the POSCO board consists of seven standing directors and eight outside directors. The audit committee consists of four outside directors while the management committee consists entirely of standing directors and reviews the company's human resource management policy. The financial and administration committee, consisting of three outside directors and two standing directors, looks at major investment plans before they are discussed at a full board meeting. The nomination and remuneration committee is also composed of three outside directors and two standing directors.

5.3.3. Rationale for Privatization

Since POSCO's performance put most private-sector companies to shame, typical charges of public sector mismanagement and efficiency arguments for privatization rang rather hollow in POSCO's case. The primary justification for privatizing POSCO instead came from the increasing politicization of POSCO management since Park Tae Joon's

⁵⁸ Korea Development Institute (1996), *A Special Diagnosis of POSCO Management* (Seoul: Korea Development Institute) [in Korean].

venture into politics. POSCO simply could not bear the risks of abrupt management changes if it was to continue to prosper as a world-class steel producer.

An additional reason for POSCO's privatization had to do with trade friction. As a late-comer, POSCO had been able to adopt the most modern facilities and benefit from low wages. POSCO combined these advantages with effective R&D to become one of the lowest-cost steel producers in the world. Because POSCO was a state-owned enterprise, however, competitors in advanced industrial countries accused the Korean government of providing subsidies to create POSCO's cost advantages. For instance, citing POSCO's "unfair" advantages, the United States threatened a Super 301 action in 1995. It was clear that lobbyists for the steel industry would file similar requests with their government as long as POSCO remained a public enterprise. For POSCO to overcome these problems, it had little choice but to sever its links to the government.

5.4. KOGAS

5.4.1. Overview

KOGAS (Korea Gas Corporation) is the state-owned importer and wholesale distributor of LNG in Korea. Unlike in the electric power market, however, retail distribution in the gas market is handled by private-sector companies with a local monopoly. Four business groups (SK, LG, Daesung, and Samchully) have a combined share of more than 80 percent of the retail gas market.

KOGAS Group is the 18th largest business group in Korea with total assets of over 9 trillion won (approximately 7.5 billion U.S. dollars) at the end of 2002. According to the Fair Trade Commission's criteria, KOGAS has only one consolidated subsidiary, Korea Gas Maintenance & Engineering Co. KOGAS, however, has affiliates that participate in the management of overseas LNG businesses with its foreign partners.

The government established KOGAS as a public corporation and GIE in 1983 in an effort to diversify energy sources and enhance energy security in the wake of the second oil crisis. The use of environment-friendly LNG took off in the late 1980s as Korea's per capita income exceeded 5,000 U.S. dollars. As of end-2002, KOGAS has three LNG terminals and operates a nationwide pipeline network in excess of 2,400 km in length.

In 1998, KOGAS was designated as one of six public enterprises to be privatized in stages. In December 1999, KOGAS shares were listed on the Korea Stock Exchange. Table 11 shows how the ownership structure of

Table 11. KOGAS' Ownership Structure

	Government	KEPCO	KOGAS	Employee Stock Ownership	Other Domestic Investors	Foreign Investors
Dec. 1999	26.86	24.46	-	5.52	43.09	0.07
Dec. 2000	26.86	24.46	8.55	5.47	32.42	2.24
Dec. 2001	26.86	24.46	9.65	5.30	28.70	5.03

KOGAS has changed. The government and KEPCO currently have a combined majority stake in KOGAS.

5.4.2. Corporate Governance

Until August 1997, KOGAS was subject to the GIE Administration Basic Act, and like KEPCO, its corporate governance was defined by the Basic Act. MOCIE exercised the government's shareholder rights in consultation with MOF. The 1997 Act on the Management Structure Improvement and Privatization of Public Enterprises changed the legal status of KOGAS from a GIE to a government-backed enterprise and exempted it from the Basic Act. The board structure of KOGAS was subsequently changed to an Anglo-Saxon type consisting of standing and non-standing directors. Under the commercial code, the board has the authority to call general shareholders' meetings, approve the budget and its settlement, effect major changes in the organization (e.g., merger and acquisition); and enact or amend the articles of incorporation and internal regulations. The KOGAS board includes 7 non-standing directors, who have the authority under the 1997 Privatization Act to participate in the CEO nomination committee and evaluate the CEO's managerial performance.

5.4.3. Rationale for Privatization

In November 1999, the government announced a basic plan to restructure the gas industry. According to the plan, the import and wholesale distribution arm of KOGAS is to be broken up into three subsidiaries. Two of these subsidiaries were to be sold to the private sector by the end of 2002. The remaining subsidiary was to be retained by KOGAS for a certain period. Under the plan, KOGAS will continue to be the sole operator of the LNG terminals and pipeline network but allow wholesale distributors open access to its facilities.

The rationale for restructuring the gas industry and privatizing KOGAS was not clearly laid out in the basic plan. In fact, the plan only listed two background factors: (1) other countries such as the U.S. and Britain had restructured their gas industry by introducing deregulation and competition; (2) other public enterprises in Korea had completed privatization or were in the process of being privatized. The restructuring plan leaned on these two “benchmarks” instead of analyzing the characteristics of Korea’s gas industry in detail.

Unlike the U.S. and Britain, however, Korea does not have its own gas fields and must meet all its natural gas demand through imports. It is not at all clear what kind of “competition” can be created in the import segment of Korea’s gas industry by splitting up KOGAS. In fact, unified KOGAS may have a better bargaining position against LNG exporters and obtain better contractual terms. The high credit rating of KOGAS and its status as a public enterprise also tend to reduce the risk premium demanded by LNG exporters. The restructuring plan simply presumed that private LNG importers would be able to negotiate better terms. Combined with these problems, fears of price hikes in the post-privatization period led the National Assembly to put the restructuring plan on hold.

5.5. KT&G

5.5.1. Overview

KT&G (Korea Tobacco & Ginseng Corp.) is a recently privatized company dealing in tobacco and ginseng products. It is the 27th largest business group in Korea with total assets in excess of 4 trillion won. KT&G Group consists of KT&G and its wholly owned subsidiary, Korea Ginseng Corporation, which was spun off from the parent company in January 1999.

KT&G traces its origins to a monopoly agency of the Imperial Household over a century ago. It was a government enterprise (GE) for a long time under the name of the Office of Monopoly. The monopoly profit from the sale of tobacco and ginseng products accounted for more than 6 percent of the total government revenue in the first half of the 1980s.

In 1987, the domestic cigarette market was opened to imports under strong U.S. pressure. To protect Korea’s tobacco farmers, however, the government retained its manufacturing monopoly of cigarettes and agreed to a zero-percent tariff on cigarette imports in exchange. The government apparently wanted to give priority to domestic tobacco leaves in manufacturing cigarettes even though imported leaves would be cheaper. In April, the Office of Monopoly was transformed into Korea Monopoly

Table 12. KT&G's Ownership Structure

	Government	Industrial Bank of Korea	The Export-Import Bank of Korea	Korea Development Bank	Daehan Investment Trust Securities	Other Domestic Investors	Foreign Investors
Apr. 1998	69.80	-	11.25	8.13	-	10.82	-
Dec. 1999	13.83	32.37	11.25	8.14	5.64	25.96	2.81
Dec. 2000	13.83	35.20	7.03	6.90	7.00	25.04	5.00
Dec. 2001	-	29.34	7.03	6.90	7.00	32.88	16.85

Corporation, a public corporation and government invested enterprise pursuant to the Korea Monopoly Corporation Act. It was felt that the organizational rigidity of a government enterprise would be a major handicap under changed market conditions. In April 1989, the name of the company was changed to Korea Tobacco and Ginseng Corporation.

In 1996, the red ginseng market was also liberalized, exposing KT&G to competition in all its major products. Faced with increasing competition, KT&G had to become a more commercially oriented company. The 1997 Privatization Act changed the legal status of KT&G from a public corporation to a joint-stock company. KT&G thus traveled along a similar trajectory as KT, moving from a government enterprise to a public corporation and finally a joint-stock company.

In 1998, KT&G was designated as one of the public enterprises to be privatized in stages. Under this privatization program, KT&G was listed on the Korea Stock Exchange in October 1999. In July 2001, KT&G's monopoly on tobacco manufacturing was finally abolished. The government completely divested from KT&G in October 2002.

5.5.2. Corporate Governance

Like KT and KOGAS, KT&G was subject to the 1983 GIE Administration Basic Act prior to the enactment of the 1997 Privatization Act. Under the Privatization Act, KT&G adopted an Anglo-Saxon type board dominated by non-standing outside directors. The board consists of 9 non-standing directors and 4 standing directors. The board operates outside director and CEO nomination committees as well as audit and administration committees. It also has a public interest committee that deals with business ethics and reviews major issues connected with consumers and tobacco growers. To protect the interests of minority shareholders, KT&G

adopted cumulative voting in 2001.

5.5.3. Rationale for Privatization

Like KT, changing competitive conditions had a significant effect on the decision to privatize KT&G. The opening of the cigarette market in 1987 under duty-free conditions made it imperative for KT&G to operate more like a commercial company. The transformation of KT&G from a government enterprise to a public corporation and ultimately a joint-stock company was prompted by this need. In terms of corporate form, KT&G thus followed a similar trajectory as KT.

5.6. Hanjung

5.6.1. Overview

Hanjung (now renamed Doosan Heavy Industries & Construction Co.) is Korea's sole producer of power plant facilities. Its business areas include nuclear, hydro, and thermal power plants, desalination plants, environmental equipment, material handling equipment, and base material casting & forging. In 2002, Hanjung had total assets of more than 3 trillion won, which would have made it the 34th largest business group in Korea had it been an independent group.

Hanjung traces its origins to Hyundai Yanghaeng, a privately owned company established in 1962 by Chung In Young, a younger brother of the late Hyundai Chairman Chung Ju Young. During the Heavy and Chemical Industry Drive (1973-1979), Hyundai Yanghaeng took advantage of generous policy loans and launched the construction of a gigantic integrated machinery plant complex in Changwon in the southeastern part of Korea. Obtaining cheap credit in return for supporting government policy was the norm among the chaebol in this period. In addition to Hyundai Yanghaeng, Daewoo, Samsung, and Hyundai (led by Chung Ju Young) also entered the heavy machinery industry. The resulting overcapacity led the government to rationalize the industry by consolidating the four companies into two groups in 1979: Hyundai Yanghaeng and Hyundai in one group and Daewoo and Samsung in the other.

In 1980, the new government led by Chun Doo Hwan went for even more consolidation, effectively trying to create a monopoly in each of the troubled heavy industries. It directed Hyundai's Chung Ju Young and

Daewoo's Kim Woo Choong to choose between automobiles and power plant facilities. When Chung chose automobiles, Kim was left with power plant facilities. Yet Kim overreached and tried to extract major concessions in the form of financial assistance. The government grew tired of Kim's demands, and decided to turn Hanjung, the consolidated power plant facilities producer, into a public enterprise. In November 1980, two state-owned banks, the Korea Development Bank (KDB) and the Korea Exchange Bank (KEB), joined hands with KEPCO and acquired Hanjung's shares. KEPCO, Hanjung's largest customer, took a 40 percent stake while KDB and KEB had an equity interest of 44 percent and 16 percent, respectively. Hanjung thus became a public enterprise as a result of the government takeover of a financially distressed private company.

Although the government tried to re-privatize Hanjung through a competitive auction in 1988 and 1989, there were no winning bids. In 1990, the government decided to retain Hanjung as a public enterprise and allow it to have a continued monopoly on power plant facilities. Thanks to this artificially created monopoly, Hanjung began to turn a profit in 1991 and was able to settle all long-term cumulative losses in 1994. In February 1996, the government finally put an end to the industrial rationalization policy and introduced competition into the power plant facilities market. In January 1997, as the WTO Treaty came into effect, this market was opened to foreign firms as well. As overcapacity again became a source of concern in the wake of the economic crisis, however, Hyundai Heavy Industries and Samsung Heavy Industries in December 1999 agreed not to enter the power plant facilities market until 2010.

Table 13 shows how Hanjung's ownership structure has evolved over time. Hanjung was listed on the Korea Stock Exchange in October 2000. The long-awaited privatization of Hanjung was completed in 2001 when Doosan Group acquired the company.

5.6.2. Corporate Governance

Before privatization, Hanjung was essentially an indirectly invested enterprise (IIE) with the government holding no direct equity stake. As such, it was exempt from the GIE Administration Basic Act. Unlike public corporations, it had no individual act of establishment. It was a joint-stock company based on the commercial code. Hanjung's three large shareholders sent their representatives to the board, but it was the Ministry of Commerce and Industry (later Ministry of Commerce, Industry, and Energy) that called the shots. In particular, its support for Hanjung's monopoly on power plant facilities had a great impact on the company's fortunes. KEPCO was not enthusiastic about having to purchase power plant facilities at monopoly prices, but the Ministry intervened to defend the arrangement.

Table 13. Hanjung's Ownership Structure

	KEB	KDB	KEPCO	Doosan Co. & Doosan Construction	Employee Stock Ownership	Other Domestic Investors	Foreign Investors
Dec. 1997	15.70	43.80	40.50	-	-	-	-
June 2001	15.70	31.30	29.00	-	10.00	14.00	-
Dec. 2001	15.74	12.60	-	38.20	-	32.89	0.57

At least on the surface, Hanjung's corporate governance structure was changed with the enactment of the 1997 Privatization Act. The company adopted an Anglo-Saxon style board, with a majority of outside directors. Yet, as in the case of most other public enterprises, genuine changes did not come until it became apparent that the company would be completely privatized.

5.6.3. Rationale for Privatization

Unlike KEPCO and other public enterprises in network industries, Hanjung raised no thorny issues related to regulation and consumer protection in the post-privatization period. After all, Hanjung had started out as a privately owned company, and only the historical accident of financial distress turned it into a public enterprise. The opening of the power plant facilities market also raised awkward prospects of having a public enterprise compete with domestic and foreign private companies. As a result, Hanjung was one of the first companies to be designated for early privatization in the wake of Korea's economic crisis.

CHAPTER 6

Conclusion

Korea's experience offers five general lessons on public enterprise reform: (1) Minimize political interference, especially in personnel and pricing decisions; (2) Clarify the firm's objectives using performance indicators; (3) Increase managerial autonomy to meet these objectives; (4) Evaluate managerial performance; (5) Link reward to performance. These lessons are by no means new or beyond common sense.⁵⁹ The devil is in the details.

Korea learned that neither general neglect nor multi-layered central control provided appropriate incentives to SOE management. Managers had to be held accountable for their performance, but first they had to have the pre-requisite autonomy. The proliferation of state control by a variety of government ministries and agencies was not conducive to managerial autonomy. Moreover, the "parachute appointment" of outsiders to executive positions lowered the morale of SOE employees.

To address these problems, Korea streamlined various controls and established an inter-ministerial council to evaluate SOE performance on an annual basis. Civilian experts worked with government officials and SOE managers to develop both general and enterprise-specific performance indicators that clarified managerial objectives. The payment of special annual bonuses was linked to performance. Based on efficiency principles, this set of performance indicators had the effect of checking managers as well as bureaucrats and politicians from pursuing their narrowly defined private interests.

Under this overarching structure, Korea introduced a German-type dual-board at each SOE. The CEO formed a virtual management board with internally promoted executive officers. The supervisory board consisted entirely of non-standing directors (except the CEO), including representatives from the supervisory ministry and the Economic Planning Board. The separation of internally promoted executive officers and non-standing outside directors was designed to reduce "parachute appointments."

Other than the management evaluation council at the inter-ministerial level and the dual-board at each SOE, the Korean government did not

⁵⁹ See, for instance, Shirley, Mary M. (1983), "Managing State-Owned Enterprises" (Washington, D.C.: World Bank).

introduce a second tier of institutions. In fact, it is generally not a good idea to aggravate the principal-agent problem by introducing another layer of control (for example, through public sector holding companies). To improve the performance of SOEs, the principles of efficiency, autonomy, and accountability are far more relevant than the establishment of new institutions.

While reforming the internal operation of public enterprises, Korea also made efforts to build market institutions and expose public enterprises to real or yardstick competition. POSCO, for instance, was exposed to the rigors of global competition from the start. These efforts to strengthen market-based incentive laid the groundwork for privatization in the post-crisis period.

The economic crisis added a new sense of urgency to privatization policy, as the sale of highly regarded public enterprises was viewed as a means of generating hard currency and securing foreign investors' confidence in Korea. The implementation of institutional reforms to reduce moral hazard, improve corporate governance, and enhance competition also supported the privatization drive.

As the crisis put a serious dent in the *chaebol's* claim for superior efficiency, most of the privatization plans for large-scale public enterprises were drafted with a view toward establishing Anglo-Saxon style corporate governance. In fact, the privatization of POSCO, KT, and KT&G proceeded along this line.

In addition, there was an increased awareness of the importance of competition and regulation in the process of privatization. In particular, the sale of co-generation facilities in Anyang and Bucheon without an appropriate transformation of regulatory policy led to significant hikes in heating bills and subsequent consumer complaints. Through this experience, the government learned an expensive lesson that the introduction of the profit motive through privatization should be accompanied by substantive competition or regulation if it is to lead to improved consumer welfare.

This lesson should not be lost on policymakers. Of the eleven public enterprises targeted for privatization in 1998, only three remain public enterprises, in electric power, gas, and district heating sectors— all network industries where competitive market design and regulation are of crucial importance. In order for privatization to improve efficiency and consumer welfare, it should be a component of a comprehensive program to enhance the operation of market forces.

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Appendix 1. Korea's Public Enterprises by Order of Asset Size (1986)

Government Enterprise (GE)	Asset (bil. Won)	Employees (#)	Supervisory Ministry
Office of Railways	3,298	28,653	MOT
Ministry of Communication	2,908	34,063	MOCM
Office of Monopoly*	2,245	11,500	MOF
Office of Supply (Procurement)	54	1,143	MOF
Office of Grain Management	1	1,160	MOAF
Sub-Total	8,507	76,519	
Mil. US\$	10,737		

Government Invested Enterprise (GIE)	Asset (bil. Won)	Employees (#)	Supervisory Ministry
Korea (K.) Development Bank	15,342	1,960	MOF
K. Electric Power Corp. (KEPCO)	12,570	25,215	MOER
K. Telecom. Authority (KT)	5,594	51,432	MOCM
Citizens National Bank	5,355	11,212	MOF
Small & Medium Industry Bank	5,051	7,849	MOF
K. Housing Bank	3,440	7,824	MOF
K. Housing Corp.	2,340	2,506	MOCN
Ind. Site & Water Resource Dev.	1,582	1,687	MOCN
K. Land Develop. Corp.	1,290	1,213	MOCN
Agri. Promotion Corp.	762	1,855	MOAF
K. Gas Corp.	480	658	MOER
K. Highway Corp.	463	2,718	MOCN
K. Coal Corp.	459	14,569	MOER
K. Broadcasting system	335	5,193	MOCI
Agri. & Fishery Mktg Corp.	203	652	MOAF
K. Tourism Corp.	124	638	MOT
Government Mint	120	2,748	MOF
K. Mining Promotion Corp.	118	462	MOER

Government Invested Enterprise (GIE)	Asset (bil. Won)	Employees (#)	Supervisory Ministry
K. Integrated Chem. Stock com.	104	46	MOC
Petroleum Development Corp.	101	428	MOER
Labor Welfare Corp.	67	1,425	MOL
K. Securities Exchange	29	344	MOF
National Textbook Com.	25	487	MOE
K. Trade Promotion Corp.	11	567	MOC
Overseas Development Corp.	4	197	MOL
Sub-Total	55,970	143,885	
Mil. US\$	70,642		

Government Backed Enterprise (GBE)	Asset (bil. won)	Employees (#)	Supervisory Ministry
K. Exchange Bank	19,217	7,460	MOF
Pohang Iron&Steel (POSCO)	4,480	18,926	MOC
Ex-Im Bank	3,954	463	MOF
K. Tungsten Mining	53	1,989	MOF
K. Appraisal Board	20	983	MOF
K. Tech. Dev.	7	91	MOST
Sub-Total	27,730	29,912	
Mil. US\$	35,000		
Grand Total (including subsidiaries)	98,688	294,739	

Notes on Supervisory Ministries:

MOF : Ministry of Finance

MOAF : Ministry of Agriculture & Fishery

MOER : Ministry of Energy & Resource

MOT : Ministry of Transportation

MOCM : Ministry of Communication

MOST : Ministry of Science & Technology

MOE : Ministry of Education

MOC : Ministry of Commerce & Industry

MOCN : Ministry of Construction

MOCI : Ministry of Culture & Information

MOL : Ministry of Labor

* Office of Monopoly became Korea Monopoly Corporation (GIE) in 1987.

Source: Adapted from Shirley (1989), pp.42-44.

Appendix 2. Performance Indicators for KEPCO in 2001

Indicator Category	Indicator <Quantitative Indicator Formula>	Evaluation Method	Weight (%)
1. General Management			<30>
	◦ Efforts to Show Responsible Management and Enhance Public Welfare	9-Grade Evaluation	8
	◦ Efforts to Carry Out SOE Restructuring and Management Innovation Plans	9-Grade Evaluation	4
	◦ Proper Administration of the Board of Directors	9-Grade Evaluation	3
	◦ Labor Productivity $100 \times (\text{Actual Performance} - \text{Min. Target}) / (\text{Max. Target} - \text{Min. Target})$	Target Assignment	5
	◦ Productivity of Fixed Operating Capital $100 \times (\text{Actual Performance} - \text{Min. Target}) / (\text{Max. Target} - \text{Min. Target})$	Target Assignment	5
	◦ Customer Satisfaction Improvement <Previous Year's Performance + (100-Previous Year's Performance) x 10%>	Target vs. Performance	3
	◦ Efforts to Improve Customer Satisfaction	9-Grade Evaluation	2
2. Primary Business Areas			<35>
A. Electricity Demand Management	◦ Rational Demand Management	9-Grade Evaluation	4
	◦ High Load Factor (Target: 71.1%)	Target vs. Performance	3
	◦ Improvement of the Rate Structure	9-Grade Evaluation	4

Indicator Category	Indicator <Quantitative Indicator Formula>	Evaluation Method	Weight (%)
B. Transmission & Distribution	◦ Transmission Cost Management <(Transmission Cost / Transmission Volume) = $f(\text{Hours})$ >	15-Year Trend	3
	◦ Distribution Cost Management <(Distribution Cost / Sales Volume) = $f(\text{Hours})$ >	15-Year Trend	3
	◦ Regular Voltage Management (Performance/Target) × 100-94.3 5.7	Target Assignment	3
	◦ Appropriateness of Transmission & Transformation Facilities Plan and Operation	9-Grade Evaluation	4
	◦ Appropriateness of Distribution Facilities Plan and Operation	9-Grade Evaluation	4
	C. Others	◦ Strengthening of Safety Management Activities	9-Grade Evaluation
◦ Sales Volume Per Employee		Target vs. Performance	3
3. Business Administration			<35>
A. Human Resource Management			
(1) Organization and Personnel	◦ Rationalization of Organizational Management	9-Grade Evaluation	3
	◦ Rationalization of Personnel Management	9-Grade Evaluation	2
(2) Remuneration and Labor-Management Relations	◦ Rationalization of Labor Cost Management - Quantitative Labor Cost <Labor Cost Per Employee = □ (Sales)>	9-Grade Evaluation	5 (2)
	◦ Rationalization of Labor-Management Relations	15-Year Trend 9-Grade Evaluation	2
(3) Internal Evaluation	◦ Reasonableness of Internal Evaluation and Appropriateness of Its Operation	9-Grade Evaluation	3

Indicator Category	Indicator <Quantitative Indicator Formula>	Evaluation Method	Weight (%)
B. Finance and Budget Management	◦ Corporate Finance Policy	9-Grade	6
	- Efforts to Reduce Financial Costs and Improve Financial Structure	Evaluation	(2)
	<Financial Costs = □ (Average Borrowings)>	9-Grade	5
	◦ Budget Administration	12-Year Trend	(2)
	- Quantitative Administration Cost	9-Grade	
C. Other Business Administration	< Quantitative Administration Cost Per Employee/Sales = □(Hours)>	Evaluation	
		15-Year Trend	
	◦ Efficiency of Business Information Management	9-Grade	3
		Evaluation	
	◦ R & D	9-Grade	3
		Evaluation	
	◦ Management of Invested Companies	9-Grade	3
	Evaluation		
		Quantitative	34
		Qualitative	66
		Total	100