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ECONOMIC DEVELOPMENT AND COMPETITION POLICY IN KOREA

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I. INTRODUCTION

Throughout the era of rapid economic growth that occurred in Korea from 1981 to 1999, the Korean government gave higher priority to large firms over small and medium-sized firms. This policy, coupled with economies of scale inherent in imported technologies, led to the concentration of economic power embodied in and symbolized by conglomerate business groups popularly known as *chaebols*.¹ *Chaebol* subsidiaries often are monopolists or oligopolists in their respective markets. *Chaebols* are owned and controlled by individuals and their immediate family members.² Most *chaebols* are based in the Korean manufacturing sector; however, many have expanded their activities into the financial sector as well.³

Korea's market structure generally was noncompetitive until competition policy issues surfaced after the Korean oil crisis of 1974. The severely distorted market mechanism and a sharp increase in the price of imported raw materials caused rampant inflation and supply-demand imbalances in many markets. To control prices and assure fair trade practices, the Korean government enacted the Act Concerning Price Stabilization and Fair Trade ("Price Stabilization Act"). Government implementation of the Price Stabilization Act lopsidedly stressed price

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1. For example, in 1997, the thirty largest *chaebols* accounted for 21% of total employment and 32% of total sales in the manufacturing sector. For time series data on the economic performance of *chaebols*, see KYU UCK LEE, COMPETITION POLICY, DEREGULATION AND ECONOMIC DEVELOPMENT: THE KOREAN EXPERIENCE (1998). Korean *chaebols* have a number of characteristics similar to those of the pre-World War II Japanese *zaibatsu*. (After all, these two words are written in the same Chinese characters with only different pronunciations.) Critics have lambasted *chaebols* for their close ties with politics, questionable business ethics, and inefficient diversification while simultaneously crediting them for their contributions to economic growth. These complex characteristics have caused ambivalent public attitudes and government policies toward *chaebols*.

2. In 2000, the average "in-group shareholding ratio" of the thirty largest *chaebols* was 43.4%. Korea Fair Trade Comm'n, The White Paper on Fair Trade 82 (2001) [hereinafter KFTC].

3. *Chaebols* took over Korea's previously nationalized commercial banks in 1981. Only a few *chaebols* shared ownership of each national bank because no single "person" was permitted to own more than 8% of any nationwide commercial bank's total stock. By contrast, there was no legal ceiling on the ownership of local banks, thereby allowing each local bank to come under the practical control of one or two *chaebols*.

control. From 1975 to 1979, the government designated hundreds of monopolistic and oligopolistic products as targets for price control.⁴ Although the number of designated products gradually decreased, the government carried out extensive price regulation until 1979.⁵

The extensive government price controls severely distorted price mechanisms and gave rise to phenomena such as dual pricing, deterioration of product quality, excess demand, and increased uncertainty about future price movement, thereby underlying the general consensus that the market mechanism should play a greater future role in the Korean economy. The government's first major effort in this direction was to enact the Monopoly Regulation and Fair Trade Act ("Fair Trade Act") on December 31, 1980. The Fair Trade Act essentially replaced the Price Stabilization Act by creating a comprehensive set of new rules for the market economy—namely, free and fair competition. Nevertheless, the Fair Trade Act did not specifically address *chaebols*.⁶

II. THE FAIR TRADE ACT

The Fair Trade Act forbids dominant firms in monopolistic or oligopolistic markets from abusing their market dominating positions.⁷ Each year from 1981 to 1999, the Korean Fair Trade Commission (KFTC) officially identified such monopolistic and oligopolistic firms.⁸ The KFTC exerted tremendous administrative efforts to identify these firms, but was only able to correct thirty-three cases of such abuse.⁹

In 1999, Korea amended the Fair Trade Act to abolish prior designation and identify whether or not the defendant firm has a market dominating position.¹⁰ The Fair Trade Act originally was designed to generally restrict business integration by firms if the integration could lead to substantial injury to competition in any line of commerce (with exceptions only for

4. See LEE, *supra* note 1, at 237-40.

5. Almost all of the eighty-five cases prosecuted on charges of unfair business practices concerned the hoarding and cornering of rice. The only case of undue concerted activity involved a cement cartel. Ironically, however, the Price Stabilization Act served not to sanction the cement cartel but to legitimize it on four consecutive occasions.

6. Numerous subsequent amendments to the Fair Trade Act corrected many such omissions.

7. Market dominating firms refer to either any single firm that has a market share of more than 50% or the three largest firms in a given market that have a combined market share of more than 75%. See Monopoly Regulation and Fair Trade Act, Law No. 3320 of 1980, art. 4, available at <http://www.apecp.org.tw/doc/Korea/Competition/krcom02.html> [hereinafter Fair Trade Act].

8. For example, in 1981, the KFTC identified 102 such firms in 42 markets; in 1999, it identified 324 firms in 129 markets.

9. See KFTC, *supra* note 2, at 498-99.

10. See Fair Trade Act, Law No. 3320 of 1980, amended by Law No. 5813 of 1999.

integration aimed at either industrial rationalization or strengthening the international competitiveness of an industry). In 1999, Korea replaced these ambiguous exemptions with the efficiencies and failing-firm defense similar to those found in the 1992 U.S. Horizontal Merger Guidelines.¹¹ When Korea originally designed the Fair Trade Act in 1980, it identified the “establishment of new enterprises” as a method of business integration to complement the typical methods of business integration like mergers and acquisitions.¹² This provision was unique compared to the competition laws of many other countries, and it was made in response to the fact that more firms were newly established than currently were merged into the rapidly growing Korean economy.¹³

The Fair Trade Act provides specific measures that mitigate the concentration of economic power in big business groups. The government amended the Fair Trade Act in 1999 to permit the existence of holding companies with certain restrictions as a means to induce *chaebols* to reorganize themselves.¹⁴ The Fair Trade Act states that “financial” holding companies cannot possess subsidiaries positioned outside the financial sector while “general” holding companies cannot have subsidiaries engaged in financial business.¹⁵ The philosophy underlying this dichotomy is that financial capital must be separated from industrial capital in order to prevent *chaebols* from dominating the national economy.

The Fair Trade Act prohibits direct cross-investment between subsidiaries belonging to the same *chaebol*.¹⁶ However, most *chaebols* have circumvented this restriction by expanding through indirect cross-shareholdings among subsidiaries, which can take or assume any combination of the radial, circular, or matrix forms.¹⁷ Because it is difficult to disentangle the complicated web of indirect cross-shareholding, the 1986 amendment to the Fair Trade Act added a clause prohibiting subsidiaries of large business groups from obtaining or holding shares in other domestic firms worth more 40% of the firm’s net assets.¹⁸ The 1994

11. U.S. Dep’t of Justice & Fed. Trade Comm’n, Horizontal Merger Guidelines, Fed. Reg. 41,552 (Sept. 10, 1992).

12. In 1986, Korea expanded the category “business integration” to include “the participation in the establishment of new enterprises” so as to include joint ventures within the purview of the Fair Trade Act. See Fair Trade Act art. 12(5).

13. See LEE, *supra* note 1, at 275.

14. See Fair Trade Act art. 8.

15. *Id.* art. 8-2(1), paras. 4-5.

16. *Id.* art. 9(1).

17. For example, in 1984, the average intercompany shareholding ratio for the thirty largest business groups was 47%.

18. The Fair Trade Act originally applied this provision to business groups whose total assets

amendment subsequently lowered this ceiling to 25%.¹⁹ *Chaebol* subsidiaries that engage in either banking or insurance also are subject to this constraint and are prohibited from exercising voting rights in domestic firms they have invested in.²⁰

To further control *chaebols*, the Fair Trade Act restricts affiliate cross debt guarantees between subsidiaries belonging to any one of the thirty largest *chaebols*.²¹ The 1992 amendment to the Fair Trade Act restricted these affiliate payment guarantees to 200% of the subsidiaries' net assets, with the 1996 amendment lowering this restriction to 100%. Finally, under the 1998 amendment, the Fair Trade Act now prohibits affiliate payment guarantees for all new borrowings of the thirty largest *chaebols*.²² Before these restrictions, *chaebols* had easy access to banks because the *chaebol* subsidiaries would have other affiliates guarantee the *chaebols*' debts under the collateral-based loan system, thus disproportionately favoring the *chaebols* and fueling their rapid expansion. The government expects the current ban on affiliate payment guarantees to redirect the flow of capital to other firms in a more balanced manner. However, it is an open question as to whether such a result will occur if banks do not abandon their conservative practice of "no collateral, no loan."²³

The Fair Trade Act prohibits firms and cartels from engaging in collective activities that would restrict competition substantially in any line of commerce.²⁴ The 1990 amendment added a supplementary provision of presumption based on circumstantial evidence, under which covert collaborations can be brought within the ambit of the Fair Trade Act.²⁵ However, the KFTC retained the power to keep alive cartels deemed necessary for achieving industrial rationalization, overcoming cyclical

exceeded 400 billion won (approximately 311 million U.S. dollars). However, since 1993, the Korean government has applied this provision solely to the thirty largest *chaebols*.

19. See Fair Trade Act art. 10(1).

20. The government rescinded this provision in 1998 but decided to reinstate it in 1999 because *chaebols* had taken advantage of the provision's absence by increasing their share of ownership in their subsidiaries from 38% to 44% in less than one year, thereby reviving fears of rampant *chaebol* expansion. Regardless of the reasons for removing and then dramatically reintroducing the provision, such a seemingly wayward policy change undermined public trust in the Korean government's ability to properly address the *chaebol* issue.

21. See Fair Trade Act art. 10-2.

22. *Id.*

23. In Korea, commercial banks stubbornly have maintained the policy of not lending money to firms that cannot submit collateral equivalent to the whole amount of loans. Consequently, small and independent firms have had very limited access to commercial banks. See KOREA ECON. RESEARCH INST., COMPETITION POLICY FOR THE GLOBALIZATION AND INFORMATION AGE 36-37 (2001).

24. By 2000, the government had remedied 329 such prohibited collective activities. KFTC, *supra* note 2, at 511.

25. See Fair Trade Act art. 14-3.

recessions, facilitating industrial restructuring, enhancing the competitive strength of small and medium-sized firms, and rationalizing transaction terms.²⁶ The Fair Trade Act also prohibits firms and cartels from engaging in seven broad categories of unfair business practices: (1) the undue refusal to transact with or discriminate against a certain partner in the transaction; (2) the undue elimination of competitors; (3) the undue allurement or coercion of competitors' customers; (4) the undue exploitation of a bargaining position against other parties involved in the transaction; (5) placing undue restrictions on any business activities of other parties; (6) any undue offering of financial or other types of support to specially related persons or other enterprises; and (7) activities other than those defined in the preceding subsections that may hamper free trade.²⁷

The Fair Trade Act prohibits resale price maintenance as a specific type of unfair business practice or vertical restraint.²⁸ This provision is automatically exempt without exception for publications specified by the Copyright Act.²⁹ In addition, the provision may not be applied to commodities that meet the following conditions: (1) their qualities easily can be recognized as being identical; (2) they are for daily use by general consumers; and (3) free competition prevails in their respective markets.³⁰ The Fair Trade Act expands these restrictions to unreasonable collaborative activities and unfair business practices between trade associations and their member firms by: (1) prohibiting trade associations from restricting the number of present or future member firms in a given area of trade; (2) unreasonably restricting other member firms' business activities; and (3) forcing members to commit unfair business practices or resale price maintenance.³¹

As part of Korean fair trade policy, the KFTC administers the Fair Subcontracting Transactions Act of 1984 (FST).³² The Korean government introduced the FST to incorporate and strengthen related provisions in

26. *See id.* art. 19(2).

27. *Id.* art. 23(1). The KFTC transferred the former regulation against false or misleading labeling and advertising to the Fair Labeling and Advertising Act, Law No. 5814 of 1999.

28. *See* Fair Trade Act arts. 29-32. By 1999, the FTC had corrected 139 cases involving resale price maintenance provision violations without granting a single exemption. KFTC, *supra* note 2, at 487.

29. *See* Fair Trade Act art. 29(2).

30. *Id.* art. 29(2), §§ 1-3.

31. *Id.* art. 26(1), §§ 1-4. By the end of 1998, there were a total of 6,313 trade associations in Korea. From 1981 until 2000, the government corrected 838 violations of the Fair Trade Act committed by trade associations. KFTC, *supra* note 2, at 838.

32. Fair Subcontracting Transactions Act, Law No. 3779 of 1984.

various competition laws, including the Fair Trade Act. The major strength of the FST is that it protects virtually all small and medium-sized firms in weaker bargaining positions from unfair business practices by larger firms in subcontracting relationships.

The KFTC plays a unique role in enhancing the efficacy of Korean competition policy by requiring other government authorities to consult with the KFTC if they wish to introduce, amend, or enact any laws, decrees, or administrative measures that may restrain competition. From 1981 to 2000, government authorities consulted with the KFTC on 3,789 separate proposed legislation or alterations, of which the KFTC corrected 685.³³ Through such consultation, each department of the Korean government has been able to better understand and abide by the principles of fair and free competition in formulating and enforcing its respective policies.

III. KOREAN ECONOMIC DEREGULATION

In tandem with fair trade policy, economic deregulation constitutes another pillar of Korean competition policy. Desiring rapid economic growth, the Korean government licensed a small number of firms to enter into particular markets, and then supported their growth by guaranteeing them monopolistic or oligopolistic positions in their respective markets. This government regulation served its purpose rather effectively in the early stages of economic development because the Korean economy was small and the capabilities of the private sector had not yet matured. However, as the economy expanded and the private sector began to mature, this government intervention in the economy began to hamper efficient business activities. Regulations originally justified by market failures eventually gave rise to government failures in that most regulations, once introduced, continued indefinitely, leading to cooptation between the regulators and the regulated businesses. This level of economic inefficiency soon led the Korean public to increase pressure on the government for wholesale economic deregulation. Economic regulation had lost what little public support it had ever had, for the Korean public widely acknowledged it as the primary cause of corruption and political scandals in the Korean government.

The Korean government responded to this public discord in the early 1980s by attempting to improve the regulatory system, but its efforts were

33. KFTC, *supra* note 2, at 136-38.

only partially effective as the government only worked to reduce the volume of associated red tape and paperwork. It was only in 1988 that the Korean government began deregulating industries on a vast scale. However, by 1995, the Administrative Reform Commission was implementing deregulation sporadically, as it had begun to focus primarily on select regulations that had a more significant and far-reaching impact on the economy.³⁴ In 1997, under the Basic Act for Administrative Regulations, the government created the Regulatory Reform Committee to scrutinize existing regulations and remove any harmful or unnecessary regulations still under law.³⁵

A salient feature of the deregulation process in Korea is that virtually every segment of Korean society has advocated the need for regulatory reform. Nevertheless, each segment maintains a differing view on deregulation and how it should be conducted. As a consequence, the government has enforced deregulation mostly in areas in which the government and private industry have no acutely conflicting interests without fully challenging the institutional barriers to entry and exit, which remain the most potent forms of regulation that hinder free competition. In essence, regulatory reform did not have the effect on the Korean economy that everyone thought it would.

Deregulation must go hand in hand with fair trade policy; otherwise, the market mechanism cannot perform its proper role. The government designed the Fair Trade Act to encourage individual initiative rather than constrain it, but many Korean business circles still consider the Fair Trade Act to be a form of government regulation.³⁶ This is a viewpoint that recently has gained significant support from Korea's population at-large. In order for regulatory reform to bear fruit and be truly effective, the government must redefine its proper regulatory role in a clear and unambiguous manner.

Even if the Korean government prepares a detailed regulatory or deregulatory program, successful enforcement would not necessarily

34. Examples of these high impact regulations include the Foreign Investment Promotion Act, Law No. 5559 of 1998, and the Industrial Placement and Factory Construction Act, Law No. 5827 of 1999.

35. See Basic Act for Administrative Regulations of 1997 art. 6.

36. For example, the Federation of Korean Industries (FKI) has argued consistently for the wholesale revision of the Fair Trade Act on the grounds that most of its provisions have served simply to hamper the free enterprise system. In November 2001, after a long, heated debate between the KFTC and the Ministry of Finance and Economics (acting upon persistent demand from the FKI), the Korean government decided to substantially relax the constraint that the Fair Trade Act imposes on investments of the thirty largest *chaebols*, and submitted the bill to amend the Fair Trade Act to the National Parliament.

follow. Those benefiting from advantageous regulations in their respective markets tend to form a considerable force opposing governmental modification of these regulations.³⁷ In order to successfully overcome such organized opposition and successfully execute deregulation, it is imperative that the government carefully orchestrates a two-pronged approach. First, the government must summon broad public support for particularly controversial deregulatory efforts to silence the boisterous voices of concerned interest groups. Second, the government must take concrete measures to reduce the adjustment costs of deregulation to affected groups.

Ultimately, deregulation requires significant governmental reorganization. The government must reorganize itself on the principle of a “small but strong government.” A small government is one that does what it should do and refrains from doing what it should not do. A strong government is one that takes initiative to reorganize and reduce itself when necessary. Neither the government nor business community should believe that deregulation is strictly for businesses. Deregulation should be more than just a response to self-serving businesses. It should serve as a fundamental underpinning for the transformation of the entire Korean economy.

IV. CONCLUSION

It would be wise to describe the evolution of Korea’s competition policy as a steady progression toward the extensive economic liberalization commensurate with a free market economy. This progression is the outcome of both natural historical dynamism and deliberate choices in response to the changing economic environment. The economic environment that once justified government regulation has disappeared and, in one respect, free competition is now the unequivocal rule governing the marketplace. Moreover, competition in Korea has assumed a new nature driven by innovation and based on globalized business activity. The Korean experience suggests that a competitive economic order cannot develop fully apart from a democracy because their ideals and logic are completely intertwined.

37. An illustrative example is the organized resistance of pharmacists and medical doctors, respectively on different grounds, to the government’s plan to enforce the separation of the prescription and dispensation of medical drugs in the process of enlarging the national medical insurance system. Compromising the vested interests of both groups, the government ended up with a scheme that did not satisfy all of the concerned parties, including the general public.

Critics of deregulation argue that monopolization and regulation are necessary to obtain efficiency while competition and economic freedom tend to be wasteful in the early stages of economic development. Although there is some logic to this argument, eventually artificial monopolies both hamper economic efficiency and impede the competitive spirit that is the real engine of Korea's economic growth. Rent generated by government intervention and appropriated by select members of society creates a strong incentive to form a community of interests. This results in high social costs that the government cannot eliminate easily in an economy marked by ill-functioning market mechanisms.

Even if a country introduces a legal framework to promote competition, that framework is meaningless unless accompanied by corresponding changes in the values, perceptions, and mentality of all economic agents, including the government. In order to promote true, interminable economic freedom, the government must revise the law continuously to keep abreast of the evolving economic reality. It is for this reason that the government must review competition policy and related administrative practices on a consistent basis to be able to respond to ever-changing economic and technological conditions.

Regulatory agencies should enforce the principle of fair and free competition across all industries; otherwise, there will be an inefficient allocation of economic resources and distributive equities may be concurrently and irreparably harmed. The disparity among industries in the speed and scope of economic liberalization has the potential to create a major crisis, as Korea's 1997 financial meltdown painfully demonstrated. With regard to Korean competition policy, the Korean government is concentrated on both dealing with violations of, and removing trivial procedural regulations from, the Fair Trade Act. However, this concentrated focus has led to a general failure to both reorganize key industries and tackle the issues surrounding *chaebols*.

Even though Korean competition policy is based primarily on the Fair Trade Act that provides fundamental rules for market order and contains elements of general industrial policy, the government must recast and implement other industrial laws and policies according to the principles embodied in the Fair Trade Act. One problem issue in need of such coordination concerns *chaebols'* dominant possession of economic power. The Korean government has only just begun to address this issue and has experienced much trial and error in its attempts to formulate a correct policy menu. As the Korean economy works to pursue fair and free competition rules, the *chaebol* issue will dissolve. Nevertheless, the significance of the *chaebol* issue to the future of the Korean economy

requires that the government properly address the issue without any further delay. This poses the most critical task for competition policy in Korea.