

Political Economy of the Polarization of LEs-SMEs Industrial Structure in Korea*

Lim, Haeran**

The purpose of this study is to analyze the polarization of the LEs (Large Enterprises)-SMEs (Small-Medium Enterprises) industrial structure in Korea within the context of political economy. The SMEs began increasing in terms of numbers, production, and value added beginning in the 1980s. This resulted from the rise in self-employment following increased unemployment, rapid liberalization and structural adjustment since democratization. The LEs and SMEs had interacted with each other through the subcontracting relationship. By applying the new institutional approach to this study, three factors can be suggested as institutional context for either the limited success or failure of SMEs policies: SMEs' exclusion from a winning political coalition, the absence of a political role of interest groups for SMEs, and the exploitative subcontracting relations between the LEs and the SMEs. The state did not put forth real efforts to prohibit the exploitative subcontracting system and to pursue a productive discourse.

Keywords: SMEs, LEs, Polarization, Subcontracting Relations, New institutional Approach, Korea

I. INTRODUCTION

The recent U.S. financial crisis of 2008 has resulted in a negative ripple effect that has shaped the global economy. Yet the conventional wisdom that everyone has a difficult time during economic recessions does not apply in the

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** Professor, Political Science Major, Department of Political Sciences and International Relations, Seoul National University

case of Korea. The profit margin of SMEs and a few LEs are worsening day by day. However, profitability of a majority of LEs shows no sign of having been affected, but instead are showing improvement. Consequently, polarization between LEs and SMEs is worsening again as it had been immediately after the 1997 financial crisis.

Economic polarization describes the widening gap between different sectors of the economy caused by the weakening of their interrelationships. The polarization appears in many forms, such as between exports and domestic demand, between industries and industries, between corporations and corporations, and between of employment and wages. The causes for intensifying polarization include globalization, the rise of China, acceleration of technological advances, and the global financial crisis that in turn negatively effected Korea's domestic structure. This research will focus primarily on the problem of polarization between the LEs and SMEs, and to shed light on the policy implications from the perspective of political economy.

The academic fields of business administration and economics have been conducting and accumulating many studies on LEs and SMEs. Most have focused on measuring fair transactions and policies that support SMEs in order to enhance the coexisting relationship between LEs and SMEs; that includes technological support, financial support, tax support and start-up assistance. It is important to discuss the relationship between LEs and SMEs from the perspective of efficiency, but it is also necessary to analyze the relationship from the perspective of politics or the political economy (Kim et al. 2008). For quite a while the government has placed much effort into creating a harmonious relationship between the LEs and SMEs, one of those being through its SME Promotion Policy. Despite these efforts, the polarization phenomenon persists. The causes range from changes in the external economic environment to internal economic situations. Among these this study will focus on the political economy, and more specifically, it will explain the truth and falsity of governmental policies initiated to promote SMEs, the role of SME interest groups, as well as the subcontracting relationships between LEs and SMEs.

The structure of this study is as follows: section 2 will examine the current situation of the polarization phenomenon of the LEs and SMEs. Section 3

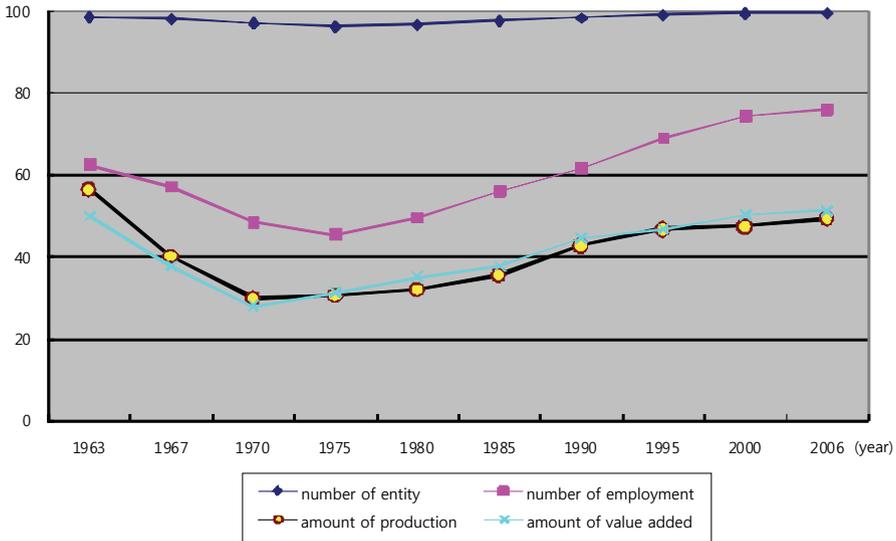
will apply the new institutional approach to examine why SME promotion policies brought only limited results. In section 4, to explain why these policies resulted in limited outcomes, it will discuss the government policies, the interest groups of SMEs and the subcontracting relationships between LEs and SMEs. Section 5 concludes this research with a summary and policy implications.

II. POLARIZATION OF LES AND SMES

Economic polarization is when economic outcomes are divided to extreme ends in the process of reacting to internal and external change caused by the heterogeneous properties of economic actors (Ju, H. 2007: 16). Thus economic actors face disparity in their economic outcomes because of a gap in their technical level and scale, adaptation capabilities, and the education level of their employees. Polarization refers to the significant gap between the two extremes, as well as that this disparity has a propensity to continuously expand. The term is used especially when the cause of this gap is structural.

Beginning in 1980, Korean SMEs began to grow and their number began increasing. According to Figure 1, before the 1980s, the scale of businesses expanded rapidly because of economies of scale for determining competitiveness in the labor-intensive export industry. As a result the priority and importance of SMEs decreased.¹ In the 1970s with the promotion of the heavy chemical industry, support for LEs was further strengthened and the merger and acquisitions of SMEs further caused their diminished importance. Nevertheless, it was necessary to create a subcontracting relationship between the LEs that produced the final product and the SMEs that made the parts and components. This provided an opportunity to reinforce awareness that there must be policy support for SME. In fact, the reinforcement of SME growth owes resulted from the expansion of subcontracting relationships and

¹ The proportion of SMEs in manufacturing employment and added value between 1963-73 decreased from 66.4% to 52.8% and 39.4% to 27.2% respectively (Baek, N. 1996).



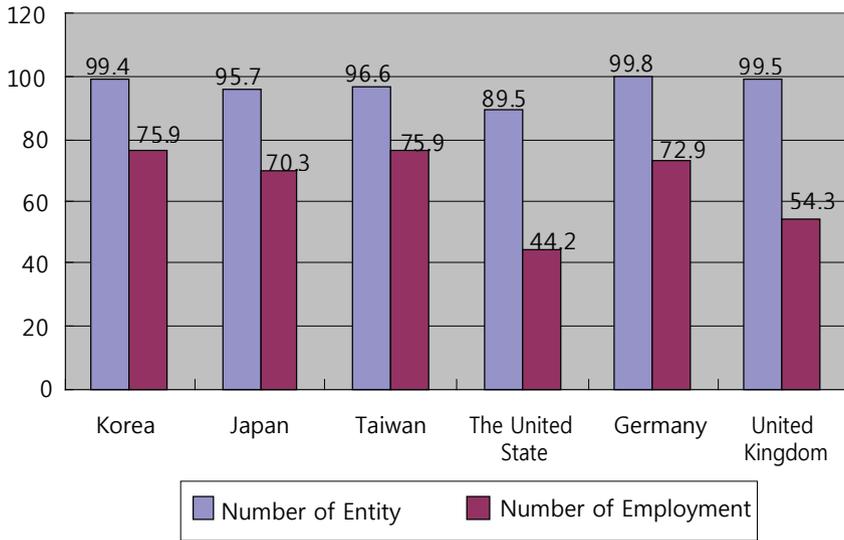
Source: Kbiz, “SME Federation Status Index”
http://info.kbiz.or.kr/volcano/global/docs/s_contain.html

Figure 1. Development of SMEs(manufacturing sector)

the change of governmental policy for promoting SMEs.²

As can be seen in Figure 1, the proportion of SMEs in the mining and manufacturing industry is 99.4% in terms of firms and 75.9% in terms of employees. However when the commerce sector is added, the proportions rise to 99.9% and 87.5% respectively. The constant and steady increase in the number of self-employed small business owners is another reason for the quantitative increase of SMEs after democratization (Kim, S. 2008). Some of the reasons lie in the a large number of workers deciding on self-employment in restaurants, wholesale and retailing in the midst of the high unemployment rates that followed democratization and market liberalization. Figure 2 compares the proportion of importance that SMEs form in several countries. The quantitative proportion of Korean SMEs does not fall behind when compared to that of other countries.

² Using the added value standard, the proportion of SMEs in manufacturing was only 31.7% in 1975 but it rose to 37.6% in 1985 and reached 49.2% in 1994 (Baek, N. 1996).

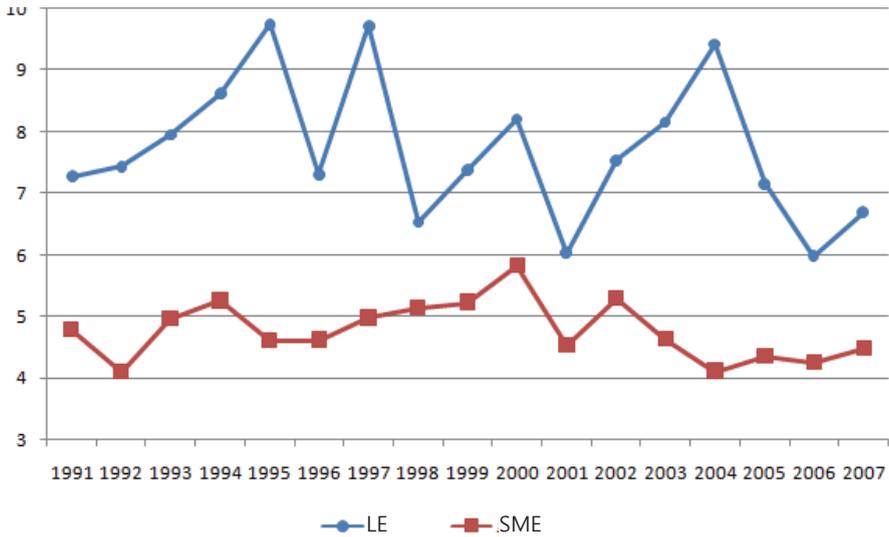


Source: Kbiz, “Statistics on Overseas SMEs”, reorganization of 2008.

Figure 2. Comparison of SMEs in Major Countries: Share of SMEs in manufacturing sector.

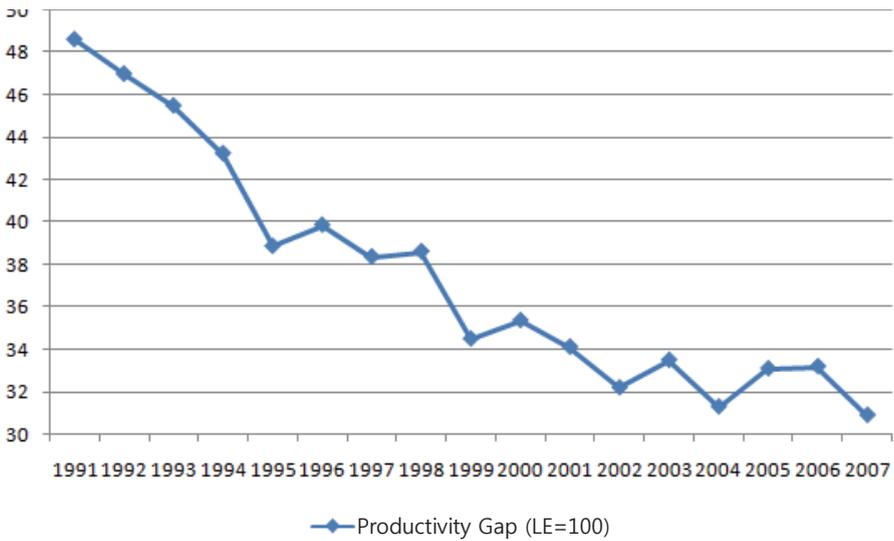
Korean SMEs expanded quantitatively after the 1980s. Yet polarization between the LEs and SMEs has been progressing as well. This phenomenon is explained by the profit and productivity gap between the two. According to Figure 3, the business profit rate of LEs has been relatively high compared to that of SMEs from 1991 until 2007. For 16 years the average profit rate of LEs has been 7.8% and 4.9% for the SMEs, with a difference of 2.9%. During 2002-2005 when polarization worsened, the profit rates of LEs and SMEs moved in opposite directions. In 2005 the disparity decreased but again increased in 2007. In 2004, the gap for the profit margin ratio reached up to 5.3%. The fact that the profitability of LEs increased while that of SMEs declined, and that both have intimate ties through subcontracting relations can cause much concern. Labor productivity (value added per capita) of SMEs in 1991 was 48.6% of the total productivity of LEs, 31.4% in 2004 and 30.9% in 2007, showing a decrease in the gap (Kbiz, each year).

When compared with other countries such as the United States or Japan, it can be seen that the polarization of Korean LEs and SMEs is more severe. In



Source: Bank of Korea, Corporation Business Analysis <<http://ecos.bok.or.kr/>>

Figure 3. Comparison of Ratio of Operating Profit to Net Sales of LEs and SMEs.



Source: Kbiz, SME Statistics DB <http://stat.kbiz.or.kr/stat_new/stat_00.asp>

Figure 4. Productivity Gap between SMEs and LEs: LE=100

Table 1. Change in Gap between LEs and SMEs in their Key Indicators

		1993	1994	1996	1998	2000	2002	2004	2006	2007
Wage disparity	All industries	77.6	76.7	77.3	76.2	71.3	67.5	64.0	64.3	64.8
	Manufacturing	73.5	70.8	67.6	66.6	65.0	62.2	57.2	59.9	58.4
Labor productivity	Manufacturing	45.7	43.2	39.8	38.7	35.4	32.2	31.3	33.2	30.9

Note: Relative wage and productivity of SMEs (LEs = 100).

Source: Kbiz, Status of SMEs in 2008, Kim, S. et al. 2008

the case of Japanese SMEs in the manufacturing sector, the labor productivity of SMEs has been 50% of that of the LEs, and this rate had been stable for quite a long period (1982-2003). The SMEs of the US also accounted for 58.2% in 1997 and 59.2% in 2002, showing even some improvement. This sharply contrasts with the Korean case where it decreased to 33.6% in 2003 from 53.8% in 1988. (Ju, H. 2007: 106-112).

The proportional significance of LEs in number of businesses, volume of output and added value show tendencies of reduction, the significance of SMEs has been increasing. However when the index indicating productivity and profitability is examined, we see that polarization has intensified in qualitative terms. The gap between the two is to some extent inevitable. However, it becomes a concern if the profitability of LEs increases while that of SMEs decreases while the two are in a coordinated subcontracting relationship. Problems such as the weakness of SMEs in the Korean economy, their low equipment investment levels, low efficiency in research and development investment, in addition to the LE centered industrial structure of South Korea, have all been continuously subject to concern.

As it can be seen in Figure 3 and Figure 4, polarization accelerated after democratization in the 1990s. As the labor union became more active after democratization, employment by corporations decreased while expanding their automated production facilities and subcontracting relationships. This resulted in expanding polarization between companies.³

³ Interview. Joo Hoon Kim, Senior Researcher at KDI, 2009. 7. 1. This is because as labor unions became more active after democratization, corporations decreased the number of employees hired and increased the number of subcontracting relationships;

Some say the reason for greater polarization between LEs and SMEs was the relatively late restructuring of SMEs compared to the prompt response by LEs. The difficulty of M&A by weak SMEs resulted from the rigid financial system, which was one cause that made SME restructuring difficult.⁴ Also the long-term high exchange rate policy implemented by the government in order to increase exports aggravated problems for domestic-demand oriented SMEs (*Hankyoreh*, 2005/1/3). In contrast, the economic power of LEs after 1997 increased significantly. The reason for this increased influence after the financial crisis was while sorting out the weak SMEs, the LE-centered economic structure was consolidated in each of the industries. Also, because of competition with China, the profitability of SMEs weakened, which also led to the intensification of this economic structure (Kim, D. 2007: 486). The rise of China's economy intensified competition between South Korea and China, resulting in a weakened export competitiveness, industrial hollowing-out, and limiting job creation in domestic SMEs. Because this study will focus on the political economic perspective, this paper will present the causes of polarization and the relevant countermeasures. It points out the truth and falsities of policies that the government has implemented by examining the dynamics of public and private interest groups related to SMEs, and examining the reality of subcontracting relations between LEs and SMEs.

III. THEORETICAL DISCUSSION: FAILURE OF THE SME POLICY AND THE APPLICATION OF NEW INSTITUTIONALISM

While studies may not agree about all the cause of polarization, it is likely that many will agree that one of the many causes is governmental policy.

this led to an increase in added value per capita for LEs.

4 In the M&A of weak SMEs, the conservative tendencies of financial institutions results in avoiding loans to SMEs. When loans are made for weak SMEs, they become primarily non-performing loans (NPL) because they are either non-recoverable or they are not interest-bearing. In this sense credit guarantee and loan opportunities for SMEs remain under strict restrictions by financial institutions. Chong Ook Rhee 2007, p. 197. Interview by Joo Hoon Kim, Senior Researcher at KDI, 2009. 7. 1.

The Korean government has continuously led LE-friendly policies, which resulted in their development and expansion. In comparison, the weakness of Korean SMEs comes not from the fact that there were no governmental SME promotion policies, but that many of them were mere policies of “relief out of courtesy” that did not reap much tangible result. This research will shed light on the SME development policies by applying the perspective of new institutionalism.

Old institutionalism, the origin of new institutionalism, emphasizes official and static laws and institutions. However, behavioralism in the 1950s-1960s criticized the old institutional perspective about its focus on mere perfunctory law and administration, and in response began emphasizing the informal distribution of power and political behavior. However the revolution of behavioralism, while focusing on the attitude and behavior of individuals and groups, cannot fully explain why different countries with similar groups and individuals with similar resources demonstrate different behaviors. It was new institutionalism that proposed a significant critique regarding this point. Different countries reacted differently to crises after the financial crises of the 1970s. New institutionalism focuses on the middle-range institutional attributes of states, the institutional network connecting corporate networks, the state bureaucracy, political parties and economic groups. Through these factors, it examines how the institutional environment offers specific incentives and constraints to the political actors (Katzenstein 1978; Gourevitch 1986). Katzenstein explains the different responses that different actors display in similar crises, focusing on the political network connecting the state and society, or the “relational character of institutions.” Similar groups or individuals display different reactions because of their differing institutional contexts. However this perspective also has limitations in that it emphasizes institutions only when the reform process and its outcomes vary over time within a single country.

New institutionalism has developed into two branches—rational-choice institutionalism and historical institutionalism. Rational-choice institutionalism accepts the role of institutions but assumes that preference is exogenously given and that it is stable and coherent. However, when there is institutional change the rules of the games change and that changes the strategic choices humans make. Historical institutionalism does not

regard human preference as exogenously given but sees them as internally constructed and redetermined (Hall and Taylor 1996; March and Olsen 1984; Katznelson and Weingast 2005).

Rational-choice institutionalism sees the institution as a 'structure' that influences the strategic choices human make, and historical institutionalism views that the institution itself shapes human preference. Both perspectives have a larger emphasis on 'structure' than the 'actor' and in the process of policy decision emphasizes 'institution' more than the 'ideas.' As pointed out before, when structure and institution are emphasized, it is difficult to discover why some policies succeed and others fail under similar institutions. In fact, individual preferences can be constructed by the structural and institutional influences, but at the same time powerful political leaders who accept new ideas can form new preferences. Also, policy choice and results may vary according to the political coalitions and conflicts (Peter et al. 2005; Schmidt 2009).

New institutionalism has overlooked the role of the state. Rational-choice institutionalism recognizes the state as a structure influencing the actors. The historical institutional perspective recognizes the state as an institution that leads to path dependency. The perspective of Varieties of Capitalism (VOC) regards the state as a regulator in the globalized environment and focuses on the firm as the basic unit of analysis (Hall and Soskice 2001). Recently the new perspective of discursive institutionalism began to draw scholarly attention, as a result of internal development of new institutionalism. Recently the perspective of discursive institutionalism emphasizes the role of 'ideas' rather than 'institutions' and the role of 'agency' rather than 'structure.' Discursive institutionalism emphasizes dynamic politics to understand the role of the state. Politics is understood as either power conflicts or coalitions among various interest groups, or as the process of the interactive discourses. Governmental discourse can be divided into coordinative discourse and communicative discourse. The coordinative discourse refers to mutual exchange and persuasion among politicians, policy experts, and entrepreneurs, whereas the communicative discourse refers to politicians or a government spokesperson attempting to persuade the public (Schmidt 2009, 529-534). In many cases the failure of reform policies can be attributed to the opposition of interest groups, but even more important is a lack of

effort for politicians to persuade the public. Discursive institutionalism places significance on the political alliance between actors, interaction as well as the process of persuasion between the government and the major actors. Political coalition is crucial in understanding state policy, and its consequences.

To explain why the SME policies failed, this study adopts the theory of new institutionalism.⁵ Its utility is that in addition to emphasizing the state's role, it includes the relationship between the state and other middle range institutions in its analysis. As the new institutional framework is applied in this study, the political coalitions among the state, the LEs, and the SMEs, the relationship between the state and SMEs, the subcontracting relations between the LEs and the SMEs, and its governmental rules on this subcontracting relations, all become significant analytical tools. This comprehensive analysis of institutional characteristics will reveal the reasons behind limited results of the SME Promotion Policies. To begin with, many policies were ineffective; most were merely 'relief out of courtesy,' and the government did not fully implement the laws on subcontracting due to their continuous LE-friendly policies. This study will also analyze the role of SME interest groups and the characteristics of LE-SME subcontracting relations.

IV. THE POLITICAL ECONOMY OF LES-SMES POLARIZATION

1. Government Policy: Limited outcomes

As observed earlier, the productivity and profitability of LEs and SMEs have become polarized since the 1990s, and became heightened during 2002-2005 after the 1997 Asian financial crisis. Economic variables such as the internal and external changes of the economic environment are significant to understand polarization, but it is also necessary to examine the political

⁵ New-institutionalism that this research intends to utilize is the most recently developed form of 'discursive institutionalism'. Discursive institutionalism reemphasizes the role of the state, and it carries out its analysis in the dimensions of state policy, polity, and politics. This research emphasizes the political dimension.

variables such as the governmental policies that implemented the SME policies, the role of interest groups that advocated the interests of SMEs, and the subcontracting relationship between the LEs and SMEs which affected the SMEs significantly in their growth.

The effectiveness of governmental policies implemented to promote SMEs was in fact quite low. As mentioned earlier, these policies were “out of courtesy.” Despite this fact, the basic foundation of SME support policies underwent change after democratization. The South Korean economy had to adapt itself to the environment of sophistication and unlimited competition of the economic structure after democratization. In this case, economic democratization took the form of deregulation and market liberalization (Lim 2008). In addition, SMEs also encountered fundamental change from receiving protection, to being thrown out into competition. The change of the large framework in SME policy can be summarized as from protection and support in the 1980s, to liberalization and competition in the 1990s, from direct to indirect support. The most representative policies in the 1990s are as follows: the abolition of designation of the *kyeyölhwa* plan, “core business industry designation policy,” and “collective private contract policies”.

The SME policies prior to democratization emphasized protecting and supporting SMEs while also regarding them as relatively weak compared to LEs. In this way, SMEs were regarded not as a source of growth but as a countermeasure to concentrated economic power and to promote social justice (Cho, M. and Kim, S. 2008). Because of HCIs (heavy chemical industries: HCIs) policy of the government, the phenomenon of capital concentration accelerated during the 1970s. M&As of SMEs by LEs resulted in the reduction in the number of SMEs, and the SME promotion policies did not reap many effective results. Rather, the governmental SME policies of the 1970s focused on passive protection policies, acceleration of vertical integration between LEs and SMEs, and consolidation of subcontracting relationships.

The Chun Doo Hwan administration during the 1980s proposed a more active SME support policy. At that time the necessity of supporting SMEs was proposed because the limitations of LE-centered heavy chemical industries had surfaced with the change of the international political economy. The HCIs industrialization strategies required constant component and material

related with imports and as a result became the main cause of the inactivity of intermediary goods and thus the trade deficit with Japan. In this situation, it was thought that SME support policies were urgently needed (Kim, S. et al. 2008: 25). However, economic policies at that time favored economic growth, and given the persistence of exclusive political coalitions comprised of the government, LEs, and technocrats, SME support policies resulted in actions of “relief out of courtesy.” The difficulty of the relationship between LEs and SMEs lies primarily in the exploitative subcontracting relationships.

The Roh Tae Woo administration, after the 1987 political democratization, emphasized equality, competition, and welfare—the democratic principles of the economy. The general consensus is that the Roh administration’s SME policies were relatively more regressive than those of the Chun administration. Market non-intervention policies were predominant for the facilitation of free competition. SMEs policies was shifted the emphasis from ‘protection’ to ‘competition.’ Revising and legislating SMEs laws were not actively sought (Kim, S. et al. 2008: 30).

We next examine in detail the government’s SME support policy since democratization in the 1990s. The Kim Young Sam administration initiated policies that reflected trends during that time of globalization and liberalization. First, while active protection and support policies were characteristics of the 1980s, during the 1990’s the Kim administration emphasized a political ideology of “autonomy and competition.” Until then the government had used direct support policies that focused on specific categories of business or specific individual firms, however, they switched to providing indirect support policies based on a neutral incentive system. This transition began in the 1980s and became more central after the establishment of the WTO and South Korea’s membership in the OECD in 1995. Secondly, they revised SME laws and merged the SME Business Regulation Act and the Gye-yol hwa Promotion Act into the SME Business Protection and Cooperation Enhancement between Enterprises Act to strengthen global competitiveness and relax regulations. The Special Act on the Promotion of Venture Enterprises (1997. 8) was also enacted at that time. Third, the Small and Medium Business Administration was established under the Ministry of Trade and Industry in February 1996 to strengthen the practical support of

SMEs, and to promote systemic governmental policies.⁶

Under the Kim Dae-jung administration, SME policy focused on the development of knowledge-intensive SMEs under the rubric of a democratic market economy. After the financial crisis, the development of Small and Medium venture companies became the center of the nation's industrial policy with the legislation of the Special Measure in relation to Venture Company Support (1997). The Kim administration proclaimed that for the next 5 years, the development of 20,000 venture companies would be promoted to transform the industrial structure into one that was technology and knowledge-intensive, and ultimately to produce more jobs. Venture companies were promoted as the new principle agent for growth to overcome the financial crisis and recover economic vitality. While the former policy centered on input, protection and development, direct support, and producer-orientation, new policies were focused on reform promotion, competition and cooperation, creation of an infrastructural ecosystem, and consumer-orientation (Small and Medium Business Administration 2007). Also, the Presidential Commission on Small and Medium Enterprise was established as presidential body for supporting SME development in 1998. Its purpose was to review, revise, and assess the SME development policies of related departments, and analyze SME's business trends necessary for the Committee to perform its tasks. Their general task was to take on the role as a mediator between the different policies of the different department's involved, encouraging cooperation and coordination (Oh, C. 2003: 206). The government wanted cooperation among the Presidential Commission on Small and Medium Enterprise, the Small and Medium Business Administration, the Korea Federation of Small and Medium Businesses, the Small & Medium Business Corporation, and other SME supporting institutions to compensate for inadequacies in SME policies.⁷ SMEs' weakness

⁶ The Small and Medium Business Administration Bureau is a central agency where SME related work is carried out. It was founded in February 1996 to promote a more systematic and effective construction of corporate support policies, discarding the Industrial Advancement Administration and expanding the SME division within the Ministry of Trade and Industry. Its regional organization is comprised of 11 Regional Small and Medium Business administration Bureaus (Kim, S. et al. 2008).

⁷ The Small & Medium Business Corporation is an institution of communication

Table 2. Progress of SME Core Business Industry Designation

	1979	1983	1984	1989	1994	1995	1997	2001	2007
New industries	23	103	104	49	0	0	0	0	0
Dismantled industries			2	17	58	45	47	43	45
Core industries	23	103	205	237	179	134	88	45	0

Source: Kbiz, 2008 "Current Status of SMEs."

in Korea is more attributed to the ineffectiveness than the lack of SME policies (Baek, N. 1996; Park, D. et al. 2006).

Despite the Kim administration's state ideology prioritizing SME policies, the Collective Private Contract Policies and Core Business Industry Designation Policies for developing and protecting SMEs were being threatened by those favoring liberalization and deregulation. Objections increased in response to possible trade conflicts resulted from market liberalization after joining the WTO in 1995, claims of reverse discrimination of national LEs, and declining competitiveness of SMEs. Core Business Industry Designation Policies that restricted market entry by LEs in business areas deemed suitable for SMEs were gradually abolished because they are against the market economy. By 2007, all 256 designations were completely abolished (Table 2). On principle, the Regulatory Reform Committee decided to remove 43 of the 83 remaining designations in 2000, and 45 more in the next 5 years (Kim, S. et al. 2008). The Fair Trade Commission insisted on prompt abolishment of the Collective Private Contract Policies because they also limited competition.

After the SME Core Business Industry Designation Policies were abolished in 2007, it was confirmed that 3 out of 4 SMEs in related industries showed reduction in their sales. This was mainly caused by extensive competition between businesses due to LE market entry (68%), recession in the domestic

channels, that efficiently conducts work for the promotion and development of SMEs. The corporation manages and operates financial loans for prospective SMEs that face difficulties in obtaining loans from banks using their own policies and criteria. It was established to foster public economic development by efficiently promoting businesses for SME development under the Small and Business Corporation Law in December 1978 (Park, D. et al., 2005: 368; Oh, C. 2003: 208).

market (63%), increased cost of raw materials (50.5%) and increase in imports of foreign products (10.3%). 89.9% responded 'no' to the question of whether SME competitiveness increased as a result of market entry of LEs (*Hankyoreh* 2008/10/17).

Collective Private Contract Policies, introduced in 1965 as a policy for SMEs, allowed the government to close contracts under its own discretion with the Korea Federation of Small and Medium Businesses without making a competitive bid when purchasing a specific product. However this policy was criticized because only a few SMEs with vested interests benefitted. In 2003 only 14.2% of the total SMEs that produced products subject to the Collective Private Contract Policies were involved in collective contracts as members of the Federation. The top 20% provided 77% of the total supply. This policy removed the members' incentive of investment to improve technology and product quality and weakened SMEs' competitiveness. It was also abolished in 2007 after two year grace period.

The Roh Moo Hyun administration's SME policy can be summarized as the development of innovational SMEs known as Inno-Biz, which promised to develop 30,000 SMEs through a tailored system. The policy focused on developing innovative SMEs, development of the part and component industries, promotion of 'Innovation Clusters' and etc. The number of innovational SMEs increased to 20,000 in 2007, new investments of venture capital increased to 6.3 billion won, and the number of SME affiliated research labs reached 12,300. The Small and Medium Business Administration supported Inno-Biz enterprises with technical skills, venture companies, and Main-Biz with high value-added. <Table 3> shows that there is a difference of efficiency between overall SMEs and Inno-Biz, in the number of jobs created, total sales, and R&D. To support these innovative SMEs, the Korea Technology Finance Corporation (KIBO) decided to increase the number of guarantees based on only 'technology' from 15.2% in 2005 to 60% in 2009. It also increased the frequency of meetings to promote cooperation between LEs and SMEs. However as it can be seen in <Table 4>, although the Kim and Roh administration strongly promoted policies to foster venture companies and Inno-biz, their implementation process has problems of overlapping and confusion.

When we analyze the overall change in growth contribution of LEs and

Table 3. Comparison of SMEs Efficiency

	Venture firms	Inno-biz	Average SME
Average job creation*	27.7 (13.4 → 41.1)	35.2 (10.8 → 46.0)	11.3 (6.5 → 18.4)
Average sales (100 million won, 2004)	79.0	99.0	27.5
Average R&D investment (100 million won, 2004)	4.3	4.6	1.3

Note: *Average employment increase during the period (Venture firms 7 years, Inno-biz 9 years, average firms 10 years).

Source: SME Survey (2005), Inno-biz and Venture firm Survey (2005).

Table 4. Progress of Inno-Biz

Year	Progress								Plan	
	'98-'00	'01	'02	'03	'04	'05	'06	07. 12	'07	'08
Venture firms	15,774	11,392	8,778	7,702	7,967	9,732	12,218	14,015	15,500	20,000
Inno-biz	-	1,090	1,856	2,375	2,762	3,454	7,183	11,526	10,400	14,200
Main-biz	-	-	-	-	-	-	2,619	6,510	2,500	3,000
Total	15,774	12,482	10,634	10,077	10,729	13,186	22,020	32,051	28,400	37,200
Overlapping firms	-	699	1,134	1,519	1,890	2,455	4,508	7,332	5,400	7200
Total (excluding overlaps)	15,774	11,783	9,500	8,558	8,839	10,731	17,512	24,719	23,000	30,000

Source: Current Status of SMEs, 2008.

SMEs over several administrations, as in <Table 5>, we see that SMEs showed the best performance under the Kim administration and the worst under the Park Chung-hee administration.⁸ During the Third Republic period,

⁸ The results compare and analyze the development of each administration's SME support policy, and the growth and contribution rate of LEs and SMEs. The research

Table 5. Changes in Growth Contribution of LEs and SMEs

		3 rd republic (1963- 1971)	4 th republic (1972- 1979)	5 th republic (1981- 1987)	6 th republic (1988- 1992)	Civilian govern- ment (1993- 1997)	People's govern- ment (1998- 2002)	Participatory government (2003-2006)
Number of Entity	SME	89.7	95.9	99.0	101.3	101.2	100.8	100.0
	LE	10.3	4.1	1.0	-1.3	-1.2	-0.8	0.0
Employ- ment	SME	28.0	48.9	72.9	62.7	24.7	841.7	62.6
	LE	72.0	51.1	27.1	-162.7	-124.7	-941.7	37.4
Production	SME	20.3	32.6	40.6	53.8	46.9	60.8	46.2
	LE	79.7	67.4	59.4	46.2	53.1	39.2	53.8
Shipment	SME	24.3	32.5	40.7	53.4	47.0	60.4	40.5
	LE	75.7	67.5	59.3	46.6	53.0	39.6	59.5
Value added	SME	25.5	35.8	41.2	53.5	45.2	67.7	49.5
	LE	74.5	64.2	58.8	46.5	54.8	32.3	50.8

Note: Growth contribution (%) = (LE or SME growth/Total manufacturing growth) x100.

Source: Digital Times.

the capacity of SMEs fell significantly, comprising less than half of the LEs except in the number of entity. During the Kim Dae Jung administration, the national economic contribution level of SMEs was the highest. Despite the financial crisis, SMEs significantly overtook LEs in the number of entities (100.8%), employment (841.7%), shipment (60.4%), and added value (67.7%), thanks to SME support policies. During this period the LEs experienced a 0.8% decrease in their establishments, a 941.7% decrease in employment, and saw their production, shipment, and added value contribute no more than 39.2%, 39.6% and 32.3% respectively which all reflected weakness. With the rise in the Chinese market and the abolition of SME core business

was based on the manufacturing sector using chronologically organized statistical data. Korea Federation of Small and Medium Businesses conducted the research in the coming of the 60th year of the establishment of the Korean government.

designation industrial policies during the Roh Moo Hyun administration, the growth of production and shipment of SMEs as well as their added value fell behind that of the LEs. As a result, polarization increased.

In surveying this progress of SME policy development, we can see that business polarization intensified beginning with democratization and the financial crisis, and that government efforts to alleviate the problem were ineffective. Several causes of such ineffectiveness can be pointed out. First, as labor unions became increasingly active, corporations expanded their automated production facilities, resulting in reduced employment and increased outsourcing. As a result, the per capita added value of LEs increased, and polarization intensified. After the 1997 financial crisis the links between *chaebols* and banks ceased, resulting in the rising cost of financing for LEs. With the relationship between the bank and *chaebols* shifting, corporations began to increase employment instead of investing in mechanical equipment. Consequently, since the end of the financial crisis through 2006, investment in machinery decreased while there was growth in employment. The employment of temporary as well as dispatched worker positions within corporations became possible, and the outsourcing rate continuously rose.

In addition, the polarization within SMEs also exacerbated polarization among firms. The number of small enterprises with less than 20 employees gradually increased, the subcontracting chain multiplied fourfold, and the number of foreign employees and temporary workers increased to lower costs. Thus, the increased number of SMEs in Korea is an increase in the number of small enterprises, and thus polarization between SMEs and LEs worsened. Another reason behind the increased polarization is a problem embedded in the Korean financial system. When the SMEs were divided according to their production or sales into categories of 30% of higher growth, less than 30% growth, and less than 0% growth, between 1999 and 2006 there has not been any significant increase in SMEs that have experienced growth of more than 30% or less than 30%. On the other hand, the number of SMEs that experienced a negative growth increased, which implies that they were not kicked out of market. The fact that these companies were not banned despite their negative profits shows that companies subject to restructuring did not have any exit points via M&A. In the case of insolvent enterprises,

they cannot even become liquidated due to their inaccessibility to secure loans. Currently the number of businesses with one or more employees is 3.4 million. However, those that have credit guarantees are only 300,000, which is less than 10%. The number of businesses that did not receive credit guarantee from the government is considerable, and that 90% must struggle to survive in a system of unlimited competition regardless of government support.⁹ This phenomenon is clear evidence of the limited outcome of the government's financial policy towards SMEs.

In conclusion, political democratization influenced economic democratization, but that democratization was limited to markets and liberalization. Consequently, the direction of SME support policy changed from protection and promotion to liberalization and competition. The problem was that the vulnerable SMEs were forced to face unlimited competition without structural reform to improve competitiveness. The government basically continued their pro-LE policies, and the SME support policies reaped only limited results in that they were mere lip-services with no binding force.

2. The Role of SMEs Interest Groups

Another reason behind the limited achievements of the numerous government policies regarding SMEs support is related to the role of institutions that represent the SMEs' interests.

Generally, the Japanese industrial structure compared to that of South Korea has developed with a good balance between LEs and SMEs. In fact, before the war, the Japanese subcontracting system also showed imbalanced relationships. However, the Japanese government continued their efforts in protecting and supporting SMEs by initiating various governmental policies and establishing laws preventing unfair subcontracting practices. Behind these efforts were pressures coming from the interest groups of Japanese SMEs, coupled with political will in the government to win electoral support (Nishigushi 1994; Lim, H. 1998). The Japanese self-employed business group's politics are more institutionalized and pluralistic. The SME groups decided on strengthening their external political connections during periods

⁹ Interview. Kim, Joo Hoon, KDI Senior Researcher 2009. 7. 1.

of crises. From the 1950s to 1960s the Federation of SMEs emerged with connections to the leftist party, which exercised a fair amount of political pressure. By demonstrating that self-employed businesses and SMEs could break away from political support, they were able to influence the Liberal Democratic Party, and led it to propose the following policy responses: the enactment of the Minor Enterprises Act, a comprehensive development plan for SMEs, proposals for creating a favorable environment for SMEs such as the establishment of exclusive banks for SMEs, signature loans, SME Restructuring Act, and the Minor Enterprises Act (Kim, S. et al. 2008: 41). The SME loan policy showed effectiveness to the extent that by 1967, the amount of bank loans received by the SMEs exceeded that of the LEs. Japan's SME development began from below, initiated by the independent SME movements.

Apart from being pushed aside in the LE-centered structure, SME interest groups also have a significantly limited role in Korea. When the influence of the Federation of the Korean Industries (FKI) and Korea Federation of Small and Medium-sized Businesses (Kbiz), the main interest groups of LEs and SMEs respectively, is compared, the rate of 20.6% whereas 10.6% (Hwang, J. 1997). It is also problematic to regard Kbiz as the main representative for all the SMEs in Korea. Kbiz in 1999 had a total of 735 associations and 64,780 companies as members, which is, only 4.9% of total SMEs in Korea (Jeong, S. 2002: 196). The ratio of registered Kbiz members lowered to 2.3% in 2006. But as it altered eligibility of membership in regard to the categories of business, the membership rate rose to 19.5%.¹⁰ The decisive factor that weakens the influence of Kbiz is their low fiscal self-reliance ratio. Since 1963 Kbiz has been receiving government support, and until 1995 government grants accounted for approximately 26.5% of the total ordinary earnings of its general account (Jeong, S. 2002). The proportion of the budget supplied by membership fees is only 4%. Its dependence on government led to circumvent main issues such as conflict with LEs, or financial problems but only to respond to minor issues. The overrepresentation of manufacturing

¹⁰ For instance, membership was only limited to cooperatives in manufacturing expanded to food suppliers. Interview 2009. 7. 7. Cho, Jin Hyung, Kbiz, Head of the Department of Budget.

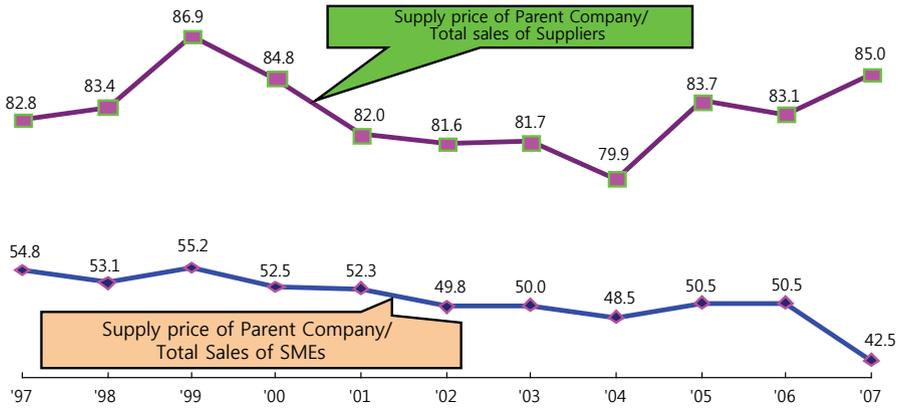
industry and the underrepresented commerce industry in Kbiz' membership also weakened representativeness of SMEs.

There is a big difference between LEs and SMEs in membership rate of their labor unions. In 2004, the number of workers employed in LEs with over 300 employees accounted for 10.1%, whereas the remaining 89.9% were employed in SMEs. 72.5% of members of The Federation of Korean Trade Union and the Korean Confederation of Trade Unions work in LEs with over 500 employees, 4.9% in enterprises of 50-99 employees, and 3.3% in small businesses with less than 49 employees (*Hankyoreh* 2005/1/3). The fact that labor unions are concentrated in LEs has close relations with the market power of LEs.

In contrast with Japan's balanced industrial structure, the imbalanced LE-centralized structure is mainly due to the political ties between the government and LEs, and the continuance of LE-oriented industrial policies. However, as we can see from the Japanese experience, the political role of SME interest groups is also significant. The government policy for supporting SMEs in Korea was ineffective because the government was reluctant to impose punishments or show political will in cases of non-compliance by LEs. SME interest groups are able to exert positive influence on the effectiveness of government policy by arranging measures to solidify internal organization and strengthen external political ties. Their continuously weak political-economic position is also caused by the subcontracting relationship between the SMEs and LEs, which will be further discussed in the next section.

3. Structure of the LEs-SMEs Subcontracting Relationship

The subcontracting rate of Korea's SMEs reached 63.1% in 2003, increasing from 48.9% in 1994. These subcontractors supply, on average, 82% of their total products to LEs. The ratio of SMEs which supply more than 90% of their total sales to LEs was 71.4%. The subcontracting rate between LEs and SMEs has increased, and the monopoly status of the former over the latter has strengthened (Kim, D. 2007: 480). According to Figure 5, whereas the number of SMEs that receive orders from other SMEs is decreased, their dependence on the LEs increased to 85% in 2007. Main complaints of SMEs in transactions with LEs are: the increased price of raw materials are



Source: The Small and Medium Business Administration, “SME Current Status Survey, 2008.”

Figure 5. Trend of Suppliers’ transaction dependence on parent company (%).

not reflected in the supply price (67.2%), pressure of lowering supply price (49.8%), pressure to shorten the delivery date (28.8%), and delaying payment (24.6%).¹¹

According to a study conducted in 2005, 80% of the SMEs identified themselves to be in a subordinate position vis-à-vis LEs. According to another study by Kbiz on 150 SMEs, only 0.7% supported to the LEs expanding into the business field of SMEs while 84.5% opposed. The difficulties for SMEs conducting business included the highhandedness of LEs in their subcontracting transactions (32.4%), manpower shortage (28.3%), lack of demand for their products (13.7%), and government interference and regulations (9.4%). The most frequent case of unfair subcontracting transactions was unilateral automatic cut of supply price (63.2%), arbitrary modification or cancel of orders (15%), and delaying payments (10.3%). What’s needed to facilitate fairness are fair practice of subcontracting (64.6%), localization (17.4%), financial support (10.2%), and joint marketing (5.4%)

¹¹ The average of assemblers for each supplier to supply the product increased to 14.5, and the Small and Medium Business Administration (SMBA) interprets this as a diversification trend of the supply structure. The SMBA has reported the Status of Korean SMEs 2007 that surveyed 4100 small and medium manufacturing companies (*Daily Labor News* 2008/11/19).

Table 6. Complaints of SME subcontractors in transactions with LEs (%)

	Harsh in-spec-tion	Under-represen-tation of raw ma-terial cost in the supply price	Pres-sure of low cost	Delay-ing pay-ment	Irregular orders (random orders)	Pressure of short-ening delivery date	Attempts to change of sub-contractors	Request for pat-ented tech-nology infor-mation	Conflict with sub-subcon-tractors	Non-pay-ment
'06	34.6	-	69.1	29.4	44.6	43.1	14.9	-	15.0	13.3
'07	22.4	67.2	49.8	24.6	22.6	28.8	4.3	1.3	11.6	11.1

Note: Exceeds 100.0 due to multiple answers; Supply price does not reflect increase in raw materials, Request for patented technology information reflected in 2007 investigation.

(*Hankyoreh* 2005/5/18).

SMEs' Financial problems aggravated after the 1997 financial crisis due to the delaying payment. Even though the supply price was made through negotiations, the majority believed that the buying assembler's influence was determinant in the price decision. No more than 5.2% agreed that the suppliers' position was adequately considered (Lee, Y. 2003: 223).

Businesses that followed each step of the transaction were asked of their experiences in receiving demands of reduced product unit price. According to the results, at the second and third step of the transactions, more demands were received for cutting unit price (33.1% for step 1, 37.2% for step 2, and 55.3% for step 3). At the second and third steps of the transactions, there was a tendency to depend more on simple, manufactured products than complicated ones, and a larger possibility of price competition within the same industry. Second and third step vendors had better provide differentiated products based on better skills, a tool to evade price competition (KOSBI 2009).

According to the companies that replied to the survey on the demand of low cost, most cited the continued LE demands of cutting cost, LE-centered economic structure, and wage increases subsequent to LE labor unions as the primary causes. 57.8%, and more than half, claimed that the fundamental problem had to do with the behavior of LEs. The following are solutions suggested, about unit price negotiations. Most of those replied claimed that

Table 7. Experiences of reduction in supply price according to each transaction step

		Experienced supply unit price reduction during 2007		Total
		Yes	No	
Steps of Transaction	Step 1	197 times 33.1%	399 times 66.9%	596 times 100%
	Step 2	87 times 39.2%	147 times 62.8%	234 times 100%
	Step 3	42 times 55.3%	34 times 44.7%	76 times 100
	No reply	1 time 50%	1 times 50%	2 times 100%
Total		327 times 36%	581times 64%	908 times 100%

Source: KOSBI, “The Survey on Transactions between LEs and SMEs, 2009”.

Table 8. Fundamental cause of the pressure of low cost

	Frequency	Percentage(%)
Continuous demand of low costs by the major LEs	234	25.8
LE-oriented business structure	291	32.0
Exploitation of higher status by consigner company	145	16.0
Technical skills of SMEs	55	6.1
Wage increase for LE labor union, pressures from increased price of raw materials, etc.	59	6.5
Competition in the global market	91	10.0
Other	33	3.6
Total	908	100

Source: KOSBI, “The Survey on Transactions between LEs and SMEs, 2009”.

Requirement for Product Unit Price Negotiation Policy would be more efficient than Pegged Unit Price. 35.7% claimed that the former will be more effective, and furthermore, 33.7% replied that there would be positive results when the government thoroughly oversees the process and secures the laws. Also, 35.7% were concerned with retaliation from LEs, which decreased the

Table 9. Causes of polarization of LEs and SMEs

Causes	Frequency	Percentage
Polarization is an inevitable trend in globalization period	141	15.5
LE-centered economic structure intensifies polarization	451	49.7
SMEs' lack of technical skills and competitiveness	159	17.5
LE labor unions have exacerbated polarization	53	5.8
Continuation of structural imbalance between LEs and SMEs	92	10.1
Other	12	1.3
Total	908	100

Source: KOSBI, "The Survey on Transactions between LEs and SMEs, 2009".

effectiveness of such measures.

According to <Table 9>, 55.5% of the companies claimed that the LE-centered economic structure and structural imbalance were primary causes of polarization, and 33.0% suggested the cause to be the trend towards globalization and lack of competitiveness of SMEs—showing that a majority attributed polarization to the LE-centered economic structure. The most popular suggestion to rectify this problem included reforming the currently LE-structured economic structure, improving technical capabilities of SMEs. And the second suggestion was strengthening the fairness of subcontracting relations. Institutional reform is necessary to prevent unfair corporate practices. For instance, in order to prevent any disadvantages for the consignees, 38.2% of the investigated group claimed that it was necessary to frequently initiate investigations regarding unjust transactions of consigners when the consignees are reported. Also, 27.1% answered that precedents of unjust cases should be reflected more effectively in the laws to exclude all unfair practices, 12.7% claimed that punishment should be intensified to increase losses when unjust practices are carried out by the consigners, and 12.5% suggested that policy consolidation for SME technology and quality competitiveness is needed.

A majority of those studied claimed polarization resulted from LEs-centered industrial structure, and this shows that government policies favor LEs. Suggested reforms include punishing unfair transaction practices and frequent investigations of LEs. This shows that there has been a constant, exclusive political alliance between the government and LEs.

Table 10. Measures for LEs-SMEs “win-win” strategy

Possible Measures	Frequency of choice	Percentage (%)
Strengthening the fair subcontracting system	185	20.4
Reforming the LE-centered economic structure	246	27.1
Strengthening technical skills and competitiveness of SMEs	210	23.1
Continuing policy implementation of LE-SME mutual existence	136	15.0
Joint collective action among SMEs	90	9.9
Alleviation of wage difference between LE and SMEs	39	4.3
Other	2	0.2
Total	904	100

Source: KOSBI, “The Survey on Transactions between LEs and SMEs, 2009”.

V. CONCLUSION

Korean SMEs have grown quantitatively since the 1980s, yet there has also been a structural weakness in a constant LE-SME polarization. The quantitative development of Korean SMEs does not lag when compared with other countries. After the 1980s, in terms of its number, production and added value, the number of LEs decreased while that of SMEs increased. Yet the profitability of SMEs decreased in their subcontracting relations with the LEs. Korean SMEs may have increased in numbers, but in qualitative terms they have reflected structural problems such as small size and low profitability.

The causes of LEs-SMEs polarization may be explained not just in economic terms, but also in terms of the government’s LE-favored policies, the ineffectiveness of SME policies, and the exploitative subcontracting relationships between the LEs and SMEs. In fact, the number of SME support policies and LE-SME cooperative policies were actually overwhelming. Moreover, polarization showed signs of intensifying after democratization and the financial crisis. Thus, the focus of the problem should not be whether there were shortages of such policies but on why these policies were ineffective. Causes included the government’s exclusive political alliance with

LEs, the lack of political representation for the interests of SMEs, and the lack of win-win strategies between LEs and SMEs. To foster cooperation between LEs and SMEs for a “win-win” strategy, the government needs to stress the importance of “win-win” strategies and continue their efforts in persuading the LEs. At the same time, the government’s willingness was not strong enough to impose severe punishments for unfair subcontracting practices by LEs. Political democratization also influenced the realm of economics in Korea, but the economic democratization was perceived as only the opening of markets and liberalization. Following democratization, the SME support policies focused on liberalization and competition and moved away from previous policies of protection and development. However, without structural reform for fair competition, SMEs were subjected to unlimited competition which caused excessive polarization of LEs and SMEs.

Japan was able to achieve a relatively balanced industrial structure because the interest groups of SMEs were institutionalized to significantly influence the government. The government also placed sustained efforts on developing SMEs to get firm political support. The most important factor was that there were effective policies such as the initiation of the Monopoly Regulation and Fair Trade Act to foster fair subcontracts between LEs and SMEs, and an expansion of financial support for SMEs. The transformation of subcontracting relations between LEs and SMEs from exploitative to cooperative was an important factor that contributed to balanced development.

According to a study conducted in 2003 identifying the number of SMEs in the manufacturing industry that developed into LEs exceeding 300 employees, of 56,000, only 57 became LEs. The number of companies that expanded to 500 employees was only 8. The current situation in Korea is that there is a structural barricade between LEs and SMEs, which cannot be considered a healthy industrial structure.¹² The financial support policies for SMEs has shown limitations, by financial institutions maintaining their conservative tendencies during takeover and M&A processes of weak SMEs. In order to prevent further polarization and to develop a balanced industrial structure, it is necessary to implement more effective policies and foster win-

¹² Interview. Kim, Joo Hoon, KDI Senior researcher 2009. 7. 1.

win strategies between LEs and SMEs. Also, SME interest groups need to consolidate internally and strengthen their external political ties in order to positively influence the effectiveness of governmental policies.

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