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Economic miracle

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Economic miracle
From post-war reconstruction to post-crisis affluence

Ingyu Oh and Hannah Jun

Introduction

Economic miracles are few and far between in modern human history, suggesting that world economic affairs have persistently upheld a biased division between a few haves and a majority have-nots. Over the post-World War years, the Cold War, an era of freer trade, and US hegemony, only eight countries have successfully ascended to the status of what the IMF calls ‘developed’ (i.e. countries exhibiting full political independence with a highly developed infrastructure, health care facilities, education, culture, strong middle class, and affluence as measured by national and per capita GDP). These countries are Israel in the Middle East; South Korea (hereafter, Korea), Taiwan, Hong Kong, and Singapore in East Asia; and the Czech Republic, Slovakia, and Slovenia in the former Soviet bloc. In this short list of newly developed countries (two of them being city-states), only four are non-European, adding further bleakness to the already gloomy picture of north-south inequality.

Among the four so-called East Asian tigers, Korea stands out because it is the only non-Chinese country without prolonged interaction with European colonial forces. Hong Kong and Singapore were modernised by the British colonial administration, whereas Taiwan was first exposed to Portuguese and Dutch colonial, or long distance, explorers. Furthermore, while Korea has survived a massive civil war with North Korea, Taiwan, Hong Kong, and Singapore have not fought any major wars during the post-war years. In addition, Korea is not a territorial part of China, whereas Hong Kong and Taiwan are under the constant threat of being annexed to the socialist regime. In fact, Korea has maintained that it plans to unify the peninsula in tandem with the expected collapse of the North’s communist rule. In contrast to Singapore, Korea is a fully democratised country that has faithfully conformed to the Lipsetian rule of democratisation through economic affluence, whereby we see a correlation between democratisation and economic growth. With regards to economic growth, Korea’s GDP per capita was just around twice that of Sub-Saharan Africa in 1960, but almost 24 times as high in 2005 (Pillay 2010). Finally, Korea underwent a long period of military dictatorship between 1961 and 1987 after Japanese colonial rule of a similar length (1910–1945). This pattern cannot be found in Hong Kong, Singapore, or Taiwan, where civilian dictatorship or UK-style colonial administration had been the norm.
Qualifying the Korean economic miracle is therefore a complicated task, given its unique presence in East Asia on the one hand and its superficial resemblance to Japan, Taiwan, Hong Kong, and Singapore on the other. Koreans share similar physical features with the Chinese populace, elements of Chinese and Confucian culture, and use many Chinese expressions and terminologies in their language. On the surface, the Korean economic miracle seems to be Chinese in origin, as was much propagated by scholars who touted Confucian work ethic and Confucian capitalism (Rozman 1990; Lew et al. 2011; Bae and Form 1986). To others, however, Korea also resembles Japan. Koreans also share similarities with the Japanese and hold on to the Japanese cultural concept of senpai (senior) and kōhai (junior) in hierarchical human relations. Like the Japanese, Koreans have respected and followed the pre-war system of selecting public officials or kōmuin through national exams. Indeed, many precedent studies of the Korean and Japanese economic miracles have highlighted bureaucratic efficiency in a developmental state as a key factor for success (Johnson 1982; Hattori 1987; Lie 2000).

Despite these cultural proximities between greater China and Korea as well as between Korea and Japan, the lynchpin of the Korean economic miracle was an idiosyncratic institutional and cultural framework that cannot be found in its neighbouring nations. For one thing, neither greater-Chinese (Hong Kong, Taiwan, Singapore) nor Japanese economic development necessitated the development of the chaeból, or family-owned and -controlled inter-market conglomerates that competed over a small domestic market during the heyday of post-war capitalism. The key aspect of the chaeból’s birth, development, and maturity involves monopolistic competition under the behest of military dictatorship (see inter alia Lie 2000; E.M. Kim 1997; Oh 1999; Cumings 1984). In East Asia and elsewhere, family conglomerates, which dominate

<table>
<thead>
<tr>
<th>Year</th>
<th>GDP ($)</th>
<th>Year</th>
<th>GDP ($)</th>
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<th>GDP ($)</th>
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<td>1985</td>
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<td>1986</td>
<td>2,906</td>
<td>2006</td>
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<td>4,813</td>
<td>2008</td>
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<tr>
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<td>292</td>
<td>1990</td>
<td>6,642</td>
<td>2010</td>
<td>22,151</td>
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<td>317</td>
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<td>7,676</td>
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<tr>
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<td>8,140</td>
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<td>1978</td>
<td>1,468</td>
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<td>1,858</td>
<td>1999</td>
<td>10,432</td>
<td></td>
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global export and Foreign Direct Investment (FDI) markets in addition to the domestic market, are rarely sustainable under military dictatorships unless they have blood ties with the military itself (Khanna and Yafeh 2007; Hattori 1997; Mo and Weingast 2013). For another, these chaebős have maintained their strong market position through both radical (i.e. either profit growth of more than thirty percent in one fiscal year or cost reduction by the same scale due to the introduction of new technology) and incremental innovation. While innovation occurs in all advanced and globally competitive firms in export markets, the kind of innovations that have occurred and are still occurring in the chaebős are considerably different from those found in the Japanese keiretsu (interlocked business groups) or in the guanxi firms based on personalized social networks in greater China. Briefly, Japanese innovations are process-based with institutional complementarity that emphasise a combination of malleable skills between management and shop-floor teams (Aoki 1990). In greater China, firms manage to innovate through collaboration between guanxi groups in the motherland and in North America through inter-faction competition (Saxenian 1999; Hsu and Saxenian 2000; Oh 1999; Wong 2005). But in the chaebős, innovation is more radical and patent/technology based than in Japan, while no chaebős groups maintain guanxi networks with Korean Americans for technological innovations (L. Kim 1997; Oh et al. 2005; Ghoshal 1988; Chang 2011). Innovative chaebős are, therefore, the fundamental institutional rubric of the Korean miracle before the 1997 Asian financial crisis.

For another, no East or Southeast Asian country that underwent an economic miracle featured Korean-style macroeconomic policies of rapid industrial restructuring, which required forcible closure of old industrial sectors to bet on untested new alternatives in the global export market (Song 2003; World Bank 1993; Pirie 2008; Eichengreen et al. 2012). This means that large-scale population displacement, massive unemployment between stages of restructuring, and geographical transfiguration involving landscape destruction and environmental pollution were far more rampant and disparaging in Korea than in Japan, Taiwan, Hong Kong, or Singapore. While predominantly agrarian in the 1950s and the 1960s, the political economy of Korea (or its peculiar state–business relations) managed a rapid, abrupt, and far-reaching movement of young people from the rural to urban areas to create the urban working class in the 1970s (Koo 2001; Lie 2000). Farmlands were converted into factory complexes in a matter of years, if not months, for light industries (e.g. textiles, wigs, toothpaste, soap), which were then bulldozed and replaced with new factories for heavy and chemical industries (e.g. oil refineries, automobiles, shipbuilding, electronics). In the 1980s and 1990s, employees of heavy and chemical industries were laid off in large numbers due to factory automation and robotics, while tertiary sector jobs (or what we call ‘McJobs’) were created in vast numbers to jumpstart a new service-sector

<table>
<thead>
<tr>
<th>Company</th>
<th>2003 Assets (KRW trillion)</th>
<th>Employees</th>
<th>Company</th>
<th>2013 Assets (KRW trillion)</th>
<th>Employees</th>
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</thead>
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<td>130,750</td>
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</tr>
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<td>58.6</td>
<td>92,283</td>
<td>Hyundai Motor</td>
<td>166.7</td>
<td>147,714</td>
</tr>
<tr>
<td>SK</td>
<td>47.5</td>
<td>29,127</td>
<td>SK</td>
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<tr>
<td>Hyundai Motor</td>
<td>44.1</td>
<td>98,706</td>
<td>LG</td>
<td>102.4</td>
<td>141,722</td>
</tr>
<tr>
<td>KT</td>
<td>30.8</td>
<td>48,344</td>
<td>Lotte</td>
<td>87.5</td>
<td>85,010</td>
</tr>
</tbody>
</table>

economy era. As a consequence, geographical and environmental metamorphoses were most
dramatic in Korea, while labour union movements were and still are the most militant among
East Asian miracle economies (Lie 2000; Hart-Landsberg 1993; Cumings 1984; Pirie 2008).
The net result of this peculiar Korean economic miracle is fourfold: (1) a mafia/predatory
state that espoused GDP growth alongside escalating class polarisation; (2) chaebol groups that
could not survive without political protection extended to them by the mafia/predatory state;
(3) a social and institutional culture that could not maintain or organise human business and
social relations without resorting to credible threats (real, thus credible, threat of using force
by power-holders to someone who does not participate in economic activities or carry out
contractual conditions), given rampant distrust among organisational members; and (4) semi-
world-class process (institutional) and technological innovation via parodying. We will discuss
these in turn before explaining the Korean economic miracle through the concept of ‘rent-
sharing’.

Four elements of the miracle
The most peculiar institutional arrangement of the Korean economic miracle was based on the
lack of credible commitment among economic actors and organisations to deliver a guaranteed
quantity of goods and services at agreed-upon prices. Amid the absence of the most fundamental
element of the Anglo-American concept of the free market and its mechanism of credible
commitment, the latter of which is undertaken in support of alliances and to promote exchange
(see Williamson 1983; North 1993), Korean economic actors and organisations had to rely on
the credible threat, which appeared in the context of conflict and rivalry. In Korea, credible
threats were realised only through what can be called the mafia/predatory state, which was
willing to exercise either legitimate or illegitimate power to enforce agreements (for credible
threats, see Konrad and Skaperdas 1997; Gambetta 2000; for Korean credible threats, see Oh
1999; Oh and Varcin 2002).
The mafia state can take many forms, although the most distinctive property is its peculiar
way of collecting revenue. While extortion is a typical mafia means of collecting revenue from
street merchants in exchange for property protection, extortion by the mafia state can be
institutionalised on an on-going basis through either rent-seeking or rent-sharing. Unlike rent-
seeking, where interest groups and individuals seek bigger rent in exchange for co-opting state
actors (Buchanan et al. 1980; Krueger 1974), rent-sharing requires an opposite arrangement of
state actors seeking a larger share of the rent than the one garnered by interest groups and
individuals (Oh and Varcin 2010). In fact, throughout the miracle years, Korean state actors
tried hard to raise the portion of rent they shared with the business sector. For example, in one
year, total rent of 100 may be divided between the state and firms at a ratio of 20 and 80,
respectively. If the state demands a greater portion of rent that exceeds rent generated for firms,
firms would have to increase total output dramatically to meet state demands while maintaining
an adequate share of the rent for themselves. As such, total rent may increase to 200 in the next
period, with the state receiving 80 and firms receiving 120.
What did the mafia state do to maximise its (legitimate or illegitimate) share of rent? First
and foremost, dictators of the first military regime (1961–1979) pursued macroeconomic policies
to boost economic growth rates via higher real interest rates. Savings ratios were high (i.e. the
K effect) throughout the regime’s lifecycle, but the state quickly moved into the banking sector
to own and control most Korean financial institutions. Savings went into state-controlled banks
that lent money out to select clients, such as chaebol families. Unlike in Japan, where savings
rates were also high, the Korean mafia state maintained high interest rates to induce savings from the working class. Although savings ratios were high, the absolute need for capital far exceeded what state banks could provide to chaebol groups. As such, the state had to underwrite most of the foreign loans and aid money to fund chaebol projects, which in turn promised paybacks to the state. Simultaneously, the state suppressed wages while improving labour productivity (i.e. the L effect). Firms subsidised night schools for workers while jailing thousands of union leaders and their supporters, and wholesale relocation of rural youth to urban factories progressed quickly thanks to government and factory buses and recruiters. Finally, the state actively subsidised firms that licensed foreign technologies, especially from Japan (i.e. the T effect). The K, L, and T effects combined, the Korean mafia state boasted GDP growth rates between eight and ten per cent during the 1960s and the 1970s (Eichengreen et al. 2012).

On the other side of macroeconomic policies was the chaebol that contributed extorted money to the predatory mafia state. Chaebol literally means ‘families with enormous wealth’. How the families accrued and expanded their wealth may remain a family secret, although all top ten chaebol families were connected to each other and to key politicians through marriage (Hattori 1987; Chang 2003). The chaebol differs significantly from other East Asian conglomerates on several accounts. First, chaebol groups have a dual-ownership structure. On paper, owning families do not possess more than two to six per cent of total shares, but in reality, they own more than sixty per cent of total equity through a pseudo holding company system (Chang 2003; Campbell and Keys 2002; Kim et al. 2004; Trautvetter 2010). It is a pseudo holding company system because chaebol holding companies indirectly own shares of chaebol member firms without publicly listing the holding company itself. The reason behind a dual-ownership structure is the thorny issue of succession. Succession from the chaebol founder to his son was not seriously challenged during the military regime under the mafia-clientele arrangement. But since rapid democratisation since 1987, the civilian government began heavily taxing chaebol inheritances (e.g. shares) while concomitantly demanding ownership diffusion according to Anglo-American standards of corporate governance, particularly after the 1997 Asian financial crisis. In order to safeguard succession without paying massive taxes, chaebols have experimented with different varieties of dual-ownership structures (Chang 2003).

Second, ownership and control are fused instead of separated, unlike in many guanxi corporations in greater China and in Japanese keiretsu groups. Although managerial professionalisation has progressed rapidly in Korea, chaebol families have actively educated male heirs in preparation to succeed their fathers as CEOs and/or chairmen and neutralise external criticism of nepotism, such as Samsung’s heir-apparent Lee Jaeyong’s education at Harvard University. Unlike in North American or European family businesses, it is not uncommon to see many chaebol heirs attending or having graduated from Ivy League schools in the United States, not to mention prestigious Korean and Japanese undergraduate programs.

Third, chaebols have increased the market value of their companies through massive diversification and tunnelling. Diversification was a bulwark or insurance against state hostility to chaebols in the form of destruction or confiscation (i.e. no property right protection). In fact, chaebols such as Yulsan, Kukje, and Daewoo disappeared during the first and second military regimes and even under the civilian government, in addition to seven chaebols that were closed down after the inauguration of the first military regime. The chaebol logic was that the government would not confiscate their property if they were big in size and highly diversified into industries such as automobiles, textiles, and even military (E.M. Kim 1997). Tunnelling is an illegal means of manipulating the price of chaebol holding company stocks by actively buying out unrelated firms through mergers and acquisitions (M&As). If unrelated firms are bought
out, chaebōl’s stock prices go up artificially with market rumours about potential revenue growth through new acquisitions (Baek et al. 2006). These practices are either illegal or uncommon in other East Asian countries.

Fourth, unlike other conglomerate groups in neighbouring countries, chaebōl groups relied heavily on labour exploitation for profit, using both workplace patriarchy and police crackdowns on militant labour unrest. Labour unrest was an anticipated response to harsh working conditions. Often, these organisations functioned as sweatshops or prison labour camps, where workers from the countryside worked in often unhealthy and poorly ventilated workspaces, eating and sleeping on the same premises. Wages were twenty to forty cents an hour, far below recommended rates for factory workers in export processing zones of many developing countries (Hart-Landsberg 1993; Lie 2000; Pirie 2008). Workers in Korean chaebōls were denied union rights, minimum wage laws, or lifetime employment during the military regime, while labour union movements instigated by the self-cremation of Jeon Taeil in 1970 were quashed by brute police force. What distinguished the chaebōl from other family businesses in East Asia was the suppression of one of the world’s most militant labour movements, either unionised or unorganised, arguably resembling a massacre of one social class by another. To this point, labour strikes reached a record high of more than 3,600 incidents in 1987 (E.M. Kim 1997).

Finally, the chaebōl has maintained a huge network of interlocking ownership, where the financial firm in the secondary finance market (e.g. insurance, stock brokerage, leasing, credit cards) and former holding companies (i.e. holding companies before the 1961 military coup) in general trading, construction, and electronics (e.g. Samsung Mulsan, Hyundai Construction, Samsung Electronics) own one another’s stock to protect ownership of the chaebōl group by one family. This system of mutual stock ownership is different from that of the keiretsu in Japan or guanxi firms in greater China; the use of financial and former holding firms within the chaebōl is to protect the chaebōl family, in contrast with the ban on owning keiretsu-style main banks or guanxi-style holding companies (Chang 2003; Oh and Park 2001).

The birth of the mafia state and the chaebōl after the 1961 military coup led by General Park Chung Hee created a new business culture of what we call ‘credible threats’, contrasting with the Anglo-American or Japanese culture of credible commitment (see Williamson 1983; North 1993). The culture of credible threats is the third element of the Korean post-war economic miracle. Credible commitment works in two ways. First, in the Anglo-American tradition, formal contractual relations in the market and between firms reduce room for opportunism. But given that contractual relations in the UK and the US cannot be institutionalised without administrative fiat or organisational (or sometimes legal) safeguarding, actual inclination to opportunism looms large. To offset opportunism rampant in the market, Anglo-American firms use institutions of administrative fiat to induce credible commitment between contractual parties. Second, in the Japanese tradition, room for opportunism is always very high given the relative absence of formal contractual relations in business practice. But given that Japanese business networks are based on long-term trust rather than short-term contracts, actual inclination to opportunism is surprisingly rare between business partners and firms, thus leading to credible commitment between liable business parties. Either system of inducing credible commitment, whether based on task or job specialization or structural stochasticity (e.g. shop-floor communication between blue- and white-collar workers), would be an acceptable institutional solution to the problem of transaction costs (Aoki 1994; Nooteboom 2001).

But in post-coup Korea, neither system of prompting credible commitment worked. For one thing, Korean business and economic actors did not possess functional specificities to lead to high levels of organisational (both technological and procedural) standardisation. They also failed to build a business network that was based on a long-term trust. Structural stochasticity,
or effective management-labour communication, did not exist within such networks because the actors lacked a sufficient level of tacit knowledge to run organisations constrained by qualitative, if not functional, standardisation. In a nutshell, Korean business firms were organised and run under the principle of informal solidarity and group norms, although they tried to quickly learn and apply American-style technological know-how and work procedures (see Oh and Varcin 2010). Amid the welter, both military rulers and chaebol owners agreed upon a new rule of using credible threats in the form of brute force to realise organisational goals. Between the state and the chaebol, credible threats worked to induce the chaebol’s commitment to economic growth and payments (both legal and illegal) to the state, and the punishment if either failed was to close down the chaebol (i.e. withdrawal of state protection of chaebol’s property rights). Between labour/suppliers and the chaebol, credible threats worked in a fashion to induce labour/supplier commitment to economic growth and sacrifice (e.g. supplier bribery to the chaebol, low salaries for workers) for the chaebol, and punishment in the case of failure, such as destroying the supplier firm or laying off workers in large numbers (Oh 1999). In order to institutionalise credible threats, both the state and the chaebol routinely punished inexorable partners. For example, 1,653 mergers and acquisitions (M&As) of small firms by the chaebol groups were reported throughout the 1980s. Although all these M&As were illegitimate under the M&A law, only one case was ruled illegal by the court (Chung and Yang 1992).

The final element of the Korean economic miracle was technological and organisational innovation, a key feature of the economic success throughout the developmental period. In order for real GDP to grow quickly, developing states need to secure either momentous labour productivity or technological innovation, whether radical or incremental (see Tsuru 1996; Eichengreen et al. 2012). For Korea, labour productivity was not always something that the government could quickly increase due to various structural difficulties and constraints. Fundamentally, the state faced low levels of skill attainment among young rural boys and girls who were almost forcibly shifted from rice paddies to urban factories. Educating the new urban proletariat class required substantial investment in education and long-term training programs, and the military state had no intention of doing either. Instead, the state and the chaebol spent enormous effort on technological and organisational innovation (or the T factor of GDP growth). To many Anglo-American economists and innovation scholars, this option would have been more difficult for Korea than that of increasing labour productivity (the L factor of GDP growth). However, Korean firms had the option of copying to improve their T factor quickly. Copying and piracy had occurred widely from the 1960s to the 1990s before Korea joined the WTO (World Trade Organization). Korea was fortunate due to its close proximity to Japan, where highly sophisticated technologies, ranging from textiles and construction to shipbuilding, electronics, and automobiles, were available for either licensing or outright copying (L. Kim 1997).

An anecdote regarding the effect of the T factor on Korean GDP growth includes that of Samsung Electronics during the 1970s. In the early days of electronics development at Samsung, the chaebol successfully garnered a loan from the Long Term Credit Bank of Japan. With the borrowed money, the firm rented a two-story house in the Tokyo neighbourhood of Akihbabara, a well-known shopping district for the most advanced Japanese electronic goods. In the house, Samsung technicians bought and disassembled Japanese electronic goods (mostly household appliances such as refrigerators, washing machines, range ovens, and TVs) to uncover secrets behind Japanese electronic technology (i.e. reverse engineering). Although they were patented in Japan and elsewhere, that proved to be ineffective in Korea.

In addition to outright piracy, the Korean chaebol also actively sought licensing opportunities with Japanese and American companies with the hopes of learning both standardised and
tacit knowledge from advanced firms. Licensing is a fast way of learning advanced technologies in a legitimate way, although it is vulnerable to knowledge theft by licensees (Davis 2008). In return for chaebols’ active T-factor improvements, the state provided R&D subsidies in tandem with a silent negligence over patent infringement. In less than four decades since the 1960s, Korean chaebol firms defeated Japanese competitors in steel (POSCO became the fifth biggest global steel company by the 1980s), shipbuilding (Korean shipbuilders are the second largest shipbuilding country in the world), household appliances, electronic hardware and semiconductors (among the top ten global semiconductor suppliers, two are Korean – Samsung Electronics and SK Hynix – while just one is Japanese), and mobile phone markets. Electronics constitutes one of the most fascinating success cases of the chaebol, in that Samsung and LG Electronics alone make more annual revenue and profit than what all Japanese electronics firms generate combined (Chang 2011). The T-factor growth story is a secret formula for export-led development strategy and cannot be easily emulated by other developing nations that do not have neighbouring countries with advanced technologies for patent pirates. To this extent, China is a case in point. With Korea, Taiwan, and Japan right next to the mainland proper, it could easily emulate Korea’s development through its own version of export-led development schemes. This is also why countries like the Philippines could not develop as quickly as China or Korea, despite the fact that the island nation was under the US Cold War protection program: it simply didn’t have any neighbours that were technologically advanced.

Be that as it may, Samsung now holds the second largest number of patents, second only to IBM in the US (US Patent and Trademark Office 2014). Despite its phenomenal track record of R&D and patenting, various rivals in the market, including Apple and Microsoft, have sued Samsung for patent infringement. While this indirectly illustrates how the chaebol is least innovative with its own Korean version of ingenuity, it remains an organisational structure that is extremely efficient in learning others’ technologies in a short period of time. In this sense, the chaebol is probably the most efficient learning organisation in the world.

Explaining and understanding the miracle: rent-sharing

Having explained in detail the four elements of the Korean economic miracle, we now present our understanding of how the Korean economic institution achieved this miracle underpinned by the mafia state, the chaebol, an organisational culture of credible threats, and a miraculous record of technological and institutional innovation. The purpose of this explanation is not only to produce some generalisations, but also to help readers understand the Korean case for a broader interpretation of global capitalism since the 1500s.

The central concept we employ is rent-sharing, or state-business relations that produce rent and concomitantly institutionalise the way rent is distributed between them. In other words, rent-sharing will explain why these four elements surfaced in Korea but not in other developing countries during the post-war years. The concept is particularly useful for this chapter because other competing concepts that attempt to explain the Korean miracle, such as the free market, crony capitalism with rent-seeking behaviour, authority structures, institutions (including transaction cost economics, failure of rationality and rational choice institutions, legitimacy and organisational isomorphism, endogenous institutional bases and outcomes of great transformations, and ideational factors of interest-based politics), and the developmental state, have neglected its dominant presence in Korean political economy. All these competing concepts can explain one or two elements of the miracle, but are unable to identify or explain all four, thus suggesting a lack of understanding rather than of explanations.
All types of capitalist development begin from a state of absence: the absence of the free market; the absence of freedom of choice; and the absence of private property protection by the state. Korea’s economic development is no exception. Throughout the colonial period and the subsequent dictatorship by President Rhee and the military, private property protection was in the grey. During land reform during the early 1950s, for example, the state actively destroyed private ownership of land by a few wealthy cliques, allowing actual land tillers and peasants to claim ownership. The urban bourgeoisie, epitomised by the chaebol families, who owned colonial properties that Japanese imperialists left behind after liberation, faced abrupt confiscation by the new state. During the Rhee regime and military dictatorship, the state’s forced extortion of private property in exchange for protection was also rampant (Mo and Weingast 2013).

In the absence of institutionalised property protection, despite the fact that private property has been legitimised, protection still awaits either to be purchased from the market or institutionalised by the public sector. Throughout history, private property protection has never been privatised systematically on a long-term basis. Instead, the birth of the state that officially provides property protection services for fees (e.g. tax) has been common in most civilised societies (Weber 2013; North 1993; Konrad and Skaperdas 1997). But before modern politics was democratised, private property protection by the state has often been carried out in a predatory manner, reducing the overall welfare of an economic unit. Some economists argue that predatory means of providing protection to the private property increases community welfare, although total economic output will be still lower than capitalist democracies where the state acts as a representative of voters who are equally divided into property owners and non-owners (Moselle and Polak 2001). Commitment by threats and fear is always less productive than commitment by freedom of choice. However, the Korean path to development overturns this economic view because (a) the Korean predatory or mafia state not only exceeded growth rates of other developing countries during the same period, but (b) Korea also continues to use credible threats, such as incarceration and worker surveillance, in chaebol private property protection despite democratisation and people’s freedom of choice. As we will show in this chapter, the main thrust of relying on credible threats during and after development is its unprecedented utility in promoting learning among people and incremental innovation for sustainable development.

In order to understand the concept of rent-sharing, we first propose to compare it with a more familiar common concept, rent-seeking. Unlike creating individual wealth without adding new wealth to GDP through both legitimate and illegitimate lobbying (i.e. rent-seeking), rent-sharing increases both group wealth (e.g. monopolies) and GDP through extortion (or other illegitimate bribery) to promote and realise group interests. How this works is rather simple. Typical predatory states that maximise extortion (i.e. rent-seeking) would abandon one community for another when state revenues run out. If a new community they can conquer and extort money from has a bigger revenue basis than the previous one, they would abandon the latter for the former (e.g. migratory predatory states). They can also expand their territory to a new community (e.g. imperialistic states). If such options are absent, as in the Korean mafia state, the only possibility of sustaining the mafia state on a long-term basis without drying up its revenue basis is through endogenous GDP growth. If this were not possible, as was the case of the Rhee regime, the predatory state would be supplanted by another one via military coup (e.g. vicious cycles of coups as in Latin American and African developing states). The military is the backbone of the predatory state, which constantly demands more budget than previous fiscal years. If the system of extortion cannot satisfy this demand, military leaders will organise coups to overthrow the incumbent government.
The only possibility of raising GDP through rent-seeking is increasing both labour productivity and introducing rapid technological innovation, while also pursuing monopolies by lobbying the mafia state. In other words, monopolies like chaebōls had to create national wealth through both L and T factors and pay off exponentially growing amounts of extortions to the mafia state. As explained above, increasing the L factor takes a long time and requires both national and private-sector education reform. Therefore, the chaebol exploited the labour force while the mafia state banned all forms of company-, industrial-, or national-level union activities through government labour unions. However, we have also seen that the chaebol could easily ensure T factor growth through Japan and the US, either under licensing agreements or piracy.

But why did the military junta in 1961 suddenly pursue rent-sharing instead of rent-seeking? Where did they spend the money that was extorted from chaebōls? Introducing rent-sharing, while stopping the vicious cycle of rent-seeking and coups, into the Korean system of development demanded several complicated processes. First and foremost, endogenous factors loomed large. Both predators (civilian and military dictators) and property holders (chaebol families) had no trust-based interactions, although they shared experiences and knowledge gained from Japanese imperialists (i.e. they knew how to operate their organisations using Japanese institutional norms and complementarities). Due to this lack of trust between the military and the chaebol, the only protection available was to make chaebōls too big to collapse, or face punishment by the military. Diversification using borrowed money from the curb market at an extraordinarily high interest rate progressed frenetically during the 1970s (E.M. Kim 1997; Oh 1999). In addition, aligning with foreign (especially Japanese) firms through technological licensing also made selected chaebol firms look legitimate and strong in the eyes of the military (i.e. mimetic isomorphism). Chaebōls could raise productivity rapidly through diversification using Japanese institutional norms and complementarities, including job rotation, functional versus malleable skills, and lifetime employment. On a shop-floor level, technological complementarity was achieved through Japanese-style technological complementarity (i.e. J equilibrium), whereas on a macro-institutional level, institutional complementarity was garnered through Japanese-style complementarity between the state bureaucracy (including banks) and the chaebol. Lack of trust in Korean society, however, made the chaebol fundamentally different from the Japanese keiretsu, as the former intensified ownership and control concentration despite economic openness through export-oriented development.

Second, exogenous factors were also critical. Unlike the previous predatory state led by Rhee, the 1961 military state had experienced devastating modern warfare and understood that the communist threat from North Korea, China, and the Soviet Union was credible and real. This means that the military regime in the South had to be able to compete with the North in terms of equal or better economic and military power. The Rhee state wrongfully believed that the US would always help its predatory state with massive military and economic aid, when in fact the US withdrew its forces from the South right before the war broke out. With US commitment to South Korean security questionable throughout the developmental period, the need for a self-subsistent military was a paramount priority for mafia-state leaders (Mo and Weingast 2013). Therefore, rent-sharing was a far better strategy than outright rent-seeking for the new mafia state to sustain itself, while it also suppressed other smaller groups of violence that could be mobilised toward another possible coup (e.g. the military, the police, guerrilla or terrorist groups, and local mafia). The US also understood the North Korean threat after losing more than 36,000 American lives and began applying the most favoured nation (MFN) status to South Korea in a similar fashion as it did to Western Europe and Japan following the Second World War (Cumings 1984; Woo 1991). Korea began export-led development only after the war, a timely
plan of expansion for the chaebol, which copied much of the export-led developmental strategy of the Japanese keiretsu.

In order to curb other groups of violence from mobilising into another coup, the military spent extorted money to either co-opt or extinguish them from the field of violence. The military regime executed leaders of the local mafia who were closely connected to the Rhee regime, disbanded the entire organisation, and later co-opted it into its new violence segment under the military and police control (Porteux 2013). Some key players in the military coup were also removed from government positions, jailed, or executed, such as Hyung-Wook Kim, a former KCIA (Korea Central Intelligence Agency) chief. Simultaneously, the government began spending huge amounts of money to manage the military. The total military budget during the first military regime remained close to five percent of GDP, or thirty-one percent of total government expenditure on average between 1974 and 1987 (Ministry of National Defense 2013). This may offer just a glimpse as to how much illicit money the military may have raised and spent during the same period for their own corporatist benefits and perks.

Miraculously, rent-sharing in Korea worked as a combination of Japanese institutional norms and complementarities, lack of trust (or credible commitment), chaebol’s own pursuit of growth through diversification, technology/productivity assistance from Japan and the US, and export-led developmental strategies at the behest of corporate buyers, and consumers to blockade communism from the Korean Peninsula. The winners of Korean style rent-sharing were the military rulers, government bureaucrats, chaebol families, chaebol professional managers, chaebol subcontractors, exporters, and rich, government-subsidised farmers; the losers were the peasants, urban workers, pro-democracy fighters, and labour union organisers who were massacred by state forces on 19 April 1960 (April Revolution), 16 October 1979, and 18 May 1980 (Gwangju Massacre), to list a few.

Rent-sharing can be easily explained in economic terms, but understanding it requires different levels of cognitive and intellectual strength. Indeed, Korean rent-sharing has not always been negative. We see that it took the same path as that of European-style development and modernisation, which required upheavals in order to establish the successful political economic regime of capitalist democracy (Lie 2004).

Future of the miracle

The second military regime (1979–1987) was unable to last longer than the first. Continuous economic development mobilised the masses more than ever toward nation-wide democratisation movements, which included intellectuals, university students, outlawed labour union organisers, and even white-collar workers at chaebol firms. Democratisation in 1987 and the subsequent election of the first civilian president in 1992 signified the victory of the capitalist market economy and its juggernaut, the chaebol, in Korea’s history of modernisation and economic development. The chaebol’s strategy of ‘too big to fail’ proved to outwit the brute force of the mafia state. Coase’s theorem gives us some clues to understand this seemingly ironic outcome.

If there is a dog in the flat next door that barks early in the morning and wakes up all the residents on the same floor, complaints from building tenants would not stop the dog owner from disowning the dog, as no law has yet been institutionalised to penalise causing public nuisance (or perhaps the dog owner is a beloved daughter of a neighbourhood mafia boss who would send horse heads to those threatening to report his daughter to the police). Coase suggested that money would resolve this issue: a rich building tenant can offer a price for the dog that she cannot refuse. The rich neighbour can then safely put the dog away after buying it from the owner (Coase 1937; for the dog anecdote, see Mankiw 2014: 210).
In a similar vein, the chaebol has technically put the menacing mafia state in Korea to death. The monopoly of violence by the capitalist democratic state is not complete unless its capitalist class buys out competing groups of violence (e.g. the military, the mafia, the police, bandits, rebels, terrorist groups) from state apparatuses (Mo and Weingast 2013). The chaebol has not only grown too big to fail, but they can now financially co-opt and manipulate holders of violence and power for their own benefit as well. It is not a shocking revelation in Korea that Samsung and other leading chaebol groups continuously hire ex-judges and state attorneys to protect the chaebol family from state indictments for any wrongdoing (Yonhap 2012). The end of the developmental state in Korea effectively opened up a new era of the instrumental state, whose biggest beneficiary is the chaebol.

The chaebol derives its legitimacy from the mafia state itself, a crucial reason why it failed to garner legitimacy from the Korean people (e.g. workers, consumers, conscientious elements, intellectuals) despite the economic miracle. Although it was the chaebol that defeated the mafia state in the fight over control of the private property protection market, its lack of legitimacy within the new Korean democratic state has forced the chaebol to actively buy institutional raison d’être from civilian bureaucrats, their bosses, elected politicians, and intellectuals. Today, a new form of state-business collusion under the democratic government is not over the issue of property protection; it is over the question of the chaebol’s institutional legitimacy. Globalisation, the 1997 financial crisis, widening class polarisation, and increasing economic concentration by the few chaebol groups have combined to threaten chaebol legitimacy in Korea, especially from the perspective of disgruntled Korean voters over illegal ownership-succession plots by chaebols to turn over property to biological heirs (Ilyo Weekly 2014). Neoliberal policies forced upon the Korean government after the 1997 crisis also worked against the chaebol, the latter of which promotes concentration and monopoly more than free market competition, accounting transparency, and managerial professionalism (Kang 2002; Siegel 2007).

Consequently, the Korean political economy still suffers from a lack of trust among business actors in the market. Rent-sharing is now replaced by rent-seeking as we do not have the creation of substantial GDP wealth. In fact, post-miracle Korean GDP annual growth rate has remained less than six per cent annually since 2003, and has fallen below the three per cent level in recent years. Rent-seeking is a means of prolonging chaebol corporate governance (i.e. family control) despite the democratic institution of guaranteed private property protection. Corrupt politicians, state bureaucrats, and chaebol owners have worked closely for this purpose. As such, we can argue that rent-seeking has been responsible for the lacklustre performance of Korean innovation (both technological and institutional) in the 2010s. Despite their splendid and sustained track records of radical innovation in the 1970s and 1980s, Korean chaebol groups do not own any world-class technology, although Samsung owns patents that are second only to IBM in quantity (Hankyung 2013). Although Korean scientists publish research and are ranked number six in the world in terms of citations, no Korean universities are ranked in the top thirty in terms of scientific reputation. Consequently, chaebol groups have been buying research results from North American, European, and Japanese scientists, while Korean scientists are rapidly forming a fourth group of rent-seekers who embezzle government research funding for their own personal use (Oh 2013).

Even worse, Korean society has suffered from serial man-made disasters since the beginning of the rent-seeking era in 1987. Starting from the ferry sinking in 1993 that killed 292 passengers on board, democratic and civilian Korea witnessed annual disasters that have included the Seongsu bridge collapse which killed thirty-two people in 1994, the downfall of Sampung Department Store in which 502 perished in 1995, the gas explosion of the Daegu subway line that killed 101 people in 1995, and most recently, the 2014 Sewol ferry sinking that killed 213 passengers.
All these accidents had roots in systematic corruption within bureaucratic supervision and regulation. Many bureaucrats and company owners were found guilty of receiving and offering bribes for bypassing strict safety inspections to maximise corporate profits (Han 1998; Yee 1998; Yadav 2014). As such tragedies have become more commonplace, the average Korean citizen has cast doubts regarding the capability of the civilian government to manage safety and security.

The future of the Korean economic miracle is not as rosy as some may think. Although the mafia state has been dismantled either by pro-democracy movements by citizens and students or by the chaebol, which successfully bought out the mafia from the state, the Korean state is still hampered by rent-seeking behaviours of politicians, bureaucrats, and business leaders. Rent-seeking in the post-miracle era disrupts the process of trust-building necessary to replace the culture of ‘credible threats’ with that of ‘credible commitment’. Why Korea, despite its global status as a developed democratic country and member of the OECD and the DAC (Development Assistance Committee), cannot establish a capitalist democratic culture of credible commitment is something that demands further exploration. It is for this very reason that Williamson and North’s new institutionalism cannot easily explain the Korean experience (cf. Mo and Weingast 2013). As credible threats no longer exist, moral hazard is rampant in Korean business organisations and bureaucracies (i.e. both room for and inclination to opportunism are high). This does not mean that threats no longer exist in Korea’s political economy. In fact, the state continuously uses the North Korean threat to crack down on dissidents and radical union leaders. However, the state can no longer wield formidable power over the chaebol, which now exercises more threats over its workers than ever.

Although GDP growth has stalled at below three per cent, globalisation (i.e. integration with the world economy) has progressed at a high speed. The effect of rapid globalisation for the Korean economy is growing inequality and class polarisation among the populace, while ethnic enclaves and segregation are much more visible than before. Class polarisation and inequality partly derive from the failure of indigenous small businesses that could not compete with incoming foreign direct investment in the service sector (e.g. shopping malls, financial services, and IT-related services). Ethnic segregation is a result of the decline of the manufacturing sector in the country, where blue-collar workers in the manufacturing sector and manual labourers in the service sector have discontinued economic participation due to the income effect.

The issue of chaebol reform will continue to fetter the development of Korea’s political economy beyond the economic miracle. The chaebol no longer seem to generate national economic wealth through the T factor, while Korean labour productivity is not increasing as fast as it needs to. Korean corporate workers work the second-longest number of hours, whereas their income is the lowest among all OECD countries (OECD 2014). Creativity remains a central question to the future viability of the Korean economy. With current chaebol organisations, creativity remains sparse, although it was the most efficient form of learning and catch-up of all industrial organisations during the miracle years. This suggests that corporate Korea should experiment with varieties of organisational forms that allow for diversity, multiculturalism, and organisational freedom (i.e. freedom to pursue individual goals within organisations). As such, chaebol reform must include not only corporate governance reform, but organisational transformation as well.

Conclusion

In this chapter, we identified four important elements of the Korean economic miracle that surfaced between 1965 and 1987. During this period, the Korean economy recorded annual GDP growth rates in excess of eight per cent. But unlike neoclassical explanations, we argued
that the Korean miracle was marked by: (1) a mafia/predatory state that espoused GDP growth with escalating class polarisation; (2) chaebol groups that could not survive without political protection extended to them by the mafia/predatory state; (3) a social and institutional culture that could not maintain or organise human business and social relations without resorting to credible threats amid rampant distrust among organisational members; and (4) semi-world-class process (institutional) and technological innovations through parodying. We also argued that the theoretical principle of the country’s economic growth was rent-sharing, an institutional process of engendering phenomenal growth based on state-business collusion and credible threats. We showed that rent-sharing was fundamentally different from rent-seeking due to actual economic growth through corruption.

However, we also noticed that credible threats had discouraged creativity and innovation in the Korean economy despite political democratisation and economic development, presenting a bleak picture for the future of Korea’s economic miracle. We also see that the Korean economy suffers from outright rent-seeking behaviour by economic and political actors despite democratisation and economic development. When the economy is in the hand of the chaebol, which remains too big to fail, economic development is hampered because credible threats are not replaced with credible commitment. We need to explore when and why credible commitments are made possible.

The lesson of the Korean economic miracle is twofold: the global capitalist regime that started from the 1500s was critical in shaping the exogenous basis of industrial transformation, although the endogenous basis of an economic system that was founded on the principle of the credible threat was equally pivotal in bringing about the miracle. At the same time, globalisation in the same world system has substantially delimited the creative potential of the Korean miracle in much the same way it has curtailed Japan’s efforts to hammer out creative solutions to its prolonged recession, following a period of high-powered growth and mass consumption. Thus going forward, there will be great academic and practical interest in how to improve the relationship between credible threats and commitments via theory-building and empirical testing.

Glossary

Chaebol: A South Korean business conglomerate that is owned and controlled by a single family. Chaebol literally means a family clique with colossal wealth. Although it originated from the pre-war Japanese zaibatsu, the post-war Korean chaebol is significantly different from the former, as its ownership and control structure are fused without a zaibatsu-style holding company. Nor is the chaebol allowed to maintain a main bank system, which was common within the Japanese zaibatsu and post-war Japanese keiretsu.

Credible commitment: In all business transactions, no verbal commitment is credible, until such commitments to a preferred strategic move in business deals can be discerned as credible with additional safeguarding mechanisms. Business reputation, written contracts, burning bridges, hostage exchanges, building credibility through teamwork, and finally the institutionalisation of the commitment through state legislatures and legal enforcements are such safeguarding mechanisms. Among these, the institutionalisation of the commitment is the safest mechanism in the modern capitalist state.

Credible threat: In all business transactions, no verbal commitment is credible, until such commitments to a preferred strategic move in business deals can be discerned as credible with additional threat mechanisms, such as the code of honour that is often employed by the mafia. The threat used in business transactions becomes credible if it is either informally or formally institutionalised as in the case of the mafia and the mafia state.
Developmental state: The developmental state became a widely used and understood concept as a consequence of Chalmers Johnson’s seminal analysis of Japan’s post-war economic reconstruction. In Johnson’s original formulation the developmental state had a number of features, including competent state agencies and carefully calibrated industrial policies. The key quality that makes a state developmental is its capacity of planning a development process rather than relying on market forces to determine the optimal allocation of resources. Unlike “market rational” states, which are concerned with establishing the rules of the economic game, the “plan rational” state seeks to formulate and pursue substantive social and economic goals.

Guanxi: Social networks in China that are established and maintained to nullify or bypass institutionalised credible threats directed against particular business transactions. Guanxi networks are created to neutralise such credible threats and defend private, individual, and group interests in business. Guanxi networks with the most social capital and financial resources will ultimately win business contracts despite legal and informal threats and difficulties.

East Asian Tigers: Following the footsteps of the Japanese economic miracle that heavily relied on the state’s macroeconomic policies with its plan-rational developmental strategies and goals, South Korea, Taiwan, Hong Kong, and Singapore succeeded in bringing about rapid economic and social developments with their strong states, symbolised as tigers. These economies share similar cultural background, although they are geographically apart in Northeast and Southeast Asia.

Economic miracle: If the gross domestic product (GDP) demonstrates a growth of more than eight per cent for more than ten consecutive years, the phenomenon becomes dramatic or unexpected. In modern economic history, the industrial revolution in the UK was the first good example of the miracle, while the post-war recovery in Germany and Japan was another. In recent years, the miracles in Asian Tigers and China are additional examples. However, continued macroeconomic expansions of eight per cent or more for more than two decades have not been witnessed in economic history.

Institutional complementarity: All economic organizations face two kinds of uncertainties: localised technological uncertainties and institutional uncertainties. Technological uncertainties affect organisations within a sector in a given time period, while institutional uncertainties affect the entire industry and the economy. In Aoki’s original analysis of the Japanese keiretsu, the institutional uncertainty had three layers: the pattern of dependence of a member firm within a keiretsu on other member firms, member firms’ reliance on keiretsu main banks, and the main banks’ dependence on the state banks. If the method of resolving technological uncertainty (e.g. bottom-up communication in Japan) is complementary with keiretsu institutions with their main bank system, institutional complementarity is achieved within the keiretsu. The keiretsu institutional complementarity can be achieved with the state institutions to resolve various types of keiretsu-wide and nation-wide economic problems (e.g. state banking system with “window guidance”).

Keiretsu: The post-war Japanese conglomerate business organisations that spearheaded the post-war economic miracle in Japan in tandem with the developmental state. The keiretsu has no owning family or holding company, unlike the pre-war Japanese zaibatsu. Instead, it is owned and controlled by institutions including member firms, main banks, and the presidential council (shachōkai). The keiretsu may be vertical (intra-market) or horizontal (inter-market) depending on their market position in the economy. Vertical keiretsus form a supply chain for one product in one market, whereas horizontal keiretsus serve different markets. During the peak of the Japanese economic development, six inter-market keiretsus
Parodying: An economy that is in a catch-up mode of development, technological innovation through piracy or parodying is the cheapest and fastest way of increasing GDP growth without excessive investments. Parodying through outright copying, licensing, or reverse engineering has been common in the case of Japanese, South Korean, and Taiwanese economic development. Product lifecycle theory predicted transfer of technologies from a declining country to a developmental country, although the prediction did not explain the process of parodying that is necessary in technology transfers.

Rent-seeking: An economic behaviour taken by individuals, corporations, and even the state to increase their wealth without affecting any GDP growth. If business owners lobby bureaucrats and politicians to obtain business permits or eradicate competitors from the market, GDP actually decreases despite their wealth accumulation. Rent-seeking is a quick way of accumulating wealth without contributing to the nation’s capital size, labour productivity, or technological innovation. If policemen collect bribes from traffic violators, the nation’s GDP does not change, or might even diminish, although the wealth of corrupt policemen increases.

Rent-sharing: If rent-seeking is organised with an on-going scheme that requires future payments to be constantly increasing exponentially, rent-seekers will have to plan strategic moves to contribute substantially to a nation’s capital size, labour productivity, and technological innovation. If corrupt politicians demand bribes from business owners who want business permits, the former can require the latter to pay annual bribes that would increase automatically every year in exponential rates. The latter may then have to formulate growth plans to meet the state’s demand in bribery payments, causing actual GDP growth. Rent-sharing therefore explains why monopolies and oligopolies sometimes can induce high GDP growth for developing economies.

Too big to fail: One way of neutralising state hostility against private property is to enlarge the sheer size of the property to threaten a “deadweight loss,” or economic inefficiencies caused by a large-scale capitalist divestment that would quickly decrease supply in the market, causing price hikes. In the case of South Korea, the chaebol used this option to co-opt the military state that tried to legitimise its regime by high GDP growth and full employment. The chaebol provided both to the economy, although simultaneously it threatened a pull-out from the market if the state taxed it too much, either formally or informally. Most importantly, the chaebol also demanded state bailout plans when it faced financial difficulties deriving from rapid expansion and diversification through mergers and acquisitions.

Tunnelling: An unethical business behaviour by corporate owners involving transfers of corporate wealth from one corporation to another. In an attempt to list a new corporation in the stock market, the owning family uses their listed company to buy goods and services from the new company in massive quantities to artificially increase the latter’s revenues. In another example, owners of a successful corporation transfer its corporate wealth to an undisclosed offshore corporation in order to avoid taxes. Artificially increasing owners’ salaries and dividends is also considered tunnelling, as well as their attempt to increase their stock values by purchasing unrelated but lucrative firms.

References


