The Competitive Challenge to Korean Industry in a New Development Economics Perspective

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Abstract

This paper provides a critique of Korea’s industrial policy in the context of a new development economics paradigm. Korea’s industrial policy, broadly speaking, is categorized into two distinct phases roughly on both sides of the mid-1980s: periods classified as the “conglomeration” and “de-concentration” periods, respectively. Our discussions on industrial policy lead us to address the fundamental question of development economics, through which we argue that the development process is characterized by “discrimination” and “verticalism”. Furthermore, growth, we argue, naturally leads to some degree of conglomeration, which we acknowledge has been a source of some concern. However, Korea’s anti-concentration and egalitarian policies of the past 15 years or so, by placing too much emphasis on equitable balanced growth, has not only been ineffective in handling issues of conglomeration, but has also stripped the country of its industrial competitiveness and growth potential. The competitive challenge to Korea is, to put it succinctly, to get out of the “egalitarian trap”. This paper provides the reasons why Korea has fallen into this “egalitarian trap”, and why we must get out of this trap if we are to restore the country’s industrial competitiveness.
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1.0 Introduction

[Hostility towards industrial policy]

With more cases of failure than success associated with the widespread adoption of industrial policy in many parts of the world, especially among countries that sought industrialization after the mid-1950s, coupled with the increasing influence of “global rules of the game” set by the international financial institutions such as the IMF, World Bank, WTO, and others, today, there is generally a climate of hostility regarding industrial policy.¹

[Korea as a unique case of success]

Notwithstanding the fact that it remains difficult to find a concrete relationship between industrial policy and economic performance, either across countries or across time, many scholars are quite happy to accept that Korea is perhaps the best example of economic success through a well planned and executed industrial policy.² A series of Five-Year Plans from the early 1960s successfully initiated, and then accelerated, Korea’s industrialization. Today, Korea is recognized internationally as a modern manufacturing and export trading country.

[Aims of paper]

In this paper, we provide an overview of Korea’s industrial policy in the context of

¹ Many of the instruments of industrial policy, for example, are now prohibited and declared illegal by international agreements. For example, the GATT, through a number of successive rounds has over the years dismantled protection through tariffs; the direct use of subsidies in export industries has curtailed under the GATT Subsidies Code; the Procurement Code limits the extent to which governments can give preference to their own product, and so on and so forth.
² Other “typical” countries include Japan and Germany. Actually, Chang Ha-Joon (2003) argues that ALL major successful countries did adopt industrial policies, or at least some form of industry protection, at
our interpretation of economic development. Korea’s industrial policy, broadly speaking, can be categorized into two distinct phases roughly on both sides of the mid-1980s. We distinguish the two policy regimes under the “conglomeration” and “de-concentration” periods respectively. A major contribution of this paper is to show how the switch from the “conglomeration” to “de-concentration” eras has adversely affected Korea’s industrial policy, which poses a major threat to the growth potential of Korean industries. This is all the more reason why we need to take up seriously, albeit in a new approach, the challenges to Korea that the new century poses.

Our discussion on Korea’s industrial policy leads us to address the fundamental question of development economics, through which we argue that the development process is characterized by both “discrimination” and “verticalism”. Furthermore, growth, we argue, naturally leads to some degree of conglomeration, which we acknowledge has been a source of some concern. On the whole, however, Korea’s anti-concentration and egalitarian policies of the past 15 years or so, which have been instrumental in trying to tackle the conglomeration/concentration issues, by placing a disproportionate emphasis on equitable balanced growth, have not only been ineffective in handling issues of conglomeration, but have also stripped the country of its industrial competitiveness and growth potential. The competitive challenge to Korea is, to put it succinctly, to get out of the “egalitarian trap”. We provide the reasons why we have fallen into this trap, and why we must get out of this trap if we are to restore the country’s industrial competitiveness.
2.0 Classification of Korea’s Industrial Policy Regimes

[World Bank classification]

Korea’s industrial policy has by no means remained unchanged over the past 40 years of rapid industrialization. Accordingly, there have been different attempts at classifying policy regimes and types in the literature. A popular categorization is the World Bank’s three-period approach, which consists of a first phase, beginning around the mid-1960s, when policies favored exports in general and without any serious specific sectoral biases; a second policy phase, spanning the mid-1970s when the most extensive government intervention took place in the form of the controversial Heavy and Chemical Industry (HCI) drive; and, a third phase of traumatic economic adjustments of 1979-81, when Korea abandoned HCI preferences and sought macroeconomic stabilization.

[Our classification of industrial policy]

In this paper, as history has certainly moved along, we take a longer view at the Korea’s industrial policy, and although somewhat at the risk of over-generalization, distinguish between two types of policy regimes, which have influenced greatly the shape and implementation of industrial policy. The two phases have followed one another: Chronologically, the first type of industrial policy era begins in the early-1960s with climax in the 1970s, when the government more or less initiated, controlled, and evaluated nearly all major industrial change, through “discrimination” of industries and, particularly, firms. This is distinguished from a second phase that spans from the period

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4 It is a little difficult to see how the last phase represents an industrial policy phase.
5 We use the term “discrimination” rather than “selection”, as the latter term has been used a little too frequently and many interpretations of it exit in the literature. “Discrimination” is a preferred term, which has a definite meaning in our new development economics paradigm presented below.
after the mid-1980s up to the present time, which in contrast with the previous phase tends to emphasize the containment of economic power concentration of economic actors. It is now being realized that the transition from an almost unquestioned support of industrial policy under an authoritarian regime to a somewhat diffused policy framework influenced heavily by the widespread democratic movement is an important feature of Korea’s economic evolution over the past 40 years or so.

Few would disagree that the earlier period of conglomeration of key industries and of firms under a highly interventionist government has been instrumental in pushing Korea’s economic growth. In essence, this highly discriminatory system, and here we use the term “discriminatory” qualitatively, on the large part, did well to mimic the market. In doing so, we were able to observe the successful take-off of Korean industries in a space of a very short time. Korea’s government-led and highly “discriminatory” industrial policy is not without side effects, however, and has stirred a considerable amount of controversy among academicians, policymakers, and the general public. In the 1980s and 1990s, with the replacement of the authoritarian regime by a weak democratic one, there has been a struggle to find an alternative viable industrial strategy to enhance Korea’s competitiveness. The record, without being too critical, is not that great.

2.1 “Conglomeration”: Korea’s industrial policy in the 1960s and 1970s

[1960s: Export Promotion]

Korea was almost completely destroyed from the War in 1950-3, and without any natural resources and a serious lack of capital, the country had no hope of economic progress. After almost a decade of uncertainty and digression, Korea’s economy began on its road to modernization in 1961, when President Park Chung-hee introduced drastic
changes in economic policy. Placing exports as its primary goal, a major policy change in the 1960s was the replacement of the import-substitution development strategy with an outward-looking one. A series of Five-Year Plans contained the framework for setting out the blueprint of Korea’s industrialization under strong government intervention and control. The government not only placed the export-drive strategy firmly in the First Five-Year Plan (1962-1966), but also simultaneously setup important economic institutions to help policy and industrial coordination, the most important of which was the Economic Planning Board established in 1961.

Under the First Five-Year Plan, export incentives were largely neutral, and on the balance without any serious sectoral bias. A comprehensive incentive system was introduced, designed to channel resources into export-oriented sectors. All exporters, regardless of what they exported, were eligible for preferential access to foreign loans and to preferential interest rates, and were allowed also to import, usually on preferential terms, machinery and intermediate inputs needed for manufacturing export products. In a sense, it can be argued that industrial policy involved neither “functional intervention” (addressing specific types of market failure) nor “selective intervention” (influencing the industry-specific composition of the economy). True, but behind the apparently simple export performance criteria, there was much preparation and work involving regular meetings for evaluation and rewarding of good business performance.

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6 The first attempt at formal planning dates back to 1954, when Robert Nathan and Associates submitted, under contract, the “Korean Reconstruction Programme” to the UN Korean Reconstruction Agency (UNKRA). However, the Korean government did not adopt the programme. It was not until 1958 that the Korean government showed its interest in overall planning by establishing the Economic Development Council within the Ministry of Reconstruction.

7 Five-Year Plans were implemented from 1962. However, from the 1980s, the plans merely served as a broad profile of the government’s economic objectives. Five-Year Plans were stopped after the Seventh (1993-1997).

8 There were a few sectors in the 1960s, specifically, fertilizer, refined oil, steel, synthetic chemical fibers and electric machinery that did receive special support. The scale of such support is hardly significant compared to what happened in the 1970’s HCI drive.

(measured in terms of exports) carried out by the government. At the end of each month, and even more dramatically at the end of the year, the Export Promotion Committee headed by the President reviewed progress and prepared necessary measures toward export targets. Moreover, public recognition was bestowed on successful exporters by awarding them with achievement medals—a citation that provided entrepreneurs with enormous social prestige, as well as various tax and financial support. Financial resources, in particular, were allocated to successful firms not only as a result of the government’s industrial policy, but also as voluntary response by banks that reacted to favorable signals from the evaluations and outcomes of the export meetings. The government through such “export contests” placed discrimination at the center of industrial policies.

['kwanchi-kumyung']

At the heart of the government’s intervention strategy was its control over credit allocation. The government introduced institutional measures to strengthen state control over finance including the revision of the Bank of Korea Act in 1962, which subordinated the power of the central bank to the government. The government had also revised the Korea Central Bank law as well as the Bank Law, thereby taking over the stocks of commercial banks owned by private enterprises, and had established special-purpose state banks such as the Kookmin Bank for the general public and the Industrial Bank of Korea for small and medium firms.

Under a state-controlled financial system, policy loans, that is bank loans explicitly earmarked for certain projects or industries and lent by banks at interest rates below that charged for general lending purposes, were important policy tools to attain government
objectives. Allocation of credit was important, but an aspect less recognized is that when credit was allocated to firms, it was done only after performance evaluation and as reward for good business performance. Here, as we mentioned above, it was the government’s evaluation system that provided the signal to banks regarding firm performance, which otherwise might have been provided by market institutions. The main point still holds, that credit allocation, although highly interventionist, was closely linked to a rigorous discrimination process, thereby, explaining partly why the system was able to resolve many ambiguities that would otherwise have created corruption and waste.

Macroeconomics statistics do show that the Korean economy did successfully take off during the 1960s; although the Consumer Price Index (CPI) inflation reached an annual rate of about 12%, GDP growth rates averaged an impressive annual rate of 8.5%, while annual export growth reached 39%. Nonetheless, it was questionable whether economic growth, as well as the strength in exports performance, would enjoy continued growth into the 1970s with only a neutral export-oriented policy in place.

[1970s: HCI drive]

In 1973, the Korean government launched the Heavy and Chemical Industry (HCI) promotion strategy with the purpose to develop certain key heavy and chemical industries including iron and steel, nonferrous metal, shipbuilding, general machinery, chemicals, electronics, and others as designated by the president.

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10 The government had already taken measures in 1961 to nationalize major commercial banks.
12 The origins of Korea’s HCI plan can be traced to the 1950s. In fact, prior to 1973, when the HCI drive was announced, the rapid expansion of the steel and petrochemical sectors were already under way.
**[Reasons for HCI]**

Essentially, the HCI plan primarily aimed at the transformation of industry from being labor-intensive to being capital-intensive, with further aims at reducing the mounting current account deficits caused by an ever-increasing import demand for capital goods and intermediate inputs for export production. At the time, the government decided that private agents alone could not be exclusively relied upon to implement critical change in Korea’s industrial structure. Particularly, the heavy and chemical industries required huge amounts of capital, which were to be locked in for extended periods of time, and such large-scale, risky investments, the government decided could not be undertaken by the private sector without decisive government leadership.\(^\text{13}\)

**[Support for HCI]**

Throughout the 1970s, to provide large investment resources into the heavy and chemical industries, the government established the National Investment Fund in 1974, and commercial banks, already under the control of the government, were directed to give out loans to targeted investment projects and companies operating in the heavy, chemical, and export-oriented industries. For example, foreign and bank loans accounted for about half the source of funds of the corporate sector, with much of the funds being lent under preferential rates.\(^\text{14}\)

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\(^{13}\) See Yoo, Jung-ho (1989). Improving self-defense capabilities was an important non-economic reason for the HCI drive. It has been argued that what had been only speculation regarding the HCI policy in the 1960s turned into an urgent need for action in the early 1970s as Korea’s military concerns became real and immediate following the “Nixon Doctrine” and American’s trauma in Vietnam, which many understood would mean lesser US military presence in the Korean peninsula. Furthermore, since the end of the Korean War in 1953, both North Korea and China had been vigorously pursuing heavy industrialization.

\(^{14}\) Loans to companies and other earmarked loans (i.e. “policy loans”) had low interest rates [See, Jwa Sung-Hee (2002, p. 24-5)]. For example, the difference between the earnings rate of commercial bills and
Tax incentives were also important instruments in industrial policy. During the 1970s, for example, the effective tax rate on HCIs was 20% compared to 50% for light industries.\(^{15}\) In general, tax support to corporations operating in the selected industries included tax reductions on export sales, reductions of indirect and customs taxes on inputs for export goods, reductions of corporate tax, and a high rate of depreciation.

\[\text{[HCI and Exports]}\]

Trade policies, together with tax, credit and interest rate policies, were also important to the heavy and chemical industries promotion strategy. That is, Korea’s HCI drive, although essentially an import-substitution policy, ironically retained an export-oriented dimension.\(^{16}\) The HCI plan took full advantage of Korea’s export-orientation development strategy. For example, by the early 1980s, although textiles and garments still occupied the largest share of exports, the Korean economy made strong progress in shifting its export structure from labor intensive to capital and skill intensive products by the early 1980s. Furthermore, the HCI plan was also effective in reducing the import dependency, as reliance on imported intermediates inputs in the production of heavy and chemical products declined from 1975 inwards.

\[\text{[Controversies of the HCI plan]}\]

The HCI drive has left an incredible mark on the Korean economy. Through the HCI plan strong progress was made in shifting the export structure from labor intensive


\(^{16}\) This contrasts somewhat with the autarky policies of Latin American countries in the 1960s and 1970s. Korea’s industrial policy has been labeled “dualistic” by Ohno and Imaoka (1986).
to capital and skill intensive products. By 1980, in fact, the heavy industry had surpassed light industries in its share of total output. Nearly all the investment projected by the Third Five-Year Plan (1977-81) in the heavy and chemical industry had been completed by 1979, and the sector continued growth throughout the 1980s.\footnote{With the exception of industrial chemicals, all HCI sectors grew faster in terms of the average growth rate than all of manufacturing from 1979 to 1988 [See, Stern et. al. (1995, p. 34)].} A major question in the economics policy literature is whether such non-neutral industrial policy on balance provides an additional positive force, or a negative or neutral one, to economic development.\footnote{A good survey article is Pack, H (2000).} In the case of Korea, it is difficult to demonstrate that an alternative development strategy other than the highly discriminatory policies would have contributed to better or even sustained growth in the 1980s. But, what exactly was it about the HCI plan (or for that mater, the export-oriented strategy) that helped distinguished it from other similar plans around the world that made it successful?

In general, criticisms against the HCI plan have been more or less on an abstract level. The neo-classical camp have criticized HCI plans on three fronts: That the HCI plans 1) by committing large amounts of capital to a relative few projects tends to forgo the risk-reducing benefits which a more diversified portfolio of smaller industrial investments might afford, 2) took on too high risks by the lengthy gestation period requirements and long payback periods, and 3) tended to be technologically complex, requiring co-ordination linked to investment in both infrastructure and projects that might not be available in less developed countries.\footnote{See, for example, Kwack, T (1984) and Rhee, S (1987), where the HCI drive has been criticized for misallocation of subsidized credit to create excess HCI capacity that gave a low financial return.} On the macro level, criticism has also been pointed out to the HCI’s negative spillover effects that triggered inflation,
worsened the current account and accelerated debt accumulation.\textsuperscript{20}

Although the initial reaction was hostile, increasingly, even neo-classical literatures of the Korean economy have become less critical of the HCI drive.\textsuperscript{21} Others, mostly institutionalists, have given Korea’s HCI drive an even more favorable standing, arguing that it was necessary for the correction of market failure,\textsuperscript{22} coordination of economic activities, risk-taking, and that it was necessary for government to intervene to create competitive advantage.\textsuperscript{23} It seems that the neo-classical economists have tended to overstate the risks involved in industrial targeting for late industrializers.

\textit{[Our evaluation]}

In our understanding, both the neo-classicalist and institutionalists seem to have put too much emphasis on the efficacy of either markets or government intervention. Our understanding of the development process does not dismiss the possibility of either markets or the government to help economic development. The heated debate between the two camps has been somewhat fruitless. Development experiences, rather, show that both government and markets can help bring about economic growth and development, and this applies both to the cases of export promotion and HCI drive. There are limitations as well. The question then remains: What is it that makes development possible? Our reply, put somewhat crudely, is the constant evaluation and reward of “good” economic behavior. Necessarily, a “discriminatory” system that helps “rank”

\textsuperscript{20} See, Park, Y. C (1988).
\textsuperscript{22} Westphal, Larry E. (1990).
\textsuperscript{23} For example, see Amsden, A. (1989), Wade, R. (1990). In general, the main rationale for state intervention in general is the infant industry support argument, of which the need to correct domestic market failure features heavily-such market failures are thought to arise from, among others, deficiencies in infrastructure, undersupply of skilled workers and technical expertise, inefficacy of domestic capital markets, and lack of experts of external markets.
economic entities (and their behavior), which either markets and governments, or both, can perform, is necessary for economic progress. We shall elaborate this point again towards the end of this paper when we re-address the fundamental question of development economics.

[End of HCI drive]

Be as it may, in the late-1970s, the government became concerned with economic stabilization and welfare issues as resistance to Park Chung-hee’s 18 years rule intensified. A stabilization plan was announced in April 1979, and following the assassination of Park Chung-hee on October 26, 1979, the central focus on HCI within government policy was removed. High-investment in HCIs and the expansionary monetary policy, as well as the poor export performance and harvest failure in 1980, was blamed as sources of high inflation. The government refrained from the HCI policies, and redirected policy more broadly to support technology-intensive industries. This by no means signaled the end of government involvement in the HCI sector, however, as the government throughout most of the 1980s closely interfered in industrial and corporate restructuring.

2.2 “De-concentration”: Korea’s industrial policy in the 1980s and 1990s

[Early industrial restructuring]

Although industrial restructuring began in the late 1960s, the government’s

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24 The international economic environment in the early 1980s was extremely unfavorable—a situation that further restricted Korea’s exports, and encouraged the new government to concentrate on stabilization, and in its first two years on controlling inflation.

25 With the emergence of many non-viable firms and worries about the nation’s credit status in international financial markets, which would impede economic growth as Korea was dependent on foreign loans, the government, despite criticism that it was itself partly responsible for failures in resource allocation, actively intervened in the corporate restructuring process. Between 1969-1971, one hundred
restructuring efforts, particularly in the HCI sector, became even more prominent after 1979. Specifically, the government carried out a program of industrial rationalization with the revision of the Tax Reduction Regulation law, which advocated that (i) the government sets the industry rationalization criteria, and (ii) firms going through rationalization according to these criteria will get tax reductions or exemptions. An important feature of the government’s restructuring efforts ever since is that industrial restructuring, and, as we shall see, corporate reform as well, has been largely carried out under government criteria, and not through market discipline.

[Economic liberalization]

Korea underwent a rapid phase of economic liberalization throughout most of the 1980s, not only in response to inflationary pressure and the current account deficit, but also because of the rapidly changing political climate. However, the shift to the market has been somewhat insufficient in many respects. Partly to blame has been the government’s unwillingness to refrain from direct economic intervention, and this government-led economic strategy changed drastically from the early 1980s. Furthermore, not only did Korea’s economy grow rapidly, but also the political system changed very quickly as well, from a strong authoritarian regime to a weak democratic one.

and twelve incompetent firms were either liquidated or acquired by other firms under government direction.

26 Until 1988, seventy firms were classified as firms necessitating rationalization. Among them, sixty-seven firms were disposed of through government-led M&As, two firms went through a reorganization process and one firm was liquidated.

27 Noland (2000) argues that with Korea securing the 1988 Olympic bid, the government had much incentive to adopt international “rules of the game” (which included economic liberalization and political democracy) as international scrutiny mounted.


29 History tends to have judged Park Chung-hee as a brutal leader, but with strong direction and determinism. On the other hand, the democratic leaders in the later-1980s and 1990s came into power on very low number of votes; for example, Roh Tae-woo won the 1987 December elections on a minority
Leipziger and Petri (1994) place the principal reference date and period when Korea’s industrial policy shifted. They write that, “Korea’s new industrial policy was formalized by the Industrial Development Law of 1985 and the simultaneous repeal of selective industrial promotion laws.”\textsuperscript{30} From the mid-1980s, support for research and technology, at least on paper, replaced directed credits as the mainstay of policy in line with the shift towards greater neutrality clearly articulated in the Fifth Five-Year Plan (1982-86).\textsuperscript{31} To back this up, a National Project for Research and Development was established in 1982 to fund public as well as public-private R&D products in the fields of electronics, chemistry and engineering. Furthermore, new tax incentives under the Technology Development Promotion Act were strengthened in 1981.

In the early stages of industrialization, Korea was comfortable with acquiring mature technology through reverse engineering of imported capital goods. In particular, Korean firms were instrumental in assimilating imported embodied technology, which they did so rapidly that they managed to undertake subsequent expansion and upgrading with little assistance from abroad or from government.\textsuperscript{32} Formal R&D seemed unimportant in Korea when imitative reverse engineering was operational. However, rapidly rising wages particularly in from the latter 1980s, and difficulties of obtaining sophisticated foreign technology, induced firms to intensify their R&D efforts. Although the government from early on realized the importance of R&D, throughout most of the 1980s, statistics show that national R&D expenditure had shifted from the government

\begin{flushleft}
\textsuperscript{31} The Plan specifically emphasized the establishment of institutions to train scientists and to conduct basic and applied research so as to advance technology development.
\textsuperscript{32} See Ahn, Choong Yong (1991) and Kim, Linsu (1993)
\end{flushleft}
to the private sector. Increasingly, the private sector has taken the leading role in domestic R&D efforts by way of setting up in-house research institutes to develop various commercial technologies while joining international networks through strategic alliances with foreign firms.

The technology driven development strategy received somewhat renewed priority in the late 1980s with the establishment of the Science and Technology Advisory Council and the Korea Industry Technology Institute. On the surface, the establishment of institutions and laws to help improve the country’s technology seems not much different from the efforts to promote export or to create the heavy and chemical industries. But, a closer look does reveal some major differences. For one, the emphasis on technology has never been sectoral-specific like the HCI drive. Also, the government’s role has been nothing comparable to their role in exports and in creating the heavy and chemical sectors. Furthermore, operationally, it differed from the export-orientation policy of the 1960s, as well as the HCI plan, in its execution, as there seems to be nothing corresponding to the “export contests” in, say, a form of “technology contests”, under which constant evaluation and rewarding takes place. Understandably, the economy had matured considerably in the 1980s, and the government-led development strategy a la 1960s/70s might have reached its limitations—for sure, economic planning had become a much more complex problem. But this is going a little astray from the point we wish to make. The real change was the replacement of the strong vertical incentive structure that involved the constant evaluation and reward cycle, by a diffused, static, horizontal system that aimed at equalizing outcomes under

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33 See Ahn, Choong Yong and Joo-Hoon Kim (1997, p. 360)
34 With these two government institutions in place, Korea’s industrial policy formulation has been closely coordinated with the national technology policy.
35 Although export performance was easily measured, usually in sales volume abroad, perhaps, it was not as easy to make a corresponding definite judgment about technological improvement.
an egalitarian view of the world. Moreover, we find that the constitution was happy to endorse this transformation.

[Economic democracy]

Korea’s 29 June 1987 democratization pledge must be regarded as a turning point in the country’s economic history. Most critical was the amendment in 1987 of Paragraph 2, Article 119 of the Korean constitution that reads, that “the state may regulate and coordinate economic affairs in order to maintain the balanced growth and stability of the national economy, to ensure proper distribution of income, to prevent the domination of the market and the abuse of economic power and to democratize the economy through harmony among the economic agents”. Quite significantly, many of the ideals of a modern society have literally been read of this Act. Economic policy thereafter, including industrial policy, has come under the influence of such terms as “regulation”, “balanced growth”, “proper income distribution”, “domination of market”, “abuse of economic power”, “economic democratization”, and so on and so forth.

[Corporations vs SMEs]

An important feature of economic democracy has been the government’s effort at restructuring corporations through the Fair Trade Laws. Under the “economic democracy” doctrine, and also stimulated by the almost atavistic fear of big businesses, the Korea Fair Trade Commission (KFTC) classified the top 30 chaebols to be subject to special regulation—much of it aimed at de-concentrating the economic power of large corporations. The regulations, however, at best, have been somewhat ineffective. For example, the proportion of value-added for the 30 largest chaebols and 5 largest corporations actually increased from 39.3% and 21.7% in 1986, to 51.5% and 25.0% in
2001, respectively. The share of value-added of Samsung Corporation (currently the no. 1 corporation in Korea) to total national product increased from 4.7% to 9.0% over the same period. It is interesting to note that the KFTC instead of emphasizing promoting competition in the private sector has, in fact, been a strong advocacy for SMEs, and somewhat tended to adopt a singular goal of limiting chaebol activities and expansion. Elsewhere, we have argued that the KFTC should have stuck to its original function of enhancing competitive pressure on the corporate sector through properly implemented competition policy. Be as it may, Jwa (2003) warns of the dangers of the “uniform” regulation system, of which the regulation of the top 30 corporations has been a classical example, as it has potential to destroy corporate entrepreneurship, investment and innovation.

A counterpart to the regulation of large corporations was the “need” to address the small- and medium-sized firms, which has since taken a central role in the new balanced growth strategy. The government in the early 1980s began promoting small- and medium-sized enterprises (SMEs) not only by establishing SME sanctuaries, but also by requiring banks to comply with a compulsory lending ratio program. Objectives related to supporting small- and medium-sized firms have included efforts to improve the sector’s industrial competitiveness, to reduce trade deficits with Japan, and to improve foreign exchange earnings power of small- and medium-sized firms’ exports. Despite such efforts, trade deficits of such the small- and medium-sized firms in intermediate capital goods and parts industries with Japan increased from $68 billion to $97.7 billion.

36 The Monopoly Regulation and Fair Trade Law was set up in 1980.
37 See, Ban, Sung-Sik (2002)
38 Jwa, Sung-Hee (forthcoming).
39 To be sure, the country’s R&D initiatives under the National R&D Program initiated by the Ministry of Science and Technology (MOST) in 1982 and based on the Technology Development Promotion Law together with the Small and Medium Business Administration has made considerable efforts to improve the structure and international competitiveness of SMEs and has also provided support for new venture
from 1987 to 1997.\textsuperscript{40} Also, as the intermediate capital goods and parts enterprises continue to rely on foreign imported parts, the foreign-exchange earnings rate decreased from 69.8% in 1995 to 63.3% in 2000, thereby falling back to the levels of 20 years ago (63.1% in 1980).\textsuperscript{41}

Increasingly, as technology became an important factor determining international competitiveness, the failure of policies trying to strengthen SMEs, for example, to provide high quality component parts at competitive prices have started to become evident. What went wrong? A critical error of the SME promotion strategy, despite its good intentions, is that it has created an artificial rift between large corporations and small- and medium-sized enterprises. The Korean business structure is one in which large and small- and medium-sized firms are closely entwined and complimentary to each other. Korean businesses, like the Japanese, consist of many smaller firms providing parts, components, and services for some bigger “parent” corporation. Thus, regulating the larger party is tantamount to not only restricting the markets for smaller and medium-sized enterprises, but also becomes a major disincentive working against entrepreneurship and business leadership. Furthermore, such a policy tends to ignore the clear advantages of Korea’s large corporations in gaining access to new markets and new technology.

[Egalitarian trap]

Given the widespread egalitarian ethic, the highly government-initiated “discriminatory” system characterized by constant evaluation and rewarding of the best performers has lost favor with consecutive governments as well as the general public.

\begin{itemize}
\item \textsuperscript{40} The deficit reduced somewhat right after the financial crisis in 1997, but has increased again recently.
\end{itemize}
Consequently, public policies, particularly those involving the allocation of resources, have become largely static. That is, for example, it is typical for policy packages to set a uniform minimum criteria, which if met allow economic agents (irrespective of their viability) access to that policy package. The added weakness is that there is no in-built continuously monitoring and evaluation mechanism within the system. It is therefore easy to see how such policy measures may become an open source for waste and corruption. Be as it may, the static populist policy framework has left industrial policy of the latter 1980s and 1990s in disarray.

Regarding the general policy direction that seeks uniformity and equality in the Korean society and economy, we have coined the term “egalitarian trap”. As we explain later in this paper, economic development cannot co-exist with “horizontal” principles. Specifically, a system that stresses the leveling out of economic outcomes under egalitarian ethos tends to destroy the very incentive to better oneself. Both those that are already performing well and those that are struggling to do better, sooner than later, become discouraged to find that despite their efforts, results or outcomes will become homogenized. Korea has experienced many economic difficulties under the weight of the ideals of the past 15 years, namely “economic democracy”, “egalitarianism” and “uniform balance”.

Let us look at some more examples of this “egalitarian trap”. It is well known that Seoul is one of the most densely populated cities in the world. Consequently, the government has tried to reduce population concentration by re-allocating some government and economic functions to areas outside of Seoul. At the same time, various ad hoc rural and local development initiatives, many of which are diffused, or at least non-discriminatory, have been proposed over the past decade. Under the spirit of

\[\text{Kim, Byung-Hoon (2002).}\]
“egalitarianism”, these policies have received much public support. But what has been the result? Including Seoul, the economic concentration of GDP for Korean metropolitan areas increased from 42% in 1985 to 47.7% in 2002. In addition, over the same period, among the total Korean population, those living in the metropolitan area increased from 39.1% and 46.7%.\textsuperscript{42} On the other hand, despite the rural support programs\textsuperscript{43} worth more than won 52 trillion, the proportion of income from farm household compared to workers in urban areas declined from 95.1% in 1995 to 73.0% in 2002. In addition, the debt per farm households increased from won 9 million to 20 million over the same period—debt ratios to income went up from 42% to 81.3%.\textsuperscript{44} On another front, not unlike the Korean political system, the country’s education system, which has tried to promote, or “balance”, education centers outside of Seoul, has become an expensive and highly inefficient system. Increasingly, more and more students are seeking to study abroad.\textsuperscript{45} And, according to the IMD of Switzerland, the competitiveness of Korean education ranked 31st out of 49 nations in 2002.\textsuperscript{46} On the whole, the attempt to “balance” things out has meant the erosion of competitiveness across-the-board. Often, the pattern has been regulation to de-concentrate Seoul, while at the same time re-allocate resources to other areas. What seems to be missing is a proper incentive structure in the other peripheral places. Put differently, discriminatory mechanisms should have been placed in non-metropolitan areas, in various selected rural farming activities, in certain regional universities, and so on.

\textsuperscript{42} Korea National Statistical Office, 2002.  
\textsuperscript{43} Structural Reform of Rural Areas, for example.  
\textsuperscript{44} Roh, Kyung-Sang (2003).  
\textsuperscript{45} According to a report from the Ministry of Education and Human Resources Development in 2002, the number of elementary, middle, and high school students seeking education abroad has increased from 1,562 in 1998 to 10,132 in 2002, and the number of students seeking education abroad together with their parents reached 28,126 in 2002.
[Road to crisis]

Seeking de-concentration and addressing primarily equity issues with emphasis on equalization and egalitarianism have distorted the country’s economic incentive system. The successful economic actors are at the end “robbed” of their efforts, while those lagging behind find it easier to practice moral hazard behavior. To be sure, the results of 15 years of egalitarian policies have not translated to improved economic performance. For example, Korea’s average total factor productivity (TFP) growth rate for 1988-1997 was significantly lower at 3.41% compared to 6.64% for the earlier 1964 to 1979 period.\(^\text{47}\) Comparing the same two periods again, the growth rates of investment in plant and equipment fell from 24.7% for the 1964-1979 period to 9.7% for 1988-1997.\(^\text{48}\) Given this serious transformation in Korea over the past few decades, the outbreak of crisis in 1997 should not be surprising. More recently, the government has identified 10 new industries for support. Are we reverting to the old sectoral-specific growth model again? Highly unlikely. There is much confusion regarding the future of Korea’s industrial policy at the present time. A better understanding of why markets drive economic growth is perhaps one important missing step.

[Post-crisis reform]

Although the discussion so far has been centered on the Korean economy, it is important to note that uniformity-seeking policies, which have been a main policy instrument of the egalitarian approach, has been practiced on a global scale as well, often in the form of “global standards”. Jwa (2003) warns of the potential dangers of the

\(^{46}\) Regarding whether colleges meet the needs of a competitive society, Korea ranked a disappointing 41st.
\(^{47}\) If we break down the TFP figures into their constituent parts such as efficiency of resource allocation, economies of scale, and so on, a similar declining rate is observed.
\(^{48}\) Of course, this is not to say that there have been absolutely no improvements in the economy and in the Korean society over the past fifteen years or so. Industrial policy unambiguously has helped bring about Korea’s “miraculous” growth of the 1960s and 1970s. We must question, however, why the phenomenal success of the initial two decades has not been repeated, let alone surpassed, despite serious economic
marriage of uniform regulation typical of developing countries in their attempt to speed up structural change (on the surface) with the one-size-fits-all “global standards” as advocated by international financial institutes. A classical case in mind is the corporate governance debate in post-crisis Korea—the government has pointed out weaknesses in the corporate governance structures as a reason to introduce a string of regulation measures, most of them advocated as proven “global standards”.49 Such uncritical acceptance of uniform benchmarks can only be met either with high mistrust and/or complacence. Rather, we advocate a more sustainable system that 1) facilitates the transition to better standards and business practices, as each economic actor will strive to out-perform their rivals, and 2) maintains dynamism and momentum by encouraging and rewarding better decisions and strategies that result in improved standards (i.e. keeping the discriminatory mechanism intact).

3.0 Rethinking Development Economics

[Crisis in Development Economics]

Modern development economics began around the mid-1940s when discussions by economists exploded as many countries in Asia, Africa and Latin America gained independence from their colonial masters.50 Economists of advanced nations were motivated by a sense of “obligation” to help “develop” former colonies. At the time, it was felt that although political independence could be legislated, economic independence and industrial growth could not. Therefore, a better understanding of the

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49 For example the 200 debt-equity ratio, pre-determined ratio of outside directors and independent auditors for listed firms, 8% BIS ratio, and so on.
50 See, for example, Meier and Seers (1984) and Arndt (1989).
forces of development was necessary and the design of appropriate policies to support these forces was deemed to be essential. The term economic development was however constituted in the neo-classical mode, where the increase in per capita income was its most important goal.

As history progressed, and regressed for some countries, pessimism surrounding this narrow interpretation of economic development began to arise particularly within developing countries that began to experience stagnation in the 1960s and 1970s. Other countries that were more fortunate, like Korea, demonstrated that a “big push” or “critical minimum effort”, often the prerogative of government through industrial policy was important for economic take-off. Around the same time, a second phase of development economics began that focused more directly on issues of poverty and inequality. At this stage, it was widely argued that growth in per capita income through industrial policy alone was not a sufficient condition to tackle poverty and other economic issues.

Development economics increasingly became a diffuse subject in the 1980s onwards. Different views and institutions have emphasized different aspects of development. For example, the World Bank has emphasized redistribution with growth. The ILO has concentrated on basic human needs. Much of the development debate now has moved away from industrialization to rural development. As such, the subject is without a consensus as to what the fundamental force of economic development is.

[New Development Economics paradigm]

The lack of a theory of development economics has prompted many scholars to look closer at the original questions of development economic—what are the forces of development? Jwa (2003*) introduces a novel idea that explains the mechanism of
economic development, some of the most important features of which are mentioned below. Basically, development embodies two dimensions, which are actually different sides of the same coin: “Verticalism” and “Discrimination”. We also discuss “conglomeration” as an inevitable and important consequence of the development process.

[Verticalism]

Development is a “vertical” concept. Like in a race, the runners come into the finishing line vertically, according to individual performances. That is, development is an evolutionary process whereby economic actors in seeking to stay ahead of rivalry find themselves on a vertical scale, where those on top of the ladder will most probably survive and proceed to the next stage of the evolution game. It might help to contrast this vertical nature of development with a horizontal dimension, say, where all runners reach the finishing line simultaneously. Development implicitly assumes that there is movement from some reference point. Progress suggests that there is a “ladder” in-built into the system. Hence, we introduce the term “verticalism”.

[Discrimination]

On the other side of the same coin is “discrimination”, which acts as a principal source of pressure that applies to all actors, who find that they have to continually seek adjustment and innovation to improve their chances of survivability, or what is the same thing, their economic performance. This “discrimination” applies not only to those that are at the bottom of the ladder, but also to those at the top wishing to keep ahead of their rivalry. An essential feature of the discrimination process is the constant evaluation and reward of good economic performance. Then “discrimination”, by helping those that
help themselves, becomes a cause and consequence of development.

In the realm of economics, “discrimination” simply means treating differences as differences, and it is here that markets may be regarded as the most important playing arena where discrimination might take place. The traditional role of markets, whether as a price mechanism or as an information and signaling device are just subsets of the “discrimination” function. Competition too is just a mechanism through which “discrimination” becomes possible. The upshot is that markets function as discrimination devices and through this, development becomes possible. In the neo-classical sense, the market was initially seen as an arena for exchange, which with the development of the monetary system has allowed for the role of pricing to become central. Although this has been important in the development of society, according to the argument provided here, it is the “discrimination” function of markets that is emphasized. The market system that evaluates and rewards, or more precisely discriminates on a continuous basis economic actors (individuals and firms), products, services, and so on, according to their economic function and performance is indispensable for economic development.

[Conglomeration]

Our view of the development process has one further important implication. Resources, we find, quite naturally will amalgamate into economic areas that prove to be successful. Put differently, as efficiency drives further efficiency, a growing economic entity, say, will tend to command more respect and will attract more resources, often further increasing its role and size in the economy. Placed on a vertical scale, those at the top of the ladder will tend to command greater amounts of resources.
Conglomeration, it would seem, is a natural result of economic progress.\textsuperscript{51} We warn that carelessly attempting to disaggregating or dissolving economic units thought to be over-conglomerated can have seriously negative effects on the economy.\textsuperscript{52}

4.0 Concluding Remarks

[Introducing markets: The way forward]

To better understand the concept of “discrimination” and “verticalism” in economic development, it is worth discussing the impact of government intervention in Korea’s industrial development. After all, it seems puzzling to claim that markets and its “discrimination” function is indispensable for development, as the neo-classical economists would agree, yet, on the other hand, we have concrete evidence of successful government-led development.\textsuperscript{53} The resolution to this puzzle is easily solved if we recognize that not unlike markets, the achievements of a successful industrial policy can mimic what markets would have done. In other words, what government intervention has done is to substitute the “discrimination” function of markets, i.e. the continuous evaluation and rewarding of viable entities (and behaviors), and as such, was actually doing what markets themselves would have done. Put differently, non-discriminatory mechanisms, of which we have referred egalitarian policies as a prime example, by mitigating the discrimination process, leave no hope for economic progress.

The discrimination process is possible either by governments or through markets, or both. One reason to favor discrimination by markets over discrimination by

\textsuperscript{51} It seems impossible to site any contrary evidence.
\textsuperscript{52} The “conglomeration” effect has also been discussed, albeit in a slightly different context, in Jacobs, Jane (1970).
\textsuperscript{53} Between 1965 and 1981, its gross national product GNP multiplied twenty times from $3 billion to $63 billion and per capita GNP increased sixteen times from $88 to $1,554.
government is that markets, by their very nature, are often consensus-based and never egalitarian. Moreover, markets are constantly evaluating and “discriminating” among economic actors and behaviors. Governments, on the other hand, might be burdened by a continuously evaluating system, or might choose to turn a blind eye, or simply provide wrongful evaluation intentionally. Government and business relations, after all, has been known to have its own set of problems that includes the contamination of politics and economics, moral hazard behavior, corruption, rent-seeking, sustaining non-viable firms, and resentment by those that are not selected by government.

But while we emphasize markets as the way forward, the upshot of our argument is that regardless of the discriminator, whether government or market, an economy will only develop if the discrimination mechanism is built firmly into the economic management system. In this sense, the old age argument between the neo-classical economists and institutionalist camps referred to above, that is, the championing of either markets or governments in driving economic development becomes redundant. “Discrimination”, rather, is the key to sustainable industrial competitiveness and national economic development.

[Containing concentration?]

As a last note, we wish to address the issue of conglomeration. We have mentioned that it is an important feature of the development process, and throughout much of the experiences of advanced capitalist economies, various forms of conglomeration, be it from complex concepts such as the concentration of economic power to simpler

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54 By consensus-based, we mean free of value judgment or void of political bias, and the like. In fact, according to our approach, a “free-market” would be one where the discrimination function is allowed to work without interruption or distortion from policy, institutional deficiencies, arbitrary regulation, and other (often man-made) restrictions.

55 Here, it is interesting to note that wrongful evaluation and rewarding are often not sustainable.
measures such as market shares, have been subjects of much concern. But why should conglomeration be worrisome? We have seen the dangers of anti-conglomeration, particularly when driven by populism and egalitarian motives. How can we properly understand how to treat conglomeration?

We do not pretend to find an answer, but the economic work on monopoly by Alchian and Allen (1977) and Demsetz (1974) proves to be a useful starting point. The views on conglomeration, not unlike that on monopoly, can be seen as either the outcome of government protection or a result of efficiency. An important implication is that in the absence of government protection, there is no presumption that behavior will be monopolistic, or in our context, simply dominant or abusive. Hence, the very notions of “dominant position” and the accompanying fear of “its abuse” tend to be meaningless in an efficient-form conglomeration. Ability should not be confused with incentives. It is therefore important that public policy refrain from exerting most of its energy in containing the apparent threat of conglomerations. Rather, policy should help create and sustain a competitive environment. After all, the threat of market power can be efficiently tackled by the existence of strong competitive pressure of potential rivals. In the context of this paper, the recommendation would be: Let market discrimination do its work.

56 Demsetz (1974) argues one belief of monopoly is that it is generated by government action that prevents rivals from competing. Alchian and Allen (1977) refer to this as “monopoly power”.
57 Demsetz (1974) argues that the other type of belief about monopoly is that it exists without an explanation of how it came about. We follow more closely the interpretation of Alchian and Allen (1977), where the term “market power price searcher” is used to define efficiency type monopoly.
58 See also Chapter 5 of Lal, Deepak (1999).
References


Chang, Ha-Joon (2003), Kicking Away the Ladder: Development Strategy in Historical Perspective, London: Anthem Press.


