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The Nature of *Chaebol* Restructuring:
Two Lessons from Professor Coase*

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In this article, the firm theory, originally suggested by Coase (1937), is extended to build up a theory of business groups in which a diversified network of closely linked subsidiaries are internalizing their transactions across a wide range. In particular, we pay attention to the major changes in the transaction costs of running the chaebol form of organization, which is internalizing necessary transactions in a group. At the same time, some core changes in markets and institutions are identified that collectively act to make market transactions cheaper to use. Focusing on the changes in the relative costs of using the chaebol vs. markets, we can make some inferences about how the chaebol will reshape in strategy, and capital structure, and other features in the aftermath of the IMF crisis. Another Coase (1960) insight shows us the proper role of the state in correcting the external costs caused by the chaebol: to set up an efficient structure of property rights. Applying this idea to the policy of corporate restructuring, we suggest a market-driven solution to the chaebol problems: to reduce the costs of using the market through institutional reform. Instead of directly intervening in the market as in big deals (or large-scale business swaps), the government needs to remove regulatory hurdles and uncertainty that prevent Coasian bargaining from striking in the market.

Keywords: Coase, chaebol, restructuring, transaction costs

1. INTRODUCTION: EXTENDING COASE'S FIRM THEORY TO EXPLAIN THE *CHAEBOL*

Coase (1937) argued in "The Nature of the Firm" that there were costs associated with the use of the price mechanism. For example, the prices available have to be discovered, negotiations must be undertaken, contracts have to be drawn up, inspections have to be made, and arrangements have to be agreed upon to settle disputes, and so on. These costs have come to be known in the economic literature as "transaction costs"[1] in using markets.

> Their existence implies that methods of coordination alternative to the market, which are themselves costly and in various ways imperfect, may nonetheless be preferable to relying on the pricing mechanism, the only method of coordination normally analyzed by economists. It was the avoidance of the costs of carrying out transactions through the market that could explain the existence of the firm in which the allocation of factors came about as a result of administrative decisions (Coase 1992: 715).

He insisted that the internal firm transaction, as an alternative coordinative device, is preferred to market transactions in terms of transactions cost saving. Extending the Coase's

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[1] Coase's original article (1937) defines transaction costs as the costs of using the price mechanism, the costs of carrying out transactions by means of an exchange on the open market, or simply "marketing costs".

theory of the firm out into a more general context, one can make a "theory of *chaebol*" to make good conjectures about how they, as multi-firm enterprises, have grown so far and how they will evolve in the future. How do the business groups determine what to produce? Here Coase's (1937) argument – firms exist only where they perform better than the market can – can be, without big modifications, applied to the explanation of how the *chaebol* have grown into what they are now.

So far the c*haebol* have been discussed in a number of studies including Jwa (1998), Hwang (1999), Lee (1999, 2000), Chang and Park (2000), and Chang (2002). Summing up their studies, one can conclude that the *chaebol* are family-owned and -controlled (corporate governance structure), highly diversified (business structure), and heavily debt-leveraged (capital structure). In more detailed examination, they would be characterized by the following factors.

- Their economic concentration is noticeable.[2]
- They are conglomerates of many companies.[3]
- They tend to spread across industries.
- Their companies hold shares in each other.[4]
- They are more dependent upon centralized control than the Japanese *keiretsu*.[5]
- Unlike the *keiretsu*, most *chaebol* do not own a bank, but have other financial institutions such as securities and insurance companies.[6]
- They are highly debt-leveraged.[7]

Why have Korean big businesses with few exceptions embraced these unique properties, and why have they prospered in Korea? To determine the relative efficiency of *chaebol* vs. market governance, one must compare their relative transaction costs. This dichotomy of market vs. *chaebol* gives a clue as to our understanding of why the *chaebol* have grown into a federation of subsidiary companies, which controls a diversified business scope. Some groups operate as holding companies with full or partial ownership in many enterprises, others are collections of closely linked subsidiaries, but all have some degree of central control just like in a multi-divisional company.

For markets to work properly, it is imperative that each country should have well-established market-supporting institutions. In other words, for market governance to dominate firm (or *chaebol* in our context) governance, the costs of using price mechanisms should be lower than those of using internal organizations such as Korean business groups. In the same context, Khana and Palepu (1997) point out that western companies take for

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[2] According to the Korea Development Institute, the top 3-*chaebol*s account for 40% of Korea's output in the mining and manufacturing sectors as of 1996.

[3] The largest *chaebol*, Samsung owns 63 subsidiaries according to a report by the Fair Trade Commission as of April in 2002.

[4] Subsidiaries of the largest 30 *chaebol* own 44.1 % of the total equities through share interlocking as of 1999.

[5] *Chaebol* chairmen and their relative successors hold just 5.4% of the total equities but actively engage in the management. In Japan, however, such large shareholders have almost disappeared owing to equity dilution.

[6] The Largest *chaebol*, Samsung owns 9 financial companies including Samsung Life Insurance Inc. and Samsung Securities Inc. as of April in 2002.

[7] Until the foreign exchange crisis in 1997, on average the debt-to-equity ratios of the top 30 *chaebol*s hiked up to above 500%.

granted a range of institutions that support their business activities, but many of these institutions are absent in emerging markets.[8] It is this difference in the institutional context that explains the success of large, diversified corporations in developing countries such as Korea and their failure in advanced economies. So far, Korean conglomerate groups have added value by imitating the functions of several institutions that are present only in advanced economies. In other words, they have necessarily "internalized those functions in a group system" that would have been "outsourced from markets" in advanced economies like the United States.

In this paper, we focus on the changes in the relation between internal chaebol transactions and market transactions, especially in the aftermath of the 1997 Korean economic crisis. We want to characterize some of primary market and institutional reforming measures, which act to shift upward the costs of using a *chaebol*'s internal organization while shifting downward those costs of using independent markets. This characterization can enable us to make many valuable predictions about the Korean business groups. To survive, they will have to adjust to these changes in terms of their relative prices. They need to totally reshape themselves to save transaction costs in almost all aspects including organization, capital structure, and management strategy. The changes in the *chaebol*'s business conditions and their optimal response during the period of 1997~2001 will be discussed in detail in the article. In Chapter 1, we introduce Coase's papers and the insights we take, and explain why the Coase insights are valuable enough to guide us to an efficient *chaebol* restructuring and public policy. In Chapter 2, sets of core changes in markets and institutions, which are shifting upward the *chaebol*'s costs of internal organizations, are identified and examined in details. Based on these findings, we can make predictions on how they will react and reshape themselves in their business strategy, debt structure, and governance system. When transaction costs using markets vis-à-vis organizations were higher, internal trade among subsidiaries would be cheaper than independent market trades. With some knowledge on how severely the relative transaction costs of using market vis-à-vis firm (*chaebol*) organization have changed since the 1997 economic crisis, one can infer the way they will evolve in the future. In Chapter 3, following Coase's (1960) insights, the *chaebol* restructuring policies, mainly driven by the government, are critically evaluated and a market-driven restructuring policy is suggested as an alternative. To justify this argument, a case study of the "big deal" program is carried out. Chapter 4 summarizes the main arguments of this article.

2. THE CHANGES IN THE *CHAEBOL*'S BUSINESS CONDITIONS AND THEIR RESPONSE

2.1. The Changes in the Transaction Costs of Using the *Chaebol* Mechanism

Since the aftermath of the IMF crisis, many institutional reforms have been implemented. As a result, in many areas such as capital, product, corporate control markets, and the

[8] Without effective securities regulation and venture capital firms, for example, focused companies may be unable to raise adequate financing; and without strong educational institutions, they will struggle to hire skilled employees. Communicating with customers is difficult when the local infrastructure is poor, and unpredictable government behavior can stymie any operation. Although focused strategy may enable a company to perform a few activities well, companies in emerging markets must take responsibility for a wide range of functions in order to do business effectively (Khana and Palepu 1997: 41).

regulatory system for corporate governance, a lot of improvements have been made. All or most of changes in institutions have been directed toward shifting the balance of the system in favor of “market transactions” as opposed to the “internally organized transactions” of the *chaebol* mechanism. In the following, such institutional changes and their impacts on the *chaebol* are discussed in more detail, particularly in capital and product markets, and the market for corporate control.

2.1.1. Capital Markets and Corporate Finance

It is the capital market that has been reshaped most drastically since the 1997 economic crisis (World Bank 2000). Now the large *chaebol* are expected to relinquish the benefits they used to enjoy in the capital market just because they were big. To lower their credit concentration and risks, banks are determined to gradually reduce the proportion of their loans that go to the large *chaebol*. In fact, since 1998 they have not increased loans to big businesses and they have actually reduced the big business share of the total.

Table 1. Bank Loan Proportion by Debtor Type

(100 Mill. Won)

Year	Big enterprise	SMEs	Households	Total
1997	601,262(30.0%)	817,492(40.8%)	585,257(29.2%)	2,004,011
1998	641,620(32.0%)	806,055(40.2%)	555,216(27.7%)	2,002,891
1999	718,713(28.7%)	992,403(39.7%)	791,259(31.6%)	2,502,401
2000	861,320(27.7%)	1,157,271(37.2%)	1,089,450(35.1%)	3,108,041
2001	703,035(19.7%)	1,294,693(36.2%)	1,576,107(44.1%)	3,573,835

Source: Seoul Securities, *Report*, 2002-c-017.

In judging whether a debt is good or bad, banks no longer depend on whether or not debtors can pay the interest. Instead, they are more concerned about forward-looking criteria such as growth potential or long-term profitability. This new practice, initiated by the Financial Supervisory Commission, has had a very detrimental effect on debt-ridden *chaebol* with low profitability. *Chaebol* of the same size are now being given quite different credit ratings. In the past, this credit discrimination occurred only between the big businesses and the SMEs. Presently, however, it is happening even among the large *chaebol*.

The capital market is already factoring in theses changes. Its evaluations of corporate restructuring performance vary widely across the *chaebol*. Business groups, which have successfully carried out restructuring plans on schedule, enjoys lots of benefits, such as increased share prices and also lowered interest payments on loans, bonds, and commercial papers. Exactly the opposite happens, however, to the *chaebol* considered as having failed in restructuring. In this respect, to restore their downgraded credibility in the market, those *chaebol* have no alternative but to show some positive restructuring results.

Non-bank financial institutions (NBFI) owned by the *chaebol* will not be able to escape special audits by regulatory authorities and more stringent monitoring by independent directors. Once regarded as a financial vehicle and "internal capital markets" [9] within the *chaebol*, the *chaebol*-owned NBFIs will have to establish a special kind of board of directors where outside directors must represent more than half of the total. They must keep more stringent disclosure rules, providing more information on investment and asset management to the public.

If a *chaebol* failed to lower its debt-equity ratio below 200%, what sanctions might be imposed against it? Banks can cut or withdraw their loans. They can also put the *chaebol* into a so-called workout program. But the harshest penalty is likely to come from the capital market itself. The fact that business groups fail to fulfill their agreement with main banks may trigger a severe credit crunch. This indicates that "penalty by the market" could be much more painful than "penalty by the government."

Table 2. Change in Asset, Equity, and Debt of the Big 30 Business Groups

(Bill. Won)

	Year	Asset	Equity	Debt	Debt / Equity (%)
Total*	1998	366.5	79.2	287.3	363.2
	1999	374.8	141.9	232.9	164.1
	Change	8.3	62.7	Δ 54.4	Δ 199.1
Big 4 groups	1998	227.7	53.1	174.6	328.8
	1999	237.7	96.5	141.2	146.3
	Change	10.0	43.4	Δ 33.4	Δ 182.5

Note: *: Total indicates 27 groups' sum, omitting the other 3 groups under dismantling process.
Source: Fair Trade Commission, each year, *White Paper*.

Since 1997, big businesses have endeavored to reduce their debt-equity ratio. As of the end of 1999, *chaebol* units succeeded in lowering the debt equity ratio to 164.1%, which is below the government set guideline of 200%. However, it was not only real decline in the amount of debt, but also the increases in the cross-ownership of equity that contributed to this lowering of the debt-equity ratio. In order to complete the debt restructuring, the *chaebol* still need to reduce a more significant amount of debt.

2.1.2. Product Market and Foreign Competition

In accordance with the IMF conditions for bailout fund provisions, the import source diversification policy (ISDP), whose main purpose was to restrain the excessive import of

[9] Williamson (1975, 1996) explains the benefits and costs using the internal capital markets relative to external capital markets.

Japanese products, has been curtailed since July 1, 1999. However, ironically the primary beneficiaries are not American but Japanese exporters that have a better reputation in Korean.[10] Many high-tech products, such as Japanese cars and electric appliances, are now being imported on a larger scale. Imports from Japan of the 48 goods, whose importation had been restricted under the ISDP, have noticeably increased, widening Korea's trade deficit with Japan.

Table 3. Imports from Japan of the 48 Goods*

Year	1998	1999	2000	2001
Amount (mil. $)	225	460	790	642
Ratio (%)**	28.1%	34.0%	41.3%	35.6%

Notes: (i) *: Those goods can be imported without restriction since the lifting of the ISDP. (ii) **: The ratio indicates the ratio of imports of the 48 goods to total imports from Japan.
Source: Korea Customs Service, June, 2002.

Manufacturing units of the *chaebol*, who used to benefit from monopolistic positions in domestic markets, are losing a significant share of the market due to their lack of competitiveness. The opening up of product markets has a significant impact on the diversification strategy of Korean corporations. Now, they need to scale down their business scope and sell-off or close divisions that do no longer have international competitiveness.

2.1.3. Market for Corporate Control and Corporate Governance

One of the remarkable changes in the aftermath of the IMF crisis is the increasing participation of foreign investors in Korean firms. In particular, FDI (Foreign Direct Investment) presents a rapid but lasting means of placing Korea's corporate sector on a stronger footing. In 1999 alone, Korea attracted a record $15.5 billion in FDI. Several of the mistakes made by the *chaebol* that led to the economic crisis in 1997 have been sold to foreigners. FDI can help Korean companies improve their balance sheet as well as provide advanced managerial practices, which are the primary objectives of corporate restructuring (Beck 2000).

Due to the lifting of investment restrictions for foreigners, blue chip shares owned by foreign investors are gradually increasing.[11] In particular, their investments are concentrated in *chaebol* holding companies, leading domestic banks, and high-tech companies. In some companies, foreign investors' equity share has already surpassed half of the total, emerging as a potential threat to incumbent corporate managers (and owners).

Foreign institutional investors often make strategic alliances with domestic non-

[10] For example, with the removal of Korea's import diversification policy, Sharp, Japanese electronics maker, has gained the opportunity to expand its business in the country, and established a new sales base in 28 July, 1999.

[11] For example, as of 14 June, 2002, foreign investors hold 53.22% of Samsung Electronics shares, 67.17% of SK Telecom, and 71.91% of Kookmin Bank.

governmental organizations (NGO), calling for more transparency in the management and accounting practices of the *chaebol* (*Financial Times* 4 May, 2000)[12]. Sometimes, they do not have a direct interest in corporate control, but existing management cannot disregard their voice because they own a high proportion of the shares.

Other important factors in fundamentally transforming corporate governance in the c*haebol* are the more frequent investigations and sanctions imposed by the government (the Fair Trade Commission) against illegal cross-affiliate transactions. Intra-group trading in the product and financial markets was taken for granted before the late 1990s. Nowadays, however, the FTC has expanded the scope of that internal trade which can be judged illegal, and even considers any transaction that deviates from market prices to be illegal. The FTC prosecuted the big 5 *chaebol*s and fined them 214.5 billion won in total for illegal internal trading during the period 1998~2000.

Table 4. Illegal Internal Trades and Fines Charged of the largest 30 *Chaebol* (1998~2000)

	Big 5 groups	**Big 6~30 groups**
Illegal trades (trill. won)	20.3	6.5
Fines (100 mill. won)	2,145	303

Source: Fair Trade Commission, each year, *White Book.*

This "get-tough" policy initiated by the FTC is expected to continue. In addition, even applying the rule of reason[13] to the challenged internal deals will not refute the FTC's charges. As a result, the *chaebol* have no choice but to adopt a new group governance system that must necessarily satisfy both efficiency and legitimacy conditions.

Despite much stronger legal protections erected for the benefit of outside investors, foreign investors still eye have a skeptically this practice of "intra-group buying and selling." Such deep-rooted distrust is revealed clearly in the fact that, in choosing companies in which to invest, foreign investors put a higher priority on the degree and depth of transparency within a company's management structure rather than the actual performance as reflected in financial reports. A survey by Mckinsey & Company (2002) confirms that good governance will help to attract more long-term capital from foreign investors, and that corporate governance is more highly correlated with bond premiums in Korea than in the United States.

2.2. *Chaebol*'s Restructuring in Response to the Changing Transaction Costs

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[12] In its struggles against SK Telecom and Samsung Electronic, PSPD (The People's Solidarity for Participatory Democracy) led the campaign demanding more transparency and stronger minority shareholder rights, together with foreign institutional investors such as Tiger Fund and Templeton Group, which are very unlikely partners.

[13] The rule of reason is a legal rule under which the FTC takes into account both of the pros and cons of an action challenged before it judges its illegality. The other rule is *per se* rule under which an action is considered as *per se* illegal once it belongs to a certain category and there is no need of considering efficiency effect of a challenged action.

As was clearly shown in the previous section, *chaebol*-related regulations and institutions are working in the direction of decreased market transaction costs while at the same time increasing the costs of using a *chaebol*-like organization. There is now plenty of evidence suggesting that the *chaebol* are rapidly replacing internal transactions with market-type transactions: the breaking up of *chaebol* into small "sub-*chaebol*", the selling-off or closing of marginal subsidiaries, various types of divisional spin-offs,[14] and the growing popularity of outsourcing to procure materials and services.

Considering such a big shift in the market and institutional environments, the *chaebol* need to fundamentally change the way they run their businesses in order to survive in the future. In addition, the digital revolution, with its dramatic reduction in information costs (a major component of transaction costs) has a great impact upon group management. It is very remarkable that Coase, over 60 years ago, highlighted the effects of information and telecommunication technology on corporate organization.[15]

> Inventions that tend to bring factors of production nearer together, by lessening spatial distribution, tend to increase the size of the firm. Changes like the telephone and the telegraphs, which tend to reduce the costs of organizing spatially, will tend to increase the size of the firm. All changes, which improve managerial technique, will tend to increase the size of the firm (Coase 1937).

While the IT revolution acts to expand the boundaries of firms through reducing the costs of organizing, it also helps to increase market transactions. On the balance, the latter effect will dominate the former. In the end, most of those changes are evidently market-enhancing, which act inversely to increase the costs of internal contracting, i.e. linking a number of businesses under a single umbrella.

The most influential factor in changing the cost of business group management, as it were, was the level of market competition. Both in domestic and international markets, *chaebol* groups are being exposed to fiercer competition than ever and the trend will continue to intensify. Again, we make us of Coase's insight. He emphasized that it is the degree of competition that ultimately determines the final configuration of the firm (of the *chaebol* in our context).

> A firm will tend to expand until the costs of organizing an extra transaction within the firm become equal to the costs of carrying out the same transaction by means of an exchange on open market or the costs of organizing in another firm (Coase 1937).

The first test for the advantages of firm trade over market trade is already well understood among economists. On the other hand, the second test, which requires a firm's superiority over another firm, has not been given enough attention. A firm's being better at organizing transactions than the market does not guarantee the emergence of the firm. If it fails to organize transactions more efficiently than other firms, then it cannot continue to stand by itself and avoid integratation into the market system. In other words, the

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[14] Spin-offs are normally defined as an individual or an organizational unit leaving an existing (or parent) firm to start as a new firm on the basis of his/her knowledge and competences. There are two types: pure spin-offs and carve-outs (partial spin-offs).

[15] "Ronald Coase: The Nobel Prize winner was a pioneer in the study of how firms do business; E-commerce has brought him back in vogue," *Wall Street Journal*, 31 December, 1999. "A Nobel Prize-winning idea, conceived in the 30's, is a guide for net business," *New York Times*, 2 October, 2000.

transactional efficiency of firms can be a function of both the market and the degree of competition.

The competitive environment has significantly changed since the breakout of the financial crisis. The increasing pressure from global competition forces the *chaebol* to institute changes in the practice of group management along the lines of "de-conglomeration" of businesses, "de-leveraging" of the capital structure, and "dis-empowering" of the controlling families. However, it is not forcing the *chaebol* to turn into a "mirror image" of the present configuration: an extremely specialized company (no diversification at all) with a purely equity-financed capital structure (no debt at all).

Without sufficient knowledge, it would be premature to conclude how the *chaebol* will react to shifts in the constraints. One thing we are sure of, however, is that internally organized transactions are more costly to use while market-type transactions are cheaper. Hence, market transactions will definitely increase. To accommodate the market pressure, it will change organizational forms drastically through diverse types of spin-offs.

First of all, many satellite- or sub-groups will spin off from the mother *chaebol*. This process can be termed FBOs (Family Buyouts) after MBOs and EBOs.[16] For example, the Hyundai Group has been moderately dismantled and restructured into a network of 6 subgroups, and it has also spun off many subsidiaries such as Hynix Semiconductor Inc. and Hyundai Engineering and Construction Company, which are independent companies without any economic ties to the Hyundai Group.

Table 5. A Group-wide Spin-offs: The Hyundai Case

Source: Fair Trade Commission, 2002, *media report* April.

	1996	1997	1998	1999
Big 5	2	7	340	99
Big 6~30	0	0	26	165

The degree of mutual dependence among these subgroups will depend on *chaebol*-specific conditions. At the firm level, managerial independence will be emphasized. Traditional MBOs (Management Buyouts) will be pursued more frequently. Instead of direct subsidization, only profit-oriented intra-group transactions will be allowed. In this sense, subsidiaries will become affiliated in a new way, in other words, not financially, but strategically.

Table 6. The Number of Spin-offs from the 30 Biggest *Chaebol*

[16] MBO is the acquisition of a company by its managers, often in the face of closure, after the acquisition of the company by another group that wishes to dispose of it, or occasionally as a result of its owners wishing to dispose of the business through a trade sale. In some cases a management buyout occurs when a large corporate group of companies wishes to divest itself of an operating division. Financial backers tend to like managers who know the company's business intimately, staking their own assets and taking full control of the company with the aim of boosting its profitability. EBO is almost similar to MBO except that it is the acquisition of a company by its employees. See Kaplan (1991) and Thompson and Wright (1995) for more detailed of leveraged buyouts.

Source: Fair Trade Commission, 2001, *White Book*.

Rank in assets	Spun-off Groups or Companies	# of subsidiaries	Current status
5	Hyundai Motor Company	25	Group
13	Hyundai	12	Group
15	Hyundai Heavy Industries Co.	5	Group
21	Hyundai Oilbank	2	Group
33	Hyundai Department Store Co. Ltd.	10	Group
34	Hyundai Development Company	10	Group
-	Hynix Semiconductor Inc.	-	Company
-	Hyundai Engineering and Construction Company	-	Company

In addition, non-performing divisions inside a firm will be shed or spun-off into independent companies. At this level, diverse types of EBOs (Employee Buyouts) are taking place in a creative manner. Statistically, this type of spin-off from the parent company holds the highest proportion. The degree and pattern of strategic alliances between the divesting and divested companies will depend much on the benefits of internal transactions, or strategic relatedness.

A large part of the functionally or vertically integrated tasks inside the *chaebol* is expected to disintegrate. For example, several functions organized inside the *chaebol* will be spun off to become subcontractors, or replaced by independent outsourcing. Any function such as advertising, R&D, finance, labor management, intermediate parts and material procurement, and general management will be considered a candidate for outsourcing. In this case, cost-effectiveness will determine whether internal procurement or outsourcing prevails.

De-diversification and de-leveraging are linked to the de-empowerment of current management. For example, debt-equity conversions, which are a popular method used in the debt restructuring process, dilute equity concentration and ultimately affect the ownership structure of enterprises. Many manager-owners have already lost their control rights after making debt-equity swaps with creditor banks.

Small shareholders and other investors are receiving more legal protection than ever as witnessed in the implementation of recent improvements in corporate, securities, and accounting regulations. Internal *chaebol* trading will be exposed to and tested by markets and regulatory agencies such as the Fair Trade Commission. As a result, managerial and accounting transparency will be significantly enhanced as well as information disclosure.

In particular, Korea, a heavily trade-oriented country nested in the global economic system, cannot avoid the so-called global standards of governance and accounting practice. More important is the issue of the speed of institutional adjustment. The more beneficial a reform, the more firms will participate voluntarily in implementing the reform. It is firms themselves that benefit most from governance restructuring.

Coase (1937) depicted firms as economic organizations where market transactions are eliminated, and instead the entrepreneur-coordinator directs production. For actual transactions, however, it would be very hard to clearly distinguish internal transactions from transactions made on the market. Even inside firms, market interface, like spot market trades, can take place.[17] Conversely, there are many instances of market transactions that resemble internal transactions typically found inside a firm.

As we can see, the market environment is changing in such a way as to increase the relative price of using coordination devices like business groups. Their response to this external environment is to adopt a practice of management that is more market-oriented. In other words, they need to bring more "market-ism" into the *chaebol* system. In this respect, Khanna and Palepu (1999) have suggested the abandonment of the traditional "command model," where a *chaebol*'s headquarters was deeply involved in directing resource allocation inside business groups. Instead, they suggest a new model for headquarters that actually provides a soft infrastructure – organizations such as venture capital funds or leveraged buyout firms.

So far, have corporate headquarters played the role of "Robin Hood," to borrow Stein's (1997) phrase, taking from cash-rich divisions with poor investment opportunities and giving to cash-poor divisions with good investment opportunities? Or have they practiced a kind of (dysfunctional) "socialism" by reallocating resources regardless of the ability of divisions to use those resources productively? As many *chaebol* critics argue, it is hard to deny that affiliates have been overly engaged in the practice of cross-subsidy. The unlimited use of so-called "internal capital markets" could be very risky.[18] In some ways it needs to be used smartly and selectively. Khanna and Palepu (1999) again make a distinction between two types of inter-group financial transactions – the financing of new ventures and the financing of ongoing operations. They believe that the financing of businesses is indeed best left to commercial banks and capital markets. In financing new businesses, however, they maintain that business groups can create significant value by providing venture capital and should retain that more focused role until independent market institutions develop.

By adopting a holding company structure and eliminating cross-holdings among individual group companies, business groups can significantly mitigate an investor's concerns about transparency and accountability. One important principle is that the headquarters should not interfere in the day-to-day operations of their ventures. If they did, the groups could have so called "corrupted" forms of organization, as Williamson (1975) expects. Business groups need to give their units greater freedom in running their operations. Operating decisions such as executive compensation must be delegated to the subsidiary level. Business units or divisions must be evaluated separately as a "profit center." Money-losing businesses should be closed rather than subsidized, or they could be charged with illegal internal trading under the antitrust law. In this sense, managers should learn to give up non-profitable businesses, or those businesses to which the head office cannot add value.

The groups also need to adopt a wholly different capital structure. They should be based more on equity financing. In theory, in order to undertake very risky projects, they need to rely far more on long-term equity capital. Before they were faced with the economic crisis in

[17] Regarding this matter, Simon (1991) explains that "the possibility of using internal division-by-division balance sheets, and internal pricing in negotiation between components of an organizations further blurs the boundary between organizations and markets."

[18] Williamson (1975) introduces the concept of miniature or internal capital market in explaining M-form enterprise.

1997, *chaebol* groups were both heavily indebted and involved in a wide range of very risky ventures. This severe mismatch between a company's asset structure and its financial structure has made Korean enterprises exposed to high rates of default risk. Therefore, in terms of group finance, business groups will need to adopt a "debt-to-capitalization" strategy.

The headquarters of business groups can also play a more active role in bringing world-class standards and practices of disclosure and governance to their affiliated companies. The successful achievement of this task is critical to restructuring conglomerates because the rational readjustment of the corporate governance structure as a long-term commitment must precede other reforms such as re-capitalization and business readjustment. At the early stages, a firm finds it a very formidable challenge to meet investor's demands for transparency, accountability, and business focus on value. However, the rewards will be substantial. Business groups that are willing to respond to these needs have access to virtually unlimited capital as Khanna and Palepu (1999) predicts. It is now common knowledge that it is firms themselves that benefit most from this governance reform.

3. HOW TO RESOLVE SOCIAL COSTS OF THE *CHAEBOL*: THE STATE'S ROLE IN *CHAEBOL* RESTRUCTURING

Economic policy makers often claim that the primary reason for state intervention in the *chaebol* restructuring process is the presence of negative (or harmful) external effects. For example, they argue that the sovereign credit rating of South Korea depends heavily on how successfully the *chaebol* restructure themselves: if a giant *chaebol* collapses, it can directly downgrade Korea's sovereign credit rate, and indirectly harm other firms.

Despite such justification in terms of social costs for state intervention, this explanation leaves much room for debate. Is externality a sufficient condition for state intervention? Coase (1988) provides a succinct answer to this problem:

> There are, without question, effects of their actions on others (and even themselves) which people making decisions do not take into account. But as employed today, the term carries with it the connotation that when "externalities" are found, steps should be taken by the government to eliminate them. As already indicated, the only reason individuals and private organizations do not eliminate them is that the gain from doing so would be offset by what would be lost (including the costs of making the arrangements necessary to bring about this result). If with governmental intervention the losses also exceed the gains from eliminating the "externality," it is obviously desirable that it should remain (Coase 1988: 26-27).

What he says is that governments should only be allowed to intervene in markets when markets fail and also the costs resulting from governments correcting market failures are less than the costs associated with the market failures themselves. This second condition implies that market failures are not a sufficient condition for state involvement. Coase pays attention to the role of the government but in a different way from Pigou. He succinctly summarizes the role of government in the following way:

> It is obviously desirable that these rights should be assigned to those who can use them most productively and with incentives that lead them to do so and that, to discover (and maintain) such a distribution of rights, the costs of their transference should be low, through clarity in the law and by making the legal requirements for such transfers less onerous (Coase 1992: 718).

This can come about only if there is an appropriate system of property rights (and that they are enforced). In other words Coase points out the role of government in finding and maintaining an "efficient structure of property rights." This insight provides us with many lessons on public policies for corporate restructuring.

A number of policies for *chaebol*'s restructuring have been vigorously implemented for early completion of an economic overhaul. In particular, large-scale business swaps were obliged to be completed by a deadline set by the government. However, the high level of transaction costs like those associated with bargaining, and uncertainty about economic regulations, caused some of the suggested deals to fail.

These economics of government intervention imply that the state needs to be very cautious in deciding to take measures to curb corporate failures. Under the "sacred" cause of reform, however, almost all *chaebol* policies have been widely supported by the public. However, such public agreement does not always guarantee the "right" policies. Sometimes it intoxicates policy makers and makes it more difficult for the regulators to discern good policies from bad ones. Some of misguided intervention measures, often found in *chaebol* policy packages, may aggravate rather than cure corporate problems.

3.1. The Traditional Paradigm: Government-Driven Restructuring

Since its start, The Kim Dae-Jung government had been advised to make corporate restructuring policies on the basis of market principle. In response to this advice, it often proclaimed its strong determination to stay on that track. However, in the process, it meddled deeply in what is regarded as purely business decisions, such as levels of diversification and capital structure. In the end, to speed up *chaebol* restructuring, the government has pushed for early reductions of debt–equity ratios below 200% and large business swaps between the *chaebol*, what were termed "big deals" by the media. When a big business was not able to abide by the debt guideline, it incurred severe penalties from its major banks, which were owned by the government. To complete the big deals, the government forced both the selling and buying parties to accept the swaps, while it was very uncertain whether the deals would produce any synergy and integration effects.

Facing the urgency of debt restructuring, for the recent years, the *chaebol* have been rushing to sell, but few have wanted to buy. When financial intermediaries are not well developed, the accurate pricing of assets for sale is almost impossible. As a result, the "restructuring market" breaks down and few transactions occur. This is what has happened in Korea over the past few years. Khanna and Palepu (1999) explain this as a classical example of what economists call the "lemon" problem.

> It works like this: If a buyer does not have reliable information about the quality of a specific product, he will pay only an amount that reflects the average quality of similar assets in the market. But the value is insufficient to pull sellers of high-quality products into the market. Their unresponsiveness lowers the average quality of products on sale, and that further reduces the price that buyers are prepared to pay. In extreme cases, the market breaks down and no transactions occur (Khanna and Palepu 1999: 130).

The main obstacle preventing corporate market restructuring from working is that economic institutions are not conducive to restructuring. Of course, it is well understood that the government has to take some emergency measures until the institutions for corporate restructuring are well established. In particular, the economic emergency might give the government some exemptions from policy failures. Public economics, particularly the Pigouvian lesson, says that when market failure occurs, the government necessarily may interfere with the market through taxes, subsidies, and regulations. But that approach would presuppose that government failures will always be negligible, or much less than market failure. Very often, however, interventions by the state are not successful and end up causing a mess that places a heavier burden (or taxes) on the public. It is needless to say that in these cases it would be best to let private negotiations dictate the outcomes.

A good example can be found in the two contrasting cases of the government-driven and market-driven swap deals. The government-driven business swaps, the so-called big deals, have been pursued in 8 major industries such as the semiconductor, auto-making, and petrochemical industries. But most of the deals have taken a longer time than expected and some have even failed. For instance, Hynix semiconductor (the old Hyundai semiconductor), which took over the LG semiconductor unit, has recorded a tremendous amount of loss since the acquisition.

On the contrary, the deal to swap petrochemical factories between Hanhwa and Daerim groups, which is purely voluntary and thus not subject to governmental guidance, has been completed much quicker and has so far been a success (*Korea Economic Daily* 29 October, 1999).[19]

3.2. The Coasian Paradigm: Market-Driven Restructuring

Now entering a new millennium, the government needs to make a fundamental shift in its economic restructuring strategy. The world economy is just entering the era of the "new economy" whose distinguishing characteristics are the burgeoning of IT (Information Technology) and knowledge-based industries. The "digital" revolution, highlighted by the Internet, is transforming the way we exchange goods, services, and even intellectual property. It alters markets as well as technology in every respect. Considering these changes and their implications for the economy, the government now needs to give up its role as a "grabbing hand," which directs resource allocation in the economy.[20] Instead, the state needs to build "restructuring-friendly" institutions that are conducive to corporate restructuring. To confirm the necessity for this policy turnaround, it is just enough to recall that excessive market intervention by the state was one of the major causes of the 1997 Korean economic crisis.

Cooter and Ulen (2000: 91-98) point out two policy implications contained in the Coase (1960) argument. One is that the government has to reform legal and economic institutions so as to lower transaction costs of using markets and hence to facilitate the Coasian private bargaining (i.e. normative Coase theorem). However, private bargaining does not always succeed. For instance, it is likely that when transaction costs such as complex regulations and tax burdens are very high, it will prevent the Coasian bargaining from succeeding. Hence, it is proper for the government to choose a more efficient institution in case of such bargaining failure. Herein lies comes the other policy implication of the Coase theorem: the government has to choose economic and legal structures (property rights) that would eventually minimize welfare loss in the case of bargaining failures (i.e. normative Hobbes theorem).

More specifically, the government must make efforts to reduce the economy-wide, high transaction costs for market transactions. Generally, heavy taxes, complex regulation, and uncertain law enforcement are considered as primary hurdles that hinder the voluntary

[19] Two *chaebol*, Daerim and Hanhwa groups swapped their petrochemical production units (factories), eventually increasing market shares in their main business.

[20] Schleifer and Vishny (1998) discuss about "invisible hand, helping hand, and grabbing hand," regarding the degree of market intervention by the government.

restructuring of business. In this respect, Coase reminds us of a lesson that policy makers must bear in mind:

> If the costs of making an exchange are greater than the gains which that exchange would bring, that exchange would not take place and the greater production that would flow from specialization would not be realized. In this way transaction costs affect not only contractual arrangements, but also what goods and services are produced (Coase 1992: 716).

In this respect, we need to reflect more closely on why the "big deal" program failed. The government urged them to finish the swapping of their unprofitable business units (subsidiaries) among *chaebol* by a specified deadline. It even threatened to force the state-controlled banking system to starve the *chaebol* of money when the *chaebol* resisted. Considering Coase's insight, one comes to realize that two explanations might exist to explain why the *chaebol* delay business swaps: The transaction costs may be extremely high in swapping businesses between *chaebol*, or the benefits from these transactions may be negligibly low. Which argument is more persuasive in explaining why the big deal policies failed?

A careful review of the automobile industry, which is one of 8 industries covered by the original big deal plan, may aid in answering this question.[21] According to the plan, the auto-manufacturing subsidiary of Samsung Group, or Samsung Motors Inc., was supposed to have been taken over by Daewoo Motor Co.[22] During the process of negotiations, however, both parties failed to narrow the wide price gap. In my view, uncertain rules regarding M&A's, and even political intervention in the process increased transaction costs prohibitively, bringing the deal to a stalemate.

For instance, it was very uncertain whether the acquiring company would be entitled to stop the SM5 production lines and to layoff the workers after the takeover.[23] Despite the legal clauses in the labor law, the right to layoff workers after M&A's was not taken for granted, but instead was supposed to be determined by political considerations,[24] not by the

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[21] The restructuring of the 5 major conglomerates was being carried out through a program dubbed 'Big Deals,' which are business swaps and mergers among the conglomerates, with the aim of resolving the problem of excessive facilities and enhancing the competitiveness of their core businesses. The original "Big deal" scheme covered eight key business sectors, including auto-making, semiconductor, and petrochemical industries. The restructuring of the 6th to 64th largest conglomerates is being accomplished through the 'workout' system, a special program designed to turn a company around through providing assistance such as new loans and debt-equity swaps from their main creditor banks.

[22] In April, 2000, the French auto-making giant, Renault acquired the Samsung Motors, triggering sweeping upheavals in the nation's long-closed automobile market. Its inroad into Korea signaled the first step in the nation's auto market globalization, posing both opportunities and threats to the domestic carmakers.

[23] The following report shows how high transaction costs would come from uncertain property right rules. "The proposed swap of Samsung Motors Inc. and Daewoo Electronics Co. appears to be progressing smoothly, following last month's agreement to select U.S. accounting firm Deloitte Touche Tohmatsu as the asset evaluation agency. But Samsung and Daewoo have yet to solve more daunting tasks, such as the decision whether or not to continue producing Samsung's SM5 car model and how to handle the strong resistance from employees." (*Korea Herald* 4 January, 1999).

[24] Samsung-developed SM5 models had already been ruled as unprofitable at that time. But the government, stung by rising antigovernment sentiment in Pusan, the home to the Samsung Motors plant, was pressing Daewoo Motor to continue to produce the Samsung car. Daewoo was known to have succumbed to government pressure and promised to produce the SM5 model for two years, but government officials reportedly went one step further, demanding five years.

bargaining parties. The Samsung-Daewoo feud over the continuing production of Samsung's SM5 cars is typical of the politically distorted aspect of the big deals.

Asset Value of (Physical) Facility
+ Transaction Costs needed for Property Right Exchange
Total Price of the Firm

To have or not to have the right to cut production lines and employees would necessarily change the ultimate price (or value) of the firm on sale. If they were not exercisable, Daewoo could not offer a higher price for the acquisition. In that case, Samsung Motors Inc. would be like land in the greenbelt zones whose ownership (property rights) rights are highly restricted. Unfortunately, no one was sure of the managerial rights to terminate or re-deploy the production lines, or of the right to layoff workers after merger. Even the mediating position of the government on this issue was very hard to predict at that time.

The above case illustrates that the costs, arising from an imperfect delineation and enforcement of property rights and political distortions of the rules by the government, might be even greater than the physical costs of a factory. It highlights that such legal and economic uncertainty might increase the costs of exchange prohibitively and also that the rules of economic institutions must be delineated and, more importantly, enforced as they are specified.

The above case study of the big deal process yields a number of policy implications. The excessive intervention by the government may do harm rather than good to the bargaining parties. In order to speed up corporate restructuring and make it a "keep-going" task, not a transitory fad, establishing more efficient rules and institutions for restructuring markets should be a primary task. Numerous issues in the corporate and financial sector restructuring must be resolved, including the elimination of tax, legal, and regulatory impediments; the strengthening of prudential regulation; the improvement of supervision over financial institutions; the establishment of procedures for out-of-court workouts; the improvement of financial disclosure and corporate governance; and the formation of other institutional arrangements (Mako 2001). More specifically, the government should lower the transaction costs of restructuring, i.e. selling and buying of firms (M&A's), assets, real property, etc. The lack of advanced restructuring institutions such as CRV or CRC, financial, accounting, and consulting intermediaries was a primary reason for the early stalemate of big deals among the *chaebol*. Hence the establishment of those institutions and efficient monitoring of the *chaebol* by the financial market must be preconditions for corporate restructuring markets to work smoothly. In addition, competition policy must be reinforced so that the Korean conglomerates have no more incentive to over-diversify, and to abuse their monopoly power (Khemani 2000).

4. CONCLUSION

In this article, the firm theory, originally suggested by Coase (1937), is extended to build up a business group theory in which a diversified structure of closely linked subsidiaries are internalizing their transactions across a wide scope. In particular, we pay attention to the major changes in terms of transaction costs for running the *chaebol*-type mechanism, which is internalizing most necessary transactions within a group. At the same time, some primary market and institutional changes are listed that collectively act to make market transactions cheaper to use. Focusing on the changes in the relative transactions costs of using the *chaebol* vs. markets, we make some inferences about how they are likely to restructure in strategy, and capital structure, and other features, and we consider what is going to be their evolutionary path following such changes in the business conditions in the aftermath of the IMF crisis.

Secondly, we derive some of valuable public policy implications from the Coase (1960), “the problem of the Social Cost.” There he suggests the proper role of the government when transactions costs are prohibitively high: to reduce the costs of using the market vis-à-vis *chaebol* organizations. More specifically, for the corporate restructuring market to work efficiently, the government needs to lower or remove institutional hurdles that prevent spontaneous Coasian bargaining from taking place in market. To illustrate a misguided policy for corporate restructuring, we take a case study of the “big deal” policy as an industrial policy, which was introduced to facilitate the *chaebol*’s downsizing to core businesses. While the government’s aggressive push for corporate restructuring, as seen in the big deals, may well accelerate the process of restructuring, it may also provoke business mistakes. In evidence of this danger, the semiconductor industry, deeply involved in the big deal policy, still suffers from misguided policy decisions. In fact, Hynix, the old Hyundai semiconductor unit, is still recording a huge loss, waiting to be acquired. This shows that the government’s intervention in the private sector could do more harm than good. In this regard, Coase suggests that the government should not interfere in private negotiations, but instead should lower the transaction costs of using markets through reforming institutions and regulatory systems so that any mutually beneficial exchange opportunities can be realized. This suggestion coincides with Khana and Palepu (1999) argument that the government should focus its attention entirely on “building institutions.” As these institutions develop, market forces – not the government – will weed out inefficient groups.

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