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## CHAPTER 7

### **CORPORATE GOVERNANCE, INDUSTRIAL POLICY, AND THE RULE OF LAW**

by **Dwight Perkins**

#### **INTRODUCTION**

The 1997–98 crisis, the continuing shift from state to market, democratization, the stress on accountability, and the recent focus on competition and competition law have directed attention to the need for corporate reform in East Asia. Indeed, “reform corporate governance” has become the current mantra both within the region and outside it. Crony capitalism is seen as the structural flaw that laid low the four crisis-hit countries and that caused a decade and more of economic stagnation in Japan. Some fear that China’s economy could go the way of Japan or even Indonesia if timely steps are not taken to correct major flaws in corporate governance there.

As this chapter will argue, there is real reason for concern about the way Asian corporations are governed, but much of this concern is taken out of the concrete historical and institutional context in which Asia’s current system of corporate governance arose. A common approach is to look at corporate governance practices in North America and Western Europe and then compare those practices with the way business is done in Asia. Reformers analyze the strengths and weaknesses of these practices in postindustrial market economies and then attempt to apply the lessons learned to Asia.

The core concern of the literature on corporate finance in the United States and Europe is how to protect owners of companies, particularly minority shareholders, from the predations of corporate managers (Shleifer and Vishny 1997). As the current scandals in the United States with respect to stock options

make clear, company managers are often in a position to divert a sizable portion of companies' assets into their own pockets. When this happens on a broad enough scale, minority owners will withdraw their funds from the capital markets or at least from those parts of the markets that deal in equities. Equity market development is thus stunted—and weak equity markets, in turn, slow the development of new companies and the expansion of old ones.

The approach to reform, therefore, was to introduce new laws to protect minority shareholders that would be enforced by an independent judiciary. Alternatively, one could substitute an independent government regulatory agency for the courts, an agency governed by rules rather than by the discretionary judgment of the executive branch of government. Regulatory agencies would substitute for or displace the courts in settling disputes and overseeing bankruptcies and mergers. Such a shift in emphasis occurred in the United States at the end of the nineteenth century and continued into the twentieth century. The belief was that regulatory agencies would administer fairer judgments than the courts because the decisions of the courts could too easily be subverted by the inequality of power that existed between the large corporations that for the most part were the source of the violations and the individuals and small companies that were the victims.<sup>1</sup>

This Western literature on corporate finance does contain many lessons of relevance to the reform process in East Asia. But this Western literature also relies on a number of critical assumptions that make it difficult to apply the rules derived from the analysis without first making a number of major adjustments or additions. First, most analysis of the economies of North America and much of Western Europe assumes that government sets the rules that govern markets but that government does not directly interfere with the functioning of those markets on a regular and discretionary basis. The role of government is to make and enforce the rules, not to decide where industrial investments should be made or how they should be financed. Second, as already pointed out, when rules are violated by companies or individuals, it is the legal system or an independent regulatory agency that is called on to redress the situation, not the prime minister or the minister of planning or finance.

These two critical assumptions about the role of the government and the presence of an efficient and independent judiciary or regulatory agency are consistently not applicable in most of East and Southeast Asia. As will be discussed at length later, governments in East Asia have frequently taken the lead in promoting particular industries and even particular companies. Nor do most of the countries in East and

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<sup>1</sup> This topic is discussed at length and the argument formalized with a model in Glaeser and Shleifer (2001).

Southeast Asia have efficient and independent legal systems or regulatory agencies. The legal and regulatory systems—except in Hong Kong (China) and, to a degree, Singapore—are weak and easily manipulated by the executive branch of the government and, in the worst cases, by anyone with money to bribe judges. Activist government industrial policies and weak judiciaries have a direct bearing on how the countries of East Asia must proceed if they are to achieve meaningful reform of corporate governance in the region. Reform is not just or even primarily a question of passing new laws, although some new laws are needed. The real challenge is to create the institutions that will enforce those laws efficiently and fairly. Creating such institutions will require a fundamental rethinking of the role of government in the economies of the countries in the region.

This chapter begins, therefore, with a discussion of how the institutions governing the economies of East and Southeast Asia developed over the past century. That historical experience has generated institutional structures that were a reasonable response to the requirements of the period when they were created but, in many cases, are barriers to progress today. This historical overview, therefore, helps define what many of these countries must do to restructure their industries and systems of economic governance. With the problems thus defined, the chapter then returns to the question of the best ways to correct the structural weaknesses that have become so apparent in recent years.

Before World War II, most businesses in East Asia, other than a few large European, Japanese, and U.S. corporations with investments in the region, were family owned and managed. Outside of Japan, stock markets did not exist and minority shareholders of Asian firms, if any, typically had close personal ties to the owner. Contract disputes among Asian-owned firms—mostly overseas Chinese firms in Southeast Asia and Chinese-owned firms in China, Hong Kong (China), and Taiwan (China)—were rarely settled through the courts. There were good reasons for overseas Chinese and the local populations to avoid the courts in colonial Asia. The courts were run mostly by the colonial powers and for the colonial elite. In China, local magistrates also had little interest in creating a fair and efficient court system for resolving local business disputes.

As Ronald Coase has argued, firms will contract with each other in ways that meet their needs without recourse to a legal system as long as contract enforcement costs are negligible. This was the pattern in Asia even though enforcement costs were not negligible. Firms relied on personal ties of trust that were based on family and family-like regional ties and guilds. Breaches of that trust led to ostracism, in effect making it impossible to do business, or, if ostracism proved unworkable, to the threat of physical harm to the wrongdoer or to the wrongdoer's family by privately controlled thugs. The Shanxi bankers of Qing Dynasty China, for example, had bank offices manned by Shanxi people throughout the empire. As

protection against malfeasance by bank managers, their families back in Shanxi were, in effect, held as hostages.

In the first decade or two after independence from colonialism, this mode of doing business continued in most of Southeast Asia plus Taiwan (China) and the Republic of Korea. Locally owned firms remained small and family run. Banks, for the most part, confined their lending to short-term letters of credit and other trade-related loans. The risk of lending for longer-term investments was simply too great. Stock markets, where they existed at all, listed the shares of only a handful of mostly foreign-owned firms that had continued on from the colonial era. Locally owned firms relied for capital on retained earnings and the extended family.

By the 1960s and 1970s, however, government leadership in East and Southeast Asia had been transferred, sometimes violently, from the immediate postcolonial generation—most of that generation had little interest in or knowledge about economic development—to individuals who saw government direction as the means of steering their economies on the road to becoming modern industrial states.<sup>2</sup> The inspiration for this activist role, in part at least, was Japan, where the Ministry of International Trade and Industry (MITI) was seen as the architect of Japan's postwar economic boom (Johnson 1982). Alongside the success of the Japanese experience and the perceived success of the far more radical, state orchestrated interventionist approach of the Soviet Union, there was widespread faith throughout the developing world in the efficacy of government intervention to accelerate economic development, in general, and industrial development, in particular. Except in Hong Kong (China) and, to a lesser degree, Singapore, therefore, activist governments in East Asia began to own or dominate the banking systems and worked closely with these banks and favored local firms to promote industrialization. In the cases of China and Vietnam, the governments went even further by erasing the private sector and filling the void with government-owned and -directed industrial and commercial enterprises.

The financing of industrial development came increasingly from the banking system and was directed toward projects favored by government industrial policymakers. In the cases of Indonesia, the Republic of Korea, and Taiwan (China), not to mention China and Vietnam, the banks were government owned as well as directed. In Malaysia and Thailand, as in Japan, the banks and nonbank financial institutions were mostly private but were responsive to government direction. Only in Hong Kong, China, could one say that the banks were independent of the government and made their lending decisions largely on the basis

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<sup>2</sup> In some cases, as in Singapore and, to a degree, Taiwan, China, it was the first generation of postcolonial leaders who presided over the shift to an activist industrial policy.

of commercial criteria. Although local stock market development commenced in the 1960s and nonbank financial institutions were started or expanded, the role of those institutions in the capital markets of the region remained small relative to the banks and self-financing.<sup>3</sup>

There was considerable variation within Asia and over time in the way activist governments intervened in the economy. At one end of the spectrum were the centrally planned command economies of China, Vietnam, and the Democratic People's Republic of Korea. A planning commission at either the central or the provincial level decided what each enterprise was to produce and what inputs were to be allocated to that enterprise to allow it to meet its output targets. Inputs were allocated administratively and could not be obtained on any legal market. Enterprises, which usually oversaw only a single factory, were really the lowest-level bureaus of a large hierarchy dominated by ministries, with the planning commission at the top. Plant or enterprise managers were more like lower-level government bureaucrats than businesspeople. The role of the financial system, mainly the mono-bank that combined commercial and central bank functions, was to monitor and enforce the plan. Banks had no independent authority to decide whether to lend to an enterprise. If the enterprise was doing what was called for in the plan, it got the financing it needed.

When China and Vietnam began to convert from a centrally planned command system to a market system, they retained many of the structures of the old system. Enterprises, as defined in the old system, became the independent enterprises of the market system. The resulting industrial organization structures, as will be discussed below, were the least concentrated industrial structures in Asia. Clearly these structures had to be changed to make them suitable for competition in a market-based system, but how and by whom? The mono-bank in China was broken up into a central bank and four large commercial banks, but those four banks continued to lend money the way the mono-bank did under the old system. If a powerful politician thought that they should lend to a particular enterprise, they did so.

The industrial policies of the other economies of East Asia did not go to the extreme of socialist central planning, but the government was heavily involved in industrial decisions nonetheless. The feature that Indonesia, Malaysia, the Republic of Korea, Taiwan (China), and Thailand had in common was the government's role in supporting certain industries over others. Korea and Taiwan, China, were first off the mark with policies in the 1960s that supported manufacturing firms that were successful in promoting exports abroad. Those firms got access to scarce foreign exchange, to bank loans at favorable rates, and to other subsidies such as generous wastage allowances. By the 1970s, both Korea and Taiwan, China,

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<sup>3</sup> This situation mimicked the experience of industrial countries. See Stiglitz (2001).

began a major effort to promote what they conceived to be key heavy industries: steel, machinery, and petrochemicals. Individual private (and some public) firms in Korea were designated by the government to carry out the heavy industry plan. These firms received favored access to credit and foreign exchange, sometimes a monopoly over the domestic Korean market, and heavily subsidized infrastructure support. In the case of Taiwan, China, mainly government-owned enterprises carried out the initial phases of the heavy industry drive, because the government believed that the business community in Taiwan, China, lacked the education and experience for the job. In 1974, when the heavy industry drive was just under way in Taiwan, China, only 16 percent of the central figures of the 100 largest business groups had a university education (Hsueh, Hsu, and Perkins, 2001, p. 101). Korean industrial policies led to an industrial organization structure dominated by a few large conglomerates or *chaebol*. In Taiwan, China, there was a dual industrial organization structure before the 1990s, in which the state often owned large enterprises while most private enterprises were small. From the 1980s onward, the Korean government saw the problem as one of how to break up the largest chaebol in order to create a level playing field for everyone else. In Taiwan, China, the government reluctantly began to privatize the large state-owned firms.

The situation in Indonesia and Malaysia was similar in some respects and different in others. In both countries in the 1970s and 1980s, the governments began a drive to create heavy industries in the steel, automobile, and petrochemical sectors. In both countries as well, the goal was to have those firms as much as possible in the hands of the *bumiputera*, the indigenous population, rather than in the hands of foreigners or the local Chinese. Thus, both countries began their heavy industry efforts with state-owned enterprises because private *bumiputera* with the necessary experience and resources did not then exist. But these state-owned enterprises, unlike those in Taiwan (China) and Korea, were often highly inefficient. Malaysia then privatized these enterprises, but it did so in a way that ensured that *bumiputera* would end up in control. Because few *bumiputera* had the financial resources to buy large automobile and telecommunication enterprises, the government used its control of some of the biggest banks to provide them with the necessary financing.

Thailand, in the initial phases of its postwar development effort, sometimes relied on new firms with key ties to the military. Those ties guaranteed the firms support from the military-dominated governments. Later, Thailand turned more to foreign direct investment, particularly from Japan, to fuel its industrial drive. Industrial policy was then geared toward creating a favorable climate for such investment. Singapore and Hong Kong, China, relied heavily on foreign direct investment for industrialization as well, but Singapore also made extensive use of state-owned enterprises in sectors in which foreigners either were not wanted or could not be attracted. Hong Kong, China, came the closest to being an

economy with no government intervention to promote particular firms and industries, but even there the government and the big property developers worked closely together to ensure that property prices remained high.

This brief review of the interventionist industrial policies of the various Asian governments is designed to make two simple points. First, in all or almost all of the countries in the region, there were close ties between the larger enterprises and the government. In some cases, those ties involved direct government ownership, whereas in other cases, the ownership was private but key guidance came from the government. Clearly this situation created problems for the government as a neutral arbiter of business conflicts. Often the government was an active supporter of particular enterprises and their management. Few Asian governments saw their role as one of protecting minority shareholders.

Second, the close government-business ties also created industrial organization structures that did not necessarily reflect market forces. This situation presented the governments with a dilemma. When the countries moved toward greater reliance on market forces, they still had to face the question of what to do about those existing structures. Should they let the existing structures continue, or should they try to break up those deemed to be overconcentrated and consolidate those deemed to be too fragmented? And if the decision was to change the structures, who had the responsibility and authority to implement these changes? Was it the enterprise management or the government? And if the government was going to do the job, how could it then say that its objective was to create a true market system in which the government was only the enforcer of the rule of law, not the director of industrial investment decisions?

## **REFORMING CORPORATE GOVERNANCE**

As already indicated, the main body of the corporate finance literature is concerned with agency problems of how to protect investors from the predations of managers. Closely related is the literature's concern with how suppliers of a firm's capital can ensure that they get some return on their investment rather than see the entire return appropriated by these same managers (Shleifer and Vishny 1997), especially in circumstances where financial reporting and auditing standards are low.<sup>4</sup> Absent these assurances, it is difficult to develop capital markets, particularly stock markets, if most of the participants typically are

<sup>4</sup> A survey by McKinsey and Co. (Coombes and Watson 2002) showed that investors were willing to pay a 20 percent premium for a well-governed company in Taiwan, China, but a 27 percent premium for a well-governed firm in Indonesia. This finding reflects the quality of financial information and strictness of accounting practices.

minority shareholders. But as the discussion above indicates, for most of the private firms in East Asia through the 1960s the suppliers of capital and the managers were one and the same. Minority shareholders, if they existed at all, relied for protection of their investment on personal ties to the owner-manager.

This system, however, was changing, and some separation of investors from management was gradually becoming a reality by the 1970s and thereafter. The number of firms listed on the various national stock exchanges and the total value of listed stock owned expanded, starting in Japan. From the 1980s onward, Japanese firms began reducing their dependence on banks (Stulz 2001).<sup>5</sup> Family control in countries such as the Republic of Korea was maintained by cross-shareholding within a group of companies, and Korea is by no means an extreme case, as can be seen from table 7.1.<sup>6</sup> The rapid expansion in the value of the shares listed on the stock exchanges in Hong Kong (China), Malaysia, Thailand, and Taiwan (China) is enlarging the role of minority shareholders in the financing of East Asian firms. However, except for a few very large minority shareholders, most Asian minority shareholders had few rights that were effectively protected by law or government regulation through the 1990s. Companies were run by and for the controlling families, for the most part, and other shareholders could only hope that some of the gains in corporate value that were being achieved would be transferred to them (Backman 1999).

In China, the majority shareholder in most listed companies was not a family but the state itself. Minority shareholders in China, for all practical purposes, did not even have the right to select boards of directors or to hire and fire management. That power remained firmly in the hands of the government and the Communist Party. Portfolio investment from North America and Europe flowing into these stock markets in the late 1980s and 1990s did not noticeably change this indifference toward minority shareholder rights.<sup>7</sup> In the few cases in Asia where minority shareholder rights were observed, as in the shares held by bumiputera individuals in Malaysia, those rights derived from the political power of the bumiputera, not from protections in the law.

<sup>5</sup> This trend is part of a wider phenomenon that is spurred by the development of information and communications technology. The new technology is making it easier for firms and households to tap the securities markets because of the greater ease of unbundling risks, securitization, and trading of financial products on electronic exchanges (see Mishkin and Strahan 1999).

<sup>6</sup> It should be noted that most publicly traded firms worldwide are family controlled, including such large firms as Wal-Mart and Ford in the United States (Burkart and others 2002).

**Table 7.1 Control of Publicly Traded Companies in East Asia, 1996**

Cutoff for voting rights of the largest shareholder	Number of corporations in the sample	Share of corporations under ultimate control	Distribution of ultimate control			
			Family	State	Widely held financial institution	Widely held corporation
<i>10 percent cutoff</i>						
Hong Kong, China	330	99.4	64.7	3.7	7.1	23.9
Indonesia	178	99.4	68.6	10.2	3.8	16.8
Japan	1,240	58.0	13.1	1.1	38.5	5.3
Korea, Rep. of	345	85.7	67.9	5.1	3.5	9.2
Malaysia	238	99.0	57.5	18.2	12.1	11.2
Philippines	120	98.4	42.1	3.6	16.8	35.9
Singapore	221	98.6	52.0	23.6	10.8	12.2
Taiwan, China	141	97.1	65.6	3.0	10.4	18.1
Thailand	167	97.9	56.5	7.5	12.8	21.1
<i>20 percent cutoff</i>						
Hong Kong, China	330	93.1	66.7	1.4	5.2	19.8
Indonesia	178	94.9	71.5	8.2	2.0	13.2
Japan	1,240	20.2	9.7	0.8	6.5	3.2
Korea, Rep. of	345	56.8	48.4	1.6	0.7	6.1
Malaysia	238	89.6	67.2	13.4	2.3	6.7
Philippines	120	80.9	44.6	2.1	7.5	26.7
Singapore	221	84.5	55.4	23.5	4.1	11.5
Taiwan, China	141	73.7	48.2	2.8	5.3	17.4
Thailand	167	93.5	61.6	8.0	8.6	15.3

*Note:* The table reports the aggregate statistics on the distribution of ultimate control among four ownership groups. The ultimate control is studied at two cutoff levels—10 and 20 percent of voting rights—to show differences in the concentration of control in individual firms.

*Source:* Claessens and others (1999).

Many minority shareholder rights are inherently difficult to enforce even when there is a will on the part of the government or relevant regulatory agencies. Insider trading, for example, is rampant in Asia, as far as one can tell, but even the United States falls far short of complete enforcement in this area. Corporate accounting practices in Asia also leave large amounts of room for maneuver on the part of management at the expense of shareholders. Improving the accounting system of most Asian economies is clearly a high priority throughout the region, but dubious accounting practices are still a problem in the United States, as recent scandals have demonstrated. Still, many firms in Asia continue to operate with two sets of books,

<sup>7</sup> By the late 1990s, minority shareholders in both Japan and Korea had begun to voice their concerns, stung in part by the 1997–98 crisis. (“Day of the Shareholder,” *Far Eastern Economic Review*).

only one of which, usually the doctored one, is available for inspection by the public or the tax authorities.

If minority shareholders continue, at the beginning of the twenty-first century, to possess few rights and little is being done to enhance those rights, the same cannot be said of capital being supplied by banks and others in the form of credit. Steps are being taken to better protect the rights of creditors, but there is still a long way to go before an adequate system is in place. The key to reform in this area involves strengthening bankruptcy procedures.

The Asian financial crisis of 1997–98 revealed widespread weaknesses in the operation of bankruptcy laws and procedures in the most affected countries. Banks and other creditors, both foreign and domestic, found that the existing laws often did little to protect them. Nor did the laws provide reliable procedures for the insolvent firms to work their way out of the crisis or to be liquidated (“Southeast Asia Bankruptcy Law” 2000). Unlike the case of minority shareholder rights, however, ongoing efforts have been made to strengthen bankruptcy laws and procedures in the region, beginning in 1998.

Good bankruptcy legislation is designed to improve the efficiency of the economic system by facilitating the exit of failed firms and paying off creditors in the process, while giving firms that are viable over the long run the opportunity to restructure their finances and make other changes that will restore them to economic health. Closing failed firms is important not only to eliminate business units that drain the country’s resources; the example of these closures also discourages other firms not yet in trouble from risky behavior.

Good bankruptcy legislation must first be transparent, in the sense that legal rules for dealing with the insolvency of a firm must be clear and sophisticated. Such legislation should also define precise guidelines about “procedure, proof, notification, time and appeals” (“Southeast Asia Bankruptcy Law” 2000). If the legislation meets these criteria (and sometimes it does not, because of the inexperience of those drafting the laws), creditors and firms will know how to play the workout game. This knowledge will reduce strategic behavior on the part of stakeholders that delays and distorts the process. Long-delayed workouts will typically lead to a reduction in the value of assets, and one way to avoid this reduction is to keep the procedures as simple as possible. Another way to shorten the process is to set time limits for the completion of various components. Since the financial crisis, such time limits have been introduced in Indonesia, Korea, and Thailand.

Transparency, however, involves more than good laws. The courts must be consistent in applying those laws to various insolvency situations. In this respect, among the Asian countries considered here, Hong

Kong (China) and Singapore have the best-developed legal infrastructure, and Malaysia, too, has had a workable system in place for decades (Pistor and Wellons 1998). Indonesia, Korea, and Thailand have changed their insolvency laws substantially since the financial crisis, but in Indonesia (and the Philippines), the inconsistency and outright corruption of the courts seriously undermines the transparency that the new laws are designed to achieve.<sup>8</sup> The nature of the courts and the rule of law in the various East Asian countries is a topic that we shall return to at length in the final part of this chapter.

Another problem with the bankruptcy process in Asia is that the courts have little experience with corporate insolvency processes, and acquiring the necessary knowledge is not a simple matter. Particularly if a firm is large and complex, it can be a daunting challenge for judges with little experience in the area to determine the conditions under which the firm is to be allowed to continue in operation and to restructure itself back to financial health. Outright liquidation of the firm is a less complex task, but it still requires specific expertise. In 1999, Thailand established a separate Bankruptcy Court. In 1998, in Indonesia, the bankruptcy law (dating back to 1911) was revised and four additional commercial courts—with 45 specially trained judges—were created to relieve the burden of insolvency cases on the existing courts (“Law Set to Push Indonesian Debtors over the Edge” 1998).<sup>9</sup> Korea has a specialized division within each district court that is responsible for insolvency proceedings (Nam and Oh 2001, p. 53).

Other East Asian countries are also struggling with the reform of their bankruptcy procedures. China has had bankruptcy legislation on the books since 1986, but it was only after 1997 that the government actually began to liquidate and reorganize a large number of mostly small and medium-sized enterprises. State-owned enterprises, in particular, were kept afloat even when they ran losses year after year and clearly were unable to repay their bank loans. When the government did decide to close some firms and to force the merger of others with more successful enterprises, the decisions were not made by the courts, nor were they made with due regard for correct legal process. The executive branch of the government, using both economic and political criteria, made the decisions. Much the same approach to liquidating provincially owned firms was followed in Vietnam in the early 1990s. Given the weakness of the courts

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<sup>8</sup> This discussion of bankruptcy legislation, including the paragraphs that follow, is largely based on the essay of Nam and Oh (2001).

<sup>9</sup> Linnan (1999) has examined the early, halting efforts to implement the Indonesian bankruptcy legislation. In its first year of operation, these efforts had yielded few results. The few voluntary debt reorganizations that they prompted involved mainly debt rescheduling and not much in the way of restructuring.

and the absence of alternative mechanisms for handling these decisions, the governments had little choice but to intervene, but government ministries were ill equipped to handle the process well.

The Chinese and Vietnamese cases illustrate another critical criterion for judging whether bankruptcy procedures are fair and efficient. When the executive branch of the government controls the workout or liquidation process, it is highly unlikely that the process will be transparent, although it may be quick. Even when the courts are involved, however, there is still the question of whether court orders are enforceable. Malaysia's courts generally have been effective in enforcing insolvency decisions, although not as effective as Singapore's courts. Korea also now has reliable enforcement mechanisms and has even been able to take on the restructuring and liquidation of large conglomerates such as Daewoo and Hyundai, although these giant company workouts involved more than the courts. Thailand, in contrast, had so many insolvency cases in the wake of the financial crisis that the courts were overwhelmed and timely disposal of the cases was undermined. In Indonesia, not surprisingly given the state of the legal system, bankruptcy enforcement has ranged from weak to nonexistent (Backman 1999, Nam and Oh 2001).

Enforcement is really the central issue in most legislation related to corporate governance. If the laws are ignored or cannot be enforced, the legislation has little practical value, at least in the short run. The enforcement of corporate governance legislation in general and of bankruptcy legislation in particular is not just a question of whether the legal institutions are capable of administering an economic system that is based on the rule of law. The system may well be able to handle most routine contract disputes and still be unable to deal with major bankruptcy cases.

A basic problem in the enforcement of bankruptcy legislation derives from the kinds of industrial policies pursued by many of the countries in the region. As noted above, most East Asian countries pursued industrial policies that involved the executive branch of the government targeting particular sectors and even particular firms for development. In seeking to promote a particular industry, the government not only eased access to foreign exchange, if foreign exchange availability was controlled, but also offered other supportive measures, such as favorable tax treatment and tariff protection. Most of all, governments used their power over the banks to direct credit to those firms.

Governments thus entered into implicit contracts to support the large firms that were chosen to implement their industrial development goals.<sup>10</sup> The nature of this support was generally not made explicit through

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<sup>10</sup> On some of the dealings between officials and chaebol, see Kirk (1999).

legislation or formal contracts, but it was no less real. With such arrangements, the implied support does not end when the firm gets into trouble. If firms are to proceed with confidence to carry out the government's wishes, they must also be reasonably sure that, after the government helps them launch the targeted industrial ventures, it will come to their assistance if the projects fail. Failure, after all, may result for reasons having little to do with the management skills of the firm itself—the government's basic idea may have been flawed from the start.

A government that wants to shore up a troubled firm can always rely on taxpayer-financed subsidies, but such subsidies can give rise to political problems. It is generally easier to instruct the government-controlled banks to provide bridging financing. Industrial policies, therefore, not only result in weak industrial firms but also saddle the banking system with nonperforming assets. The implication of industrial policy for bankruptcy processes is unavoidable. Whatever creditors may want the courts to do to recover some of the resources the creditors have lent, the executive branch of the government has an obligation to override those decisions for firms that have done the government's bidding.

The experience of the Republic of Korea illustrates the problem.<sup>11</sup> During the heavy industry and chemical industry drive of the 1970s, the Korean government went to great lengths to ensure the successful development of selected industries and firms, including the large-scale diversion of bank credit to those firms (Stern and others 1995, Kim 1997). Many of the industries so promoted were successful, but some were not, and the new Korean government of the early 1980s was forced to wrestle with the failures. In the majority of cases, the government decided to continue financing the unsuccessful industries while they were being restructured and, often, put under new management. The process was handled not by the courts but by the executive branch of the government.

In the 1980s and the 1990s, Korea began to try to move away from industrial targeting,<sup>12</sup> but past commitments made it difficult for the government to relinquish all responsibility, especially after the 1997–98 financial crisis. Largely because of the crisis, Korea, by then a democracy, elected a president, Kim Dae Jung, who had no personal or political obligations to the existing industrial arrangements and who expressed a strong desire to see the Korean chaebol restructured and dismantled. He also had to find

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<sup>11</sup> See, for example, Krueger and Yoo (2001).

<sup>12</sup> After peaking in the 1970s during the heavy industry and chemical industry drive (as high as 19 percent), the share of preferential loans from deposit money banks to total loans declined. During the latter half of the 1990s, preferential loans accounted for only a small share (2–3 percent) of total loans (Krueger and Yoo 2001).

a way to refinance the banks, most of which were in trouble both because of the financial crisis and because of decades of often misconceived government direction. The challenge facing the government with regard to industrial restructuring was how to enforce its plans. The answer, not surprisingly, was to rely on the government's control of the banks, which was greatly enlarged following the virtual takeover of many of the leading banks by the authorities following the crisis (Kirk 1999). The chaebol, most of which were deeply in debt and basically insolvent, had to turn to the banks for refinancing. Refinancing was made available only if the industrial firms were prepared to make major efforts to implement the government's restructuring objectives. Thus, the intention to create a market economy in which all firms competed on a level playing field and to discontinue industrial policies faltered, and policies tended to return to the interventionist industrial regime of the past.

The eventual goal of the Korean government is to end such *dirigisme*, but it remains to be seen whether successor governments will be willing to let the market and the courts handle company workouts in the future. If the government does succeed in removing itself from the center of these decisions, the various new laws on bankruptcy and minority shareholder rights will, with the support of the courts, become meaningful. The issue of whether the government should continue to try to shape the development of the large conglomerates became important in the presidential election at the end of 2002 and has yet to be resolved.

The evolution of Korean industrial policies and their relationship to bankruptcy and other corporate governance issues is not unique in East Asia. Since at least the mid-1980s, Taiwan, China, has been trying to relinquish industrial targeting and move toward market-determined industrial outcomes.<sup>13</sup> Taiwan, China, has had one advantage over Korea in this regard: many of its industrial enterprises were quite small and not subject to micromanagement by government. When the government did pursue targeted industrial policies, it tended, as already noted, to rely mainly on state-owned enterprises supported by favored treatment from the largely state-owned banks. As the government has disengaged from targeted interventionist policies, the role of corporate governance legislation and the courts has taken on greater significance.

Malaysia has been more reluctant to move away from targeted industrial policies, and the aftermath of the financial crisis has been marked by major executive branch efforts to restructure both the banks and some of the government-favored firms, firms that are mainly but not exclusively owned by newly wealthy

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<sup>13</sup> For a discussion of these changes in policies, see Hsueh, Hsu, and Perkins (2001). The industrial policies of the pre-1986 period are also discussed at length in Wade (1990).

bumiputera businesspeople. For smaller firms and more generally for firms owned by Malaysian-Chinese, however—most of which do not receive assistance from the government—the bankruptcy laws and the courts are largely in charge of the workout or liquidation processes where needed. In China and Vietnam, as indicated above, the executive branch of the government, at both the national and provincial levels, is in charge.

Rewriting bankruptcy legislation is, thus, only the first step in moving the economies of East and Southeast Asia to a rule- or law-based system of corporate governance. Enforcement of that legislation by suitably empowered entities is the next step. Even where the courts are reasonably effective, the interventionist industrial policies of the past continue to involve the executive branch of the government in deciding these issues. Executive branch decisionmaking is inevitably far more discretionary and less rule based than the rulings of the legal system. Conceivably, these governments could create special regulatory bodies to handle bankruptcies and other disputes related to corporate governance, but these bodies, if they are to be rule based and effective, would really be performing what in essence is a judicial function.

The logic inducing a shift from discretionary economic intervention by the executive branch is reasonably straightforward, but that does not make it easy to translate into practice. There is also a political logic that makes it difficult to pursue these desirable economic objectives. Discretionary interventions in industrial policy not only create opportunities for individual rent seeking; they also pave the way for financing of political campaigns and political organizations. Few countries anywhere have been able to create transparent and legal means for funding political campaigns. Discretionary government power over industry in Asian countries has made raising funds for political purposes extremely easy (Kirk 1999). In most cases, the politicians expect firms to contribute funds to participate in major economic initiatives of the government. Large Korean firms were expected to ante up large sums of unrecorded cash to the politicians if they wanted to be able to bid on projects that the government was interested in. In Indonesia, President Suharto's business friends were able to support his political organization with hundreds of millions—and probably billions—of dollars of funds obtained through political connections from timber concessions and similar sources. In a few situations, as occurred in Malaysia and under the Kuomintang in Taiwan, China, the ruling party owned or controlled firms that received favored treatment in the awarding of government contracts.

Reforming the economic system, therefore, may also require a parallel reform of the political system and the financing of that system. It is simplistic to argue that introducing democratic processes alone will solve the problem. In Korea, Kim Dae Jung was elected democratically, but two of his sons, along with

other members of his government, were charged by prosecutors with illegal influence peddling. Indonesia acquired a democratic government after the fall of President Suharto, but payoffs to politicians continued. Democracy, therefore, is not a panacea, but it is hard to imagine a solution that does not involve open democratic elections together with a free press. Also needed is a legal system capable of protecting the rights of those who criticize government wrongdoing.

### **COMPETITION POLICIES: WHO DETERMINES MERGERS AND ACQUISITIONS?**

While the attention of international organizations and foreign investors has been on changes in the management of insolvency, many of the countries in East Asia have been and continue to be equally concerned with the organization of their industrial sectors. As pointed out above, much of East and Southeast Asia at the beginning of the twenty-first century possessed industrial organization structures that were the product of each country's particular history and bore no clear relationship to the needs of the present. Industrial policy since at least the 1970s, in cases such as Korea and Taiwan (China), and earlier, in the case of Japan, not only has targeted particular industries and firms; it also has been concerned with how to create firms and industrial organization structures in a wide range of sectors that would be internationally competitive.

In the United States and Europe, competition policy usually involves efforts by the government, working through the legal system and regulatory bodies, to discourage or to negate actions by individual firms aimed at establishing a dominant market position. The most recent well-known examples in the United States are the breakup of AT&T and the government's attempt to limit the monopoly powers of Microsoft (see Fisher 2000). East Asia also has competition policies with objectives similar to those in Europe and North America, but these laws have had little influence in most of the region—including Japan—until very recently. Aspects of competition policy that have mattered most to governments as diverse as China, Korea, and Malaysia focus on how to create internationally competitive firms, not on how to curb domestic market power. In fact, many countries in the region have, for significant periods, given domestic market monopolies to individual firms, to make it possible for them to earn profits while they gradually become competitive on the international scene. Korea is now moving away from that approach, in part because of international pressure and its participation in the World Trade Organization, but many other countries in the region have yet to do so.

For many countries, the model of how to create internationally competitive firms, particularly in large-scale heavy and chemical industries, was provided first by Japan and later by Korea, as the two countries built up internationally recognized conglomerates such as Toyota, Matsushita, and Hitachi and Hyundai,

Samsung, and Daewoo. For governments in Malaysia and China, for example, and, to a lesser degree, for several other governments in the region, the prime task was to create similarly successful and internationally recognized national companies along the lines of the Korean chaebol and the Japanese *keiretsu*.

All countries, of course, go through periods of corporate restructuring through mergers and acquisitions or through sales of subsidiaries. In the market economies of Europe and North America, however, this process is largely left to market forces, which now include cross-national forces in what is a rapidly globalizing world. The rules governing mergers and breakups are set by legislatures and are increasingly coordinated internationally and administered by the legal system. The role of the executive branch of the government is largely confined to helping write the rules and to ensuring that the new arrangements do not unduly restrict competition.

In East Asia, by contrast, industrial organization is governed as much by the actions of governments as it is by the efforts of the firms themselves or by the rules and procedures of the legal or regulatory systems. This activist government role in Asia, which came into full flower in the 1960s and 1970s, is still very much a reality. The objectives of industrial organization policies, however, have changed over time.

In the 1970s, the goal of the Korean government was to support the large conglomerates by putting them in charge of implementing the heavy and chemical industry drive. After 1997 and with the election of President Kim Dae Jung, the goal was to restructure the conglomerates by forcing them to sell off subsidiaries unrelated to what the government considered to be their core businesses. From the latter half of the 1990s, the Chinese government has been busy merging enterprises to form business groups (*jituan*). By the end of 2000, there were 6,027 of these groups, of which 2,655 were large enterprise groups accounting for 57 percent of the assets of the industrial sector and 11 percent of urban employment. Although less than two-thirds of these had majority state ownership, the ones that did held 92 percent of the total assets (China, National Bureau of Statistics 2000, 2001). The models that originally inspired these efforts, at least those sponsored by the government, were the conglomerates of Japan and Korea. Since the financial crisis and the difficulties faced by the Korean chaebol, the ultimate goal of enterprise consolidation has begun to be reconsidered, but the mergers and acquisitions continue.

On a more modest scale, Vietnam has also been inspired by the Korean and Japanese models, although Vietnam's efforts have involved more the relabeling of government bureaus than the creation of truly independent large-scale firms. The government bureaus often continue to behave like government bureaus and not like the independent conglomerate headquarters that the reorganization had hoped to create.

Malaysia, since the 1980s, has struggled with how to create large bumiputera business groups that can compete both internationally and with Malaysia's own Chinese-Malaysian companies. Initially, as pointed out previously, this effort took the form of new state-owned enterprises to produce steel, cement, and, most of all, automobiles.<sup>14</sup> Then these state enterprises were sold off, mainly to favored bumiputera entrepreneurs, but the goal remained the same and had the backing of government-supported loans and other subsidies. After the financial crisis, the government also took on itself the task of restructuring and consolidating the banking system.

With all of this industrial restructuring activity, past and ongoing, one might assume that governments and academic economists know a great deal about how various industries should be organized for a given level of per capita income and a given size of a country's economy. If they were so informed, the decision to promote either mergers or breakups of companies would be a straightforward process of comparing the existing structure with one that promoted greater competition at a given level of development, and then taking steps to bring the existing structure in closer alignment with the preferred structure. European and North American government regulators of competition attempt to proceed along these lines. In the United States, for example, the government calculates the change in the level of concentration resulting every time a merger above a certain size occurs. If the resulting level of concentration exceeds a certain level, a model is then used to estimate the likely effect of the merger on the prices of the goods in question.<sup>15</sup> Developing countries could make a similar calculation, although its utility would be limited by the absence of a theory that defines a normative relationship between the structure of industry and the level of per capita income or the size of the developing country's economy. Moreover, there are few studies that have looked at the degree of concentration in various industries in developing countries.

Given the lack of international normative guidelines, the level of industrial concentration in the emerging economies of East Asia is the outcome of a combination of market forces, institutional constraints designed for other purposes, and direct government intervention to try to improve the industrial organization. The models for China, Malaysia, Vietnam, and, to a lesser degree, several other Asian economies, as discussed, have been the Korean chaebol and the Japanese keiretsu—at least until the financial crisis of 1997–98. On closer inspection, however, the character and suitability of these models raises serious questions. Even before the financial crisis, were these models good examples of highly

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<sup>14</sup> By 2001, the difficulties confronting the domestic state-owned auto companies—Proton and Perwaja—had forced the government to seek a foreign strategic investor.

<sup>15</sup> I am indebted to Ariel Pakes for this information.

diversified and successful conglomerates? Were the two models in fact similar to each other in more respects than just that the conglomerates in both cases were large and diversified?

In the case of Japan, the original Asian model for highly diversified conglomerates, there is some uncertainty about the conglomerates' organizational coherence over the past one and a half decades. The prewar period *zaibatsu* (Mitsui, Mitsubishi, Sumitomo) were closely knit conglomerates that were supposedly dismantled by the allied occupation authorities. The conventional view is that, starting in the 1950s, the old relationships were reconstituted in the postwar keiretsu, in which firms belonging to the group have much closer ties with each other than with outside firms. This closeness involves protective cross-shareholding within the group and association with a main bank that is itself a part of the group and provides much of the financing for members. Firms belonging to a keiretsu typically purchased inputs from other members of the group rather than from outsiders, even when the outsiders could have delivered the desired inputs on more favorable terms.

That is the image of the keiretsu, but doubts have been expressed as to whether such groups are, or even were, especially close knit.<sup>16</sup> There were, to be sure, many individual firms using such names as Sumitomo or Hitachi, but the evidence does not appear to support the view that there is substantial cross-shareholding among the firms bearing the same name. Nor have these member firms borrowed unusually heavily from their main banks as compared with their borrowing from banks not in the group. Many of the members of the Mitsui group, for example, do not use the Mitsui Bank or the Mitsui Trust Bank as their main source of credit. Furthermore, borrowing from banks has declined significantly since the 1980s, because firms have found it convenient to raise money on the stock markets (Stulz 2001). Thus, a compelling question arises whether the keiretsu are real business groups at all, as contrasted to firms that share a name or a common history but are, in fact, run as independent entities.

Whatever the case with the keiretsu, there is no question that the Korean chaebol were groups of firms controlled by a single individual or family. These conglomerates were highly diversified in that they operated in a wide variety of industries (Kim 1997). Among the top 30 chaebol before the financial crisis, the average number of industries per group was 19, and among the 5 largest, the average number of industries included was 30. Cross-shareholding within the group was standard and was the mechanism used by the family to retain control. Among the largest 30 chaebol, the lead family's ownership was roughly 15 to 17 percent of the outstanding shares of the group in the early 1980s, falling to 10 to 12 percent by the mid-1990s. Cross-shareholding within the group accounted for 40 to 45 percent of the

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<sup>16</sup> The brief discussion in this paragraph is drawn from Miwa and Ramseyer (2001).

shares in the early 1980s and a still high 33 to 35 percent in the mid-1990s (Yoo and Lee 1997, pp. 460–63). These groups, however, were prohibited from owning banks, although they did include other financial institutions. Initially, the banks were largely state owned, and even when they were finally privatized, there were specific rules prohibiting purchase by the chaebol. This formal separation based on ownership, however, did not keep the chaebol from establishing close relationships with the state banks, relationships determined not so much by the banks themselves as by the government’s directed lending.

If Japan and Korea have been seen, until recently at least, as the models that other Asia countries strove to emulate, what in fact have those other countries done, and does what has occurred appear to make economic sense? Before attempting to answer these questions, one should have a picture of the degree of industrial concentration elsewhere in East Asia. Concentration, it should be noted, can have two distinct meanings. One is the level of concentration within an industry—the percentage of sales in the industry controlled by the largest four firms, for example. The other is the control exercised by a conglomerate or family over industry as a whole or the economy as a whole, rather than over an industrial sector. Data on the level of concentration by industry are presented in table 7.2.

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The table shows that the levels of industrial concentration varied enormously across the Asian countries for which estimates could be found. At one extreme, with a high level of concentration, are Korea, Malaysia, and the Philippines (at the end of the Ferdinand Marcos years, in 1983 but not later). At the other extreme is China, where in only 4 industrial sectors out of a total of 39 did large firms control more than 60 percent of gross output. Moreover, the number of firms in these highly controlled sectors was several times the number of firms (usually four) used in calculating the concentration ratios for other countries. The exception in China was the petroleum and natural gas sector, where the number of firms with 60 percent or more of gross output was less than four. In 1995, after a period of economic liberalization, the Philippines and Taiwan, China, were more concentrated than China but roughly comparable to Japan and the United States several decades ago. Japan and the United States at this time had quite similar levels of industrial concentration despite the widespread belief to the contrary.<sup>17</sup>

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<sup>17</sup> This point was made some time ago by Caves and Uekasa (1976).

**Table 7.2 Industrial Concentration Ratios**

	<b>China</b>	<b>United States</b>	<b>Japan</b>	<b>Korea, Rep. of</b>	<b>Malaysia*</b>	<b>Philippines</b>	<b>Taiwan, China</b>		
<i>Year</i>	1988	1963	1972	1963	1974	1990	1983	1995	1976
Share of Industry controlled by the largest firms	Top 18–100	Top 4	Top 4	Top 4	Top 5	Top 4	Top 4	Top 4	Top 4
<i>Number of sectors</i>	39	417	183	512	205	22	31	31	131
<i>Concentration ratio</i>									
80–100 percent	7.7	12.2	6	5.6	26.9	18.2	25.8	9.7	10.7
60–80 percent	5.1	9.1	13.7	7.8	17.9	40.9	41.9	16.1	12.2
40–60 percent	12.8	19.6	26.8	27.9	27.3	31.8	16.1	29	24.4
20–40 percent	17.9	39.3	34.9	25.4	21.9	4.5	16.1	35.5	35.2
0–20 percent	56.4	19.8	18.6	33.3	6	4.5	0	9.7	17.5
<i>Total (percent)</i>	100	100	100	100	100	100	100	100	100

*Note:* The concentration percentages are based on the value of shipments by the top four firms as a percentage of total shipments in each industry for the Japan, Korea, the United States, and probably Taiwan, China. The Philippine data refer to the share of output in each industry. The Chinese data are derived by the author from data published by the National Bureau of and refer to the output produced by firms with over 100 million yuan of gross value output, a number that varies by sector from 0 to 293 firms. The number of firms in the most concentrated sectors (with over 60 percent of the output in that sector) ranges from 18 to 100 firms.

a. \*Adjusted to account for competition from imports.

b. *Sources:* Caves and Uekusa (1976, p. 471); De Vito (1995, p. 22); Hill (forthcoming); Hsiao (1982, pp. 46, 48); Yoo and Lee (1997, p. 443).

The U.S. pattern of concentration is presumably mainly the result of decisions made by individual firms in response to market forces, the working of the legal system, and the government's decision to pursue or not to pursue perceived antitrust violations. In 1963, Japan's level of concentration was presumably a result of individual firm decisions, measures introduced by the occupation government to break up the conglomerates, and policies of MITI. MITI pursued a highly interventionist industrial policy that included a concern that some sectors had too many firms to be internationally competitive.

In both Korea under Park Chung Hee and the Philippines under Ferdinand Marcos, the high degree of concentration reflected the government's use of directed credit and access to key inputs to assist a few large conglomerates or families. The Korean government also allowed explicit monopolies over the domestic market for certain heavy industries, although these monopolies were temporary. There is little doubt, therefore, that the industrial organization of Korea and of the Philippines was determined largely by government policy, not by market forces.

China's industrial organization was not a product of market forces either. Industrial enterprises in China, as pointed out earlier, were in part a creation of the pre-1979 Soviet-style command economy with central planning. Enterprises were not really business organizations but simply factory units under the active and direct supervision of central and provincial government industrial bureaus. Once industrial reforms began in 1984, China began attempting to turn these enterprises into truly independent business firms, with limited success. The resulting degree of industrial concentration, however, had little if anything to do with market forces.

Given these historical patterns, the Chinese decision to create a more concentrated industrial structure and the Korean decision to move in the opposite direction probably should lead to greater efficiency and competitiveness. The decline in concentration in the Philippines following the liberalization of a number of markets (see Hill 2001) further reinforces the view that there was a good reason to move away from historical patterns of high concentration, which were shaped largely by government rather than market forces.

The question remains, who should be making these decisions? In China and Korea, the outcome is being dictated by government industrial policies that may or may not be market conforming. The same is true of Vietnam. The government is also playing a central role in Malaysia, at least in a limited number of key industries. In all of these instances, the government appears to be trying to make industrial merger and acquisition decisions based primarily on economic and technical criteria as opposed to political or rent-seeking criteria. Former Prime Minister Zhu Rongji and many others in the Chinese government are well-

trained engineers, and former Prime Minister Mahathir Mohamed in Malaysia, although trained as a medical doctor, spent much time—including long visits to automobile plants in Korea and elsewhere—better acquainting himself with key industrial sector requirements. But government leaders and bureaucrats, however well intentioned, are poor substitutes for senior businesspeople with expertise and motivation, who have spent much of their lives engaged with the issues of technology, scale, and profitability in their particular industries. Such expertise can only be brought to bear on the decisions to merge or divest if those decisions are market determined.

Hong Kong (China) and Singapore have left decisions on industrial concentration almost entirely to the market. Hong Kong, China, however, no longer has much manufacturing since most of the plants controlled by firms there have moved into mainland China. In Singapore, except for the state-owned monopolies such as Singapore Airlines and the publicly controlled banks, the level of concentration in manufacturing is largely determined by which foreign firms choose to locate there. The openness of these two economies also means that industrial concentration ratios have little bearing on the level of competition present.<sup>18</sup>

Taiwan, China, may be the other economy that is closest to having an industrial organization dictated mainly by market forces. The government in Taiwan, China, did reserve certain sectors for state-owned firms, although their share of the public sector has diminished steadily over time as private firms have been permitted to enter more sectors, such as petrochemicals, which had been reserved for the government's China Petroleum Corporation. The industrial organization structure in Taiwan, China, however, is difficult to interpret. Numerous small firms are often imbedded in organizations led by larger firms and are not truly independent except in an accounting sense (Hsueh, Hsu, and Perkins, 2001, chapter 4). The same, of course, could be said of some small firms in Japan that serve as just-in-time suppliers to large companies. Thus, there is no industrial organization in Asia that can reliably serve as a wholly market-determined model for others to follow.

Concerns regarding the degree to which individual large firms or conglomerates control industry as a whole in a given country (as opposed to controlling sector by sector) relate partly to economic efficiency. They also relate partly to the desired degree of concentration of political power, especially in countries

<sup>18</sup> Concentration ratios are sometimes presented adjusted for the level of import competition, and these ratios probably more accurately reflect the level of competition in these industries. Such data are available for Malaysia and do show that the level of concentration is much lower if competitive imports are taken into account, but such figures for the other countries were not readily available.

such as Korea. The relevant data for three Asian economies in a comparison with the United States are presented in table 7.3.

**Table 7.3 Business Groups Concentration Ratios: Share of 100 Largest Firms in Total**

Manufacturing (percent)

Concentration ratio as a % of	Korea, Rep. of (1990)	Japan (1984)	Taiwan, China (1980)	United States (1985)
Shipments	37.7	27.3	21.9	n.a.
Value added	35.1	n.a.	n.a.	33
Fixed assets	40.8	33	25.9	49.1

n.a. = not available.

Sources: Chou (1988, p. 82); Yoo and Lee (1997, p. 460).

Again, it appears that the major companies in Korea, in comparison with those in the other Asian nations, control the largest share of total manufacturing output and assets, although less than is the case for major corporations in the United States. Single families rarely control the bigger U.S. corporations, however, and thus the degree of economic (and political) power is much less concentrated in the hands of a few individuals in the United States than in Korea.<sup>19</sup> Taiwan, China, in contrast to Korea, has a much lower share of industry controlled by the top 100 firms. Data have not been found for Hong Kong (China), Malaysia, and Singapore, but the mixture of domestically owned firms, a large number of foreign-owned firms, and—in Singapore, at least—a considerable number of state-owned firms, probably means that the control exerted over the entire manufacturing sector by a few family-based groups is less than in Korea. The Philippine manufacturing sector, on the other hand, is perceived as being dominated by a few powerful families, much as in Korea.

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The state remains the largest owner of manufacturing in Vietnam, controlling 39 percent of gross industrial output in 2003, although foreign direct investment firms, which control 36 percent, are catching

<sup>19</sup> Another issue is how efficient family ownership is compared with other forms of ownership. Contrary to popular perception, Wiwattanakantang (2001), using detailed ownership data on Thai firms, finds that firms owned by a family are as efficient as foreign-owned firms. One reason for this finding is reduced agency cost.

up fast.<sup>20</sup> In China, state-owned firms (including shareholding firms effectively controlled by the state) accounted for 48 percent of gross industrial output (China, National Statistical Office, 2001). State ownership, particularly in China, however, does not mean that control is concentrated in the hands of a few individuals or families. Different ministries vie with one another, and provincial and lower-level governments control a large share of total manufacturing and compete with one another.

On the grounds of economic efficiency and competitiveness, economists have often concluded that, when firms diversify across many different industrial sectors, the result is a reduction in the value of the firm relative to what the components would have been worth in the absence of diversification—there is what this literature calls a “diversification discount.”<sup>21</sup> Capital markets internal to these conglomerates more often transfer funds to shore up their weaker divisions, rather than transfer funds to those divisions with the best prospects for high rates of return. This conclusion, however, is not without its critics. The problem is one of endogeneity. It is often the weaker firms that decide to diversify, so the diversification discount may be much smaller than is commonly supposed. Furthermore, this conclusion is largely based on the experience of the United States, where capital markets are well developed. In countries where capital markets are underdeveloped, it may be that reallocation of capital across industries is more efficient within large diversified firms than it would be when allocated across independent firms through the capital markets (Stein 2001, p. 51).

The Kim Dae Jung government in Korea shared the view of those who hold that conglomerates are inefficient and tried to correct the perceived problem by forcing the chaebol to reduce their level of diversification and concentrate on their core businesses. Much of the dislike of high levels of market power in the hands of a few families, however, had more to do with politics than economics. If a few families control the destiny of a major segment of manufacturing, they also control the direction of the economy, which people and how many people get hired, and which companies—other than those that are directly controlled—are chosen as suppliers of key inputs. They also have the resources to fund the political campaigns of their supporters and to withhold funding from their detractors. With these levers, they exercise a degree of political power that is widely perceived to be incompatible with democratic government. This political power, in turn, makes it possible for these conglomerates to protect and

<sup>20</sup> These figures are from Vietnam, General Department of Statistics (2003, p. 5). I am indebted to David Dapice for pointing out this source to me.

<sup>21</sup> This discussion is based primarily on Stein (2001). For an earlier work on these issues, see Ravenscraft and Scherer (1987).

perpetuate their economic dominance despite the pressure of market forces that might otherwise erode that dominance over time.

In the early years of industrialization, it might have been desirable for governments to shape industrial organization. Governments in the early stages of development often have little choice but to intervene, given that no alternative institutions exist to guide mergers and acquisitions. But after the experience of the past two decades and given the much more complex economies that exist today in East Asia, little reason exists to believe that the executive branches of governments in Asia are well qualified to intervene. Even where governments have a high level of technical expertise in this area—and not many do have that expertise—there are few guidelines to follow from the experience of other developing countries as to what the optimal industrial organization structure should be. In addition, even where government technicians think they know whether to support or break up a large conglomerate, the actual decision is likely to be heavily influenced by political considerations that will undermine economic efficiency.

Government-line ministries are, thus, not well qualified to direct the organization of industry, but the process of mergers, acquisitions, and breakups still needs to be governed by rules. Simply leaving matters in this area to the market and existing institutions with no government involvement may mean that existing inefficient structures will be perpetuated. It may also mean that individual companies will succeed in stifling competition by acquiring excessive control over their markets. The remaining choices are to set up a special regulatory agency that has the technical expertise and the power to make these decisions or, as in the United States, to create a group within the government to deal with competition policy. That group would be required to implement its decisions by bringing a case before the judiciary, thus giving the judiciary final authority to decide whether the case has merit. One approach requires a regulatory body that is independent of political manipulation and independent of the companies it regulates, a goal that few industrial countries and even fewer, if any, developing countries have been successful in achieving. The other approach requires an independent and technically competent judicial system. The state of the judiciary in Asia is the main topic of the final part of this chapter.

## **ESTABLISHING THE RULE OF LAW**

In the earlier discussions of corporate and financial sector governance reforms, the role of the judiciary has repeatedly figured as an essential component of any effort by the countries of East Asia to move away from a system based on central government intervention to one based more on market forces and the independent judgments of individual firms. Brief statements have been made as well about whether the

judiciary in one country or another in the region was up to this task. This section addresses the capacity of the judicial systems of these countries explicitly and in greater depth.

Assessing the ability of a judicial system to adequately support efficient and equitable corporate and financial sector governance is no easy task.<sup>22</sup> Some quantitative data do exist that purport to measure the effectiveness of judicial systems across a wide range of countries. In addition there are in-depth studies of individual countries, but few of these look at these issues in a comparative framework involving several Asian countries. Both of these approaches have their limitations when it comes to measuring judicial capacity in the various countries of East Asia. Ignoring the problem of measurement, however, is not an option. The main message of this chapter is that the economies of East Asia need to rely less on government intervention and more on the market, but that greater reliance on the market will work efficiently only if there are either judicial or regulatory bodies that are strong enough to enforce the rules governing the market or that can be made strong enough within a reasonable time.

To understand why the judicial systems of many of the countries of East Asia are relatively weak, one should first briefly review the history of modern legal systems in the region (see also Glen 2000). In the countries that were European colonies, the legal systems were transplants from the European home country. Those that were not colonies, notably China and Japan, had traditional legal systems that continued to exist throughout much of the nineteenth century before being gradually displaced by borrowed transplants from Europe, mainly Germany. These German transplants were then again transplanted to Japan's colonies in Korea and Taiwan, China.

The European colonial systems were largely run by and for the European colonists. The business communities of Southeast Asia, most of which were overseas Chinese, rarely went to court to resolve business disputes and often fared badly when they did. Thus, as suggested earlier in this chapter, these overseas Chinese businesses developed their own ways of enforcing contracts outside the judicial system. Much the same was true of the Chinese in China and others who relied on traditional systems of governance. In China, historically, the county magistrate doubled as a judge mainly in criminal cases. Magistrates played little role in providing a supportive framework for commercial transactions. The traditional system was not very supportive of commerce and saw it mainly as a potential source of revenue. Contract disputes that ended up in court were likely to bankrupt both parties to the dispute or to

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<sup>22</sup> A substantial empirical literature summarized and extended by Beck and others (2001) maintains that the efficacy of the legal system determines the effectiveness of the financial system in promoting growth.

be decided in favor of one on nonjudicial grounds. When in the twentieth century China did begin to adopt European laws, there was no comparable effort to create strong European-style legal systems.

After the colonies in Asia regained their independence at the end of World War II, the people of the region felt little sense of ownership in the transplanted legal systems. The traditional legal systems, which had never functioned well in the commercial sphere in any case, were also in irretrievable decline. Following the takeover of China, the Communist government adopted many of the laws of the Soviet Union, but then, during the Cultural Revolution (1966–76), it dismantled what little existed in the way of a legal system and abolished the legal profession. When the gradual move toward a market system began in 1978, the Chinese legal system had to be recreated from scratch. Hence, much of East Asia entered the postwar era with a very weak legal system, particularly when it came to providing a framework for commercial transactions. Even in Japan, with a transplanted German legal system in place since the end of the nineteenth century, lawyers and judges played only a minor part in commercial affairs.

A few economies of East Asia did evolve stronger commercial legal systems in the latter part of the twentieth century, and it is instructive to analyze why this development occurred where and when it did. It is widely conceded that the most effective legal systems of the region are those of Hong Kong (China) and Singapore. The quantitative indicators presented in table 7.4 support this conclusion, as do numerous qualitative statements by informed observers. Japan also ranks very high on these quantitative indexes but there is reason to question whether these indicators reflect reality in the sphere of Japanese commercial law as contrasted to criminal law (Ramseyer and Nakazato 1999). We will return to the strengths and limitations of these quantitative indicators subsequently. Here we are concerned mainly with why Hong Kong (China) and Singapore acquired much stronger legal systems than other countries in the region.

Both Hong Kong (China) and Singapore were major commercial centers before they began building legal systems to serve more than the colonial power. In fact, it was not until the 1970s that the government in Hong Kong, China, embarked on a major effort to develop a legal system that gave a wide variety of rights to individuals. In the 1960s, for example, there were only a few hundred lawyers (solicitors, barristers, and judges combined) for a population of four million people. It was not until 1969 that the first law school was established at the University of Hong Kong, and even then there were only 50 graduates a year in the 1970s. By the end of the 1980s, however, a second law school had been established and was graduating 150 or so lawyers a year, and simultaneously Hong Kong, China, was importing more lawyers from the United Kingdom and the United States. At the turn of the century, shortly after the territory reverted to China, it had roughly 5,000 lawyers of all types. By the 1990s, prior to reversion, it was the one economy in Asia where the judiciary had nearly equal standing with the

executive, and citizens increasingly saw that system as something that protected them as well as the colonial power.<sup>23</sup>

**Table 7.4 Alternative Measures of the Rule of Law**

<b>Economy</b>	<b>Legal origin</b>	<b>Rule of law</b>	<b>Tax compliance</b>	<b>Corruption</b>	<b>Political rights</b>	<b>Risk of expropriation</b>	<b>Business regulation</b>
China		3.58	2.51	6.53	1	—	2
Hong Kong, China	United Kingdom	4.93	4.56	8.52	4	8.29	5
Indonesia	France and Spain	2.39	2.53	2.14	1	7.16	2
Japan	Germany	5.39	4.41	8.51	7	9.67	4
Korea, Rep. of	Germany	3.21	3.29	5.3	6	8.31	3
Malaysia	United Kingdom	4.07	4.34	7.38	4	7.95	4
Philippines	France and Spain	1.64	1.83	2.92	6	5.22	3
Singapore	United Kingdom	5.14	5.05	8.21	3	9.3	5
Taiwan, China	Germany	5.11	3.25	6.85	—	9.12	—
Thailand	United Kingdom	3.75	3.41	5.18	5	7.42	3
Vietnam		—	3.25	4.51	1	—	1
Sweden		6.00	3.39	10.00	---	---	---
United States	United Kingdom	6.00	4.47	8.21	7	9.98	4
111-country average		3.37	3.22	5.74	---	---	---

---Not available

*Source:* These data are from the datasets compiled by La Porta and others. The 111-country average was calculated by the author from a reduced 111-country subsample of the broader datasets. I am indebted to the La Porta and others for making this dataset available to me.

This growing and relatively independent legal system, where the decisions of the courts are enforced, does not mean that most locally owned businesses rely mainly on the courts to settle major business disputes. Most of the smaller ethnic Chinese businesses still rely on informal mechanisms, built on the

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<sup>23</sup> This discussion of the legal system in Hong Kong, China, owes much to an interview with Dean Albert H. Y. Chen of the Law School of the University of Hong Kong. Dean Chen bears no responsibility for any errors in my interpretation of his remarks.

relationships of the past, to settle their differences. However, larger Chinese firms and the numerous multinational corporations that are headquartered in Hong Kong, China, do make extensive use of the legal system in commercial matters.<sup>24</sup>

In Singapore, as well, the presence of many firms with foreign investment has been one source of demand on the legal system. Singaporeans themselves, by the 1950s and 1960s, had also learned that U.K. law could be used to their advantage, even when the opposing party was the colonial government. This discovery helped them gain a sense of ownership over and appreciation of the U.K. law that they had inherited.<sup>25</sup> That said, the legal system in Singapore at the turn to the twenty-first century was not really independent of the executive branch of the government to a degree comparable with that found in the United Kingdom or the United States. The main task of the courts was and is to help implement the policies of the government, not to challenge them. In the economic sphere, this subordination may not matter a great deal because the Singapore government does not, for the most part, use its discretionary powers to promote particular companies. Settlement of business disputes, therefore, does rely heavily on the courts, because in these kinds of matters the courts are seen as impartial. It is also the case that informal nonjudicial methods of settling disputes such as the collection of debt are not widely used, because many of these methods are likely to entangle those who resort to them in Singapore's formidable criminal law system (Kamarul and Tomasic 1999).

While Hong Kong (China) and Singapore clearly have legal systems that are of significance both socially and in their commercial spheres, in what sense is it valid to say that those systems are 82 and 85 percent, respectively, as effective as the U.S. or Swedish systems, as the data in table 7.4 indicate? One possible answer is that these are ordinal, not cardinal, indexes, and thus one cannot speak of one country's system as being a certain percentage below another in effectiveness. But these indexes are frequently used in analyses of economic growth and corporate governance as if they were cardinal indexes. For our purposes in this chapter, it is sufficient to say that the legal systems of Hong Kong (China) and Singapore are fully capable of supporting a market system governed by the rule of law with minimal discretionary government intervention in that system.

<sup>24</sup> For a discussion of how the law has been applied in Hong Kong, China, after the territory's return to China, see Chen (1999, pp. 287–320).

<sup>25</sup> For a description of how political activists in Singapore used the law and the legal system to further their goals before independence, see Lee (1998).

The legal systems of Korea, Malaysia, and Taiwan (China), are often ranked below those of Hong Kong (China) and Singapore, although Taiwan (China) actually ranks higher than Hong Kong (China) in table 7.4. Qualitative appraisals of the legal systems of Korea and Taiwan (China) suggest that the two systems are broadly rather similar. Both have the same origin: the German system introduced originally by the Japanese colonialists. Law in both economies was subordinate to decisions of the executive branch of government during the decades of authoritarian rule that ended in both places in the latter half of the 1980s. Governments in both economies pursued highly interventionist industrial policies. In the two legal systems, judges were more like civil servants, and that was true in Japan as well. Judges were graduates of undergraduate law schools who had passed an examination before receiving an additional year or two of formal training. They thus were young and inexperienced and lacked stature.<sup>26</sup>

Japan, the model on which the systems of Korea and Taiwan (China) were built, generally produced only 500 people a year to serve as judges, lawyers, and prosecutors, although by the end of the twentieth century this number had been raised first to 750 and then to about 1,000 a year. On a per capita basis, the 500 a year figure was less than half the production of Hong Kong, China, in the 1970s—a figure that did not give Hong Kong, China, enough legal personnel to handle its commercial disputes. As Lincoln (2001, p. 195) noted, “Unless government authorizes a dramatic increase in the number of lawyers and judges, a deluge of lawsuits initiated by private shareholders will clog the system.” Current reform efforts are thus under way to increase the number of lawyers produced to 3,000 a year by 2010 and to establish law schools by 2004.<sup>27</sup>

The low number of lawyers in Japan, to be sure, is misleading in some respects. Even though only lawyers can practice law through the courts, there are numerous professions and judicial administrative sciences (patent agent, tax agent, and so forth) that assist companies in legal matters. Companies may hire licensed attorneys, but many of them also hire those who studied law at the undergraduate level. Given that there are about 36,000 university graduates per year from law departments (by comparison, 50,000 pass the bar exam in the United States each year), the number of trained law personnel in Japan is not as small as the number of licensed attorneys suggests. These university graduates from law departments,

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<sup>26</sup> This discussion and the paragraph that follows owe a great deal to exchanges with William Alford of the Harvard Law School, who bears no responsibility for any errors in interpretation.

<sup>27</sup> There are no law schools in Japan. Effectively, law departments at the university level are the training grounds for would-be lawyers (from Asahi.com). However, many schools are now considering offering programs by 2004, including the University of Tokyo.

however, cannot go to court. The shortage of personnel who can go to court, therefore, effectively limits the role of the courts in settling business disputes.

The number of lawyers in Korea was even more restricted than in Japan. Before 1981, only 100 individuals a year were allowed to pass the examination to become lawyers, judges, and prosecutors. That number was subsequently raised to 300 a year, and then to about 800 a year in the 1990s. Still, at the turn of the century, the total number of people in the legal profession, including judges and prosecutors, was less than 7,000, only slightly more than in Hong Kong, China, which had one-eighth of the population that Korea did. As the economy of Korea has become more complex, the business community has begun to complain that the legal system is both too expensive and too often unavailable. A similar complaint is heard in Japan. In Korea, for example, it was not long ago that the trade ministry had no in-house lawyers at a time when it had to deal increasingly with international trade laws and treaties based on technical legal rules and regulations.

The limited number of Korean lawyers might explain why Korea scores so low on the rule-of-law index, except that the situation is little different in that respect from Japan or Taiwan, China, where judges have backgrounds similar to those in Korea and their numbers (on a per capita basis) are similar. Japan's judiciary, of course, has operated in the context of a democratic society since the 1950s, and that was not the case in either Korea or Taiwan, China, until the late 1980s. In the latter two societies, the advent of democracy ended the clear dominance of the executive over the judiciary. In the case of Taiwan, China, one can observe this fact through the change in behavior of the Council of Grand Justices, which before 1987 took few if any steps to limit the inappropriate exercise of power by other branches of government. After 1987, the council not only supported private citizens who brought cases against the government based on the government's failure to comply with the laws, but also declared a number of laws unconstitutional (see Cooney 1999).

Taking the legal systems of Japan, Korea, and Taiwan, China, together, one can probably fairly say that they are not yet up to the task of fully overseeing and enforcing the rules of the market in their economies, but the framework for doing so is in place. These economies must still rely on the many informal mechanisms developed over the years to handle contract disputes and the like—informal mechanisms that are increasingly inadequate for these complex modern economies. What is now required is to continue to expand the size of these legal systems and to strengthen the prestige and competence of judges.

At the time of independence in 1957, Malaysia's legal system was comparable to that of Singapore, but the degree of independence of the Malaysian legal system has eroded significantly since the late 1980s.

Before 1985, Malaysia's legal system retained most of its inherited features. The first three prime ministers of Malaysia were trained in the law in the United Kingdom, and the top judges were formidable figures in Malaysian society. The right of appeal to the Privy Council in the United Kingdom was not ended until 1985. It was not unusual for the courts to decide against the government in some cases.<sup>28</sup>

But from the 1980s onward, with the rise to power of Prime Minister Mahathir, the independence of the judiciary was increasingly circumscribed. The tension between the judiciary and the executive arose because of the government's interventionist development policy, which was designed to promote certain industries and companies, notably companies run by bumiputera businessmen or those with close ties to the ruling political party, the United Malay National Organization. When the courts ruled against these government development initiatives in the award of contracts, for example, the government either managed to win on appeal or, when that failed, amended the constitution to achieve its ends. Then, in 1988, the government went further by removing the lord president of the judiciary from office and followed that by dismissing two Supreme Court justices who had come to the defense of the lord president. From that point on, it was no longer possible to speak of Malaysia's judiciary as being independent or impartial, at least when major initiatives of the government were being challenged. This reduction in the independence of the courts also reduced the prestige attached to being a member of the judiciary. When lowered prestige was combined with uncompetitive salaries, the quality of the judiciary deteriorated. Businesses still turned to lawyers and the law to draw up contracts, but increasingly these contracts were drawn up in a way that would make it possible to avoid the court system. It was not that the courts had become corrupt or biased in favor of certain parties, at least not when the government was uninvolved, but the low quality of many of the judges meant that court decisions were less reliably rooted in sound legal reasoning. Because the quality of the legal profession otherwise remains high, however, one can still speak of a legal system that functions reasonably well in the commercial sphere. There is no compelling need for the government to intervene to compensate for the weaknesses of this legal system. To the contrary, the government needs to end the practices that are undermining the strength and integrity of that system.

The weakest legal systems in East Asia are those of China, Indonesia, the Philippines, and Vietnam. In the quantitative rule-of-law index in table 7.4, China actually ranks above Korea, but this ranking is difficult to understand. It is probably reasonable to rank the legal systems of Indonesia and the Philippines below the others. It is widely perceived in both countries that judges are frequently influenced by bribes,

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<sup>28</sup> This discussion of Malaysia's legal system is based in part on discussions with knowledgeable lawyers and others in Kuala Lumpur and in part on Teik (1999). See also Pistor and Wellons (1998).

which turn civil court battles into an exercise in the balance of economic and political power between the contending parties. One survey of Manila lawyers indicated that 48 percent of them knew of a judge who had taken a bribe, presumably implying that 52 percent of the lawyers did not know of a corrupt judge.<sup>29</sup> In Indonesia, in contrast, estimates of the number of judges who are corrupt range from 50 to 90 percent, suggesting that most lawyers must know of judges who are corrupt (Bourchier 1999; Backman 1999, p. 33).

The problem is not that Indonesia and the Philippines do not have good laws on the books. With technical assistance from the International Monetary Fund and the Harvard Institute for International Development, for example, Indonesia had written and enacted a long list of new financial laws, many of them more modern and up to date than those in far more industrial countries (Coles and Slade 1996). When the financial crisis hit Indonesia in 1997–98, however, many of these laws made little difference. Prudential regulations designed to improve the banks' portfolios had been put in place in 1991–92, but little effort was made to rein in the overseas borrowing that was to be the immediate cause of the crisis. And in the immediate aftermath of the crisis, close ties between several of the worst-performing banks and the leaders of the government, as well as their family members and business associates, ensured that the actions of regulators were overridden, whatever the law said. If the courts had been willing to intervene, they would have had little power to do so. The situation in 1997–98, to be sure, would have put heavy pressure on any legal system, but Indonesia's legal system did not perform during noncrisis periods either, at least not when the rich and powerful were involved.

China's and Vietnam's legal systems are probably less corrupt than those of Indonesia and the Philippines, but it is unlikely that they perform much better, despite the lower level of outright bribery. China began the process of restoring its legal system in the early 1980s. There are now shelves full of new laws designed to provide a legal framework for foreign investment and for a market economy. In the 1980s and even more so in the 1990s, the judiciary has been increasingly active in settling economic disputes, especially in the most advanced parts of the country, such as Shanghai. Among the larger firms in the major cities, formal contracts with suppliers are the norm, although disputes still rely mainly on informal negotiation for settlement. Still, in a World Bank survey of 1,500 firms in five major cities, 12.2 percent of the disputes were resolved through the courts; the figure for Shanghai was 22 percent (Steinfeld 2002). China's entrance into the World Trade Organization will further reinforce the role of formal legal proceedings, but an enormous amount of work still has to be done simply to make Chinese

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<sup>29</sup> This survey is referred to in World Bank (2000).

laws on the books compatible with what the World Trade Organization requires. The enforcement of those laws will be even more difficult.<sup>30</sup>

The Chinese legal system must first confront the cauldron of conflicting rules and regulations created by the many different authorities that possess the right to introduce rules and regulations. The job of the courts is thus made much more difficult from the start, because the courts are not supposed to interpret the laws but to adjudicate. More importantly, when the courts do render decisions, enforcement is problematic. Courts do not have primacy over the ministries and other government organs, and large numbers of court rulings are simply ignored.<sup>31</sup> Informally, in addition, high-level officials of the Communist Party can overrule both the courts and government organizations. The situation in Vietnam is similar to that in China, only the role of the judiciary is even less developed and less independent, in part because Vietnam's economy is at an earlier stage of development.

In China, Indonesia, the Philippines, and Vietnam, therefore, the legal systems are clearly not yet up to the task of overseeing and enforcing the rules of a market economy. There is little choice but to rely on the many informal mechanisms that have grown up as a substitute for a law-based system, however inadequate those systems may be. There is also little choice but to continue to rely on discretionary government intervention in the economy where fundamental restructuring is required. The long-term goal—and *long-term* in this case could mean several decades—should be to build the kind of legal systems that will replace government intervention and these informal institutions. That task needs to start now.

This brief review of the legal systems of East and Southeast Asia leads to a number of conclusions. One is that the quantitative indexes purporting to measure the quality of the different legal systems or related variables are flawed, at best.<sup>32</sup> Our review suggests that the rule-of-law index in table 7.4 probably overstates the strength of the legal system in Taiwan, China, relative both to that of Korea and to those of North America and Europe. The Philippines' judiciary is probably not worse than that of Indonesia. And

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<sup>30</sup> For a discussion of the effect of accession to the World Trade Organization on the legal system, see Kong (2001).

<sup>31</sup> For a discussion of these issues at greater length, see Lubman (1999) and Clarke (1996).

<sup>32</sup> Recognition of the limitation of some of these indexes has led some scholars to try to find less subjective measures of the performance of the legal system by constructing indexes of specific dispute resolution procedures across countries, such as those used in evicting tenants from rental housing or collecting on bounced checks (see Djankov and others 2001).

the strength of China's system is probably overstated relative to both Korea and the Philippines. These problems with the indexes are hardly surprising, given the way they were compiled. Many indexes of this type are compiled by sending out questionnaires to businesspeople, few of whom are in a position to make more than crude comparisons of a handful of countries where they have direct experience. Other indexes are compiled by asking for the opinions of experts, but experts too seldom have experience in more than one or two systems. The number of people who have sufficient knowledge to make informed comparative judgments across more than three or four countries is far smaller than the number who get asked to fill out such forms. Many of these indexes measure little more than popular opinion at any given point in time.

The far more important conclusion is that the legal systems of many of the Asian nations at the turn of the century are clearly unequal to the task of supporting rules that effectively oversee corporate and financial sector governance. The indexes suggest that the quality of most of the East Asian legal systems is above—often well above—the world average. But if so, the only parts of the world with systems capable of supporting a law-based system of economic management are Europe and North America, plus a handful of other countries that have come close to achieving a similar level of legal development. It is not just China, Indonesia, the Philippines, and Vietnam that need to reform their legal systems. With the possible exception of Hong Kong (China) and Singapore, corporate governance reform will have to be accompanied by equally far-reaching judicial reform in all of the other systems, including Japan.

Is it realistic to expect that East Asia can achieve this goal over the next decade or so? On the positive side, the introduction of democracy into both Korea and Taiwan, China, has made it possible to begin to create a judiciary with the power to curb government actions that violate the law, as well as the power to settle commercial disputes that do not involve the government. Democratic politics have yet to exert equivalent pressures in either Indonesia or the Philippines, however.

The increasingly complex nature of their economies has also induced Japan, Korea, and Taiwan, China, to enhance the capabilities of their judicial systems in the commercial arena. The same has been happening in China, although from a much lower starting point. No comparable influence is yet in evidence in Indonesia, the Philippines, or Vietnam.

On the negative side, the persistence of interventionist industrial policies continues to provide a rationale for the executive branch of the government to overrule the judiciary in China, Malaysia, and Vietnam. More important, at least in the cases of China and Vietnam, the Communist Party's decision to retain a

monopoly of power and to exercise that power with wide discretion throughout society clearly stands in the way of a legal system capable of rendering and enforcing independent and fair decisions.

Creating legal systems that are competent, strong, and relatively independent of the executive branch of the government is going to take a long time in many of the Asian countries looked at in this study—time that in the worst situations will be measured in generations rather than years or even decades. But in the more industrial economies and polities of the region, that process is well under way. Not only in Hong Kong (China) and Singapore, but also in Japan, Korea, and Taiwan (China) it is already possible to see an economic system that is governed by the rule of law rather than by government fiat or by mainly informal arrangements among private parties.

## CONCLUSION

As this chapter has argued, without question the industrial and financial sectors of most of the economies of East and Southeast Asia require restructuring.<sup>33</sup> If financial markets are to continue to develop in the region and to perform their role efficiently, rules must protect investors who are not the owner-managers of the firms. To start with, much better bankruptcy legislation is needed than has existed in much of the region in the past, and the legislation must be enforced efficiently and fairly. This effort will be highly significant for the long-term health of the banking systems in these economies, but it will only be a first step toward protecting the rights of minority shareholders.

The level of concentration of ownership over financial and industrial firms also must change. In some cases, the direction of change should be toward fewer firms through consolidation of existing enterprises; in other cases, the move should be in the opposite direction through the breakup of excessively concentrated conglomerates.

But the central question addressed in this chapter is not what the ideal corporate governance laws or the ideal level of industrial or financial sector concentration should be. The central point of this chapter is that the market—subject to transparent rules enforced fairly and objectively—should make these decisions whenever possible. Although the 1990s witnessed substantial change in this regard, the approach to industrialization and financial sector development in much of Asia remains to a greater or lesser degree in conflict with this goal. Outside of Hong Kong (China) and, to a degree, Singapore, it is the executive branch of the government that has taken the lead in making many of these decisions and in enforcing

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<sup>33</sup> Such restructuring could be coordinated by the Asian Financial Institution proposed by Eichengreen in chapter 2.

them through the government's command over the banks. This circumstance has led both the industrial firms and the banks to rely on the government when they run into trouble, a situation that has created moral hazards, often in extreme forms.

The challenge for most of the countries in the region is to reduce or eliminate this interventionist government role, but that is easier said than done. One cannot move to a true market system unless a set of institutions exists that is capable of independently, efficiently, and fairly enforcing the rules of a market system. The choices are either an independent judiciary or a set of independent regulatory agencies. Independent regulatory agencies have been difficult to establish, even in the most industrial economies, and in Asia they are generally the creatures of the executive branch of government. That branch, particularly in countries with authoritarian political regimes, is generally closely tied to the large firms that it is charged with regulating. Making governments adopt a more arm's-length relationship with big business has been a halting process. Democratization has helped in this regard in Korea and Taiwan, China, but in Japan it had little effect for decades. In the absence of effective and independent regulatory agencies, countries have the option of establishing independent and efficient legal systems.

The problem that East Asian economies face in creating independent and efficient legal systems is that the region started its industrialization and financial sector development effort from a weak legal base. Most of the former colonies in the region inherited a legal system toward which few in the economy felt much sense of ownership. Even in Hong Kong (China) and Singapore, where the colonial legal system did take root, this ownership was not felt until the final two or three decades of the twentieth century. For those economies that were not colonies, and for the overseas Chinese business community, the inherited Chinese legal tradition was a weak foundation on which to build a modern system of commercial law. Instead, a variety of informal institutions were created that performed many of the tasks of a judicial system, but these informal mechanisms have become increasingly inadequate for the complex modern economies that now exist in much of East Asia.

Creating the legal institutions of a modern market economy is a daunting task for any country. For those that are the furthest behind in this regard—such as China, Indonesia, and Vietnam—the effort will certainly take decades. For economies that are further along in developing a modern legal system, notably Japan, Korea, and Taiwan (China), the timeframe can be much shorter. The basic structure is in place in these last three countries, which mainly need an increase in the numbers and in the competence of judicial and legal personnel plus some rewriting of laws.

But even in the countries that have made substantial progress toward a modern system of commercial law, ~~that system will be constantly undermined as long as the government continues to actively intervene in~~ the economy to achieve industrial policy goals. Abandoning interventionist industrial policies will not be easy. It is not just that government officials and politicians are reluctant to give up power anywhere. It is also that interventionist industrial policies meet certain political needs. Few countries have found a legal and inexpensive way of financing political organizations and campaigns, and, as was discussed above, interventionist industrial policies make it extremely easy to generate the funds required. Firms either give to the party organization or they do not get to participate in government-directed economic activities.

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Even if the countries of East Asia are willing to abandon a Korean- or Japanese-style industrial policy, much more institution building will be required for the legal system of a market economy to function properly. At some point, the executive branch of government must also be willing to devolve sufficient power to the judiciary to overrule decisions of the government itself. In the economies of East Asia where this has occurred, in all cases except for Hong Kong, China, the true independence of the judiciary was preceded by the introduction of political democracy and competitive elections.

Establishing a complete market economy with supporting legal institutions, therefore, is going to be a slow process in many of the countries of East and Southeast Asia. Countries such as China, Indonesia, and Vietnam will thus have to continue to rely in part on government intervention to accomplish whatever economic restructuring they consider essential. The cost will be restructuring efforts that continue to generate moral hazards even when implemented by competent technocrats. If politics and rent-seeking play a major role in the process, the results will be worse. Over the long run, the goal will be to get beyond this stage of development to a complete market system, in which these decisions are made by private economic actors who reap the rewards of successful restructuring and in which they themselves, not the general public, pay the price for failure. The only way countries such as China, Indonesia, and Vietnam will ever arrive at that point, however, is if they make a concerted and continuing effort now—even if completion of the process takes decades.

Some may interpret these conclusions as implying that the economies of East and Southeast Asia will not be able to continue the rapid development of the past several decades, but no such implication is warranted. Economic development never depends on having all of the institutions of a modern market economy in place at the start. If it did, no economy would ever have developed. The conclusion that is warranted is that the countries of East and Southeast Asia must steadily improve their market-supporting institutions or they will over time face more and more serious difficulties as their economies become increasingly sophisticated and complex.