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Formation of Corporate Governance in Korea: The Rise of Chaebols (1910-1980)

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Abstract

Purpose – This aim of this study is to examine how conglomerates in Korea have evolved from the perspective of institutional economics. The growth of the economy, dominated by large conglomerates, is projected in light of the dynamic equilibrium between government and capitalists.

Research design, data, and methodology – The historical formation of big business groups is examined in chronological order. For the analysis, we divide the assessment into three different eras: Japanese colonial rule, liberation up to the civil war, and the fast growing period since the military coup. Each period is viewed as a dynamic equilibrium that is shaped by economic agents.

Results and Conclusion – Despite the rise of modern commerce during the colonial era, contemporary conglomerates came into being with the "enemy property" allotted by the government. Around the civil war, the government coexisted with prototype conglomerates through foreign aid. As the external aid decreased, the system could not be sustained anymore, thus the military coup took place. The reinstated strong bond between government and the conglomerates has shaped the forms of the modern conglomerates thereafter.

Keywords: Chaebol, Corporate Governance, Self-Reinforcing Equilibrium.

JEL Classifications: N45, N85, N95.

1. Introduction

Going through the financial crisis during the late nineties, the countries in East Asia were forced to face sudden change in society. In Korea, unprecedented unemployment rate skyrocketed and rosy hope for the permanent job was shattered into the air. People started to suspect that the old regime would not persist

anymore while the government was introducing new economic reforms of social safety net, unemployment insurance scheme, bankruptcy law, regulation or deregulation of the financial sectors, and so on.

The government came to realize that there were some problems in microeconomic structure although macroeconomic variables seemed quite sound. Some measures were taken to reform conglomerates which were long believed to lead inefficient investment controlled by the owners connected with corrupt politicians: Debt guarantee among subsidiaries of a business group was limited, indirect cross ownership came under new regulation, and holding company law was modified to streamline conglomerates' complicated ownership structure. Consequently, corporate governance became an important issue to regulators as well as academic researchers in Korea.

2. Literature Review and Research Methodology

Berle and Means (1932) described a modern corporation in which a professional manager insulated from the dispersed stockholders wields the power of running a business. Most of the literature on this issue has highlighted on the conflict of interest between the controlling manager with no ownership and the shareholders with minuscule voting right. According to Aoki (2004), the manager, the investors and the workers are crucial elements for corporation, and "corporate governance is a set of self-enforcing rules (formal or informal) that regulates action choices of these players contingent on evolving states." The manager and the investor (owner) are supposed to be distinct conceptually.

However, the image of controlling manager with completely dispersed shareholders is not universal all across the world. It was mainly about the United States and the United Kingdom with legal background of common law (La Porta, Lopez-de-Silanes & Shleifer, 2008). Most of continental European countries and Asian countries still have the corporate system in which family or institutional owners run big business groups (Moradi, Piri, Shiri & Salehi, 2013; Salehi & Asgari, 2013; Saparovna & Sayatovna, 2014).

Korea's corporate system is featured by a large corporate groups controlled by the descendants of the founders. Samsung,

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LG, SK, and many sizable non-financial business groups, called *chaebols*, are dominating other stand-alone firms all over the domestic industries. It differs from the trans-Atlantic corporations and also slightly from European and other Asian systems. Contrasted to the United States, there are controlling shareholders in *chaebols*, but the controllers are not large financial institutions as in Japan (La Porta, Lopez-de-Silanes & Shleifer, 1999). Using pyramids, dual class of stocks, or cross ownership as commonly observed around the world, the controller entrenches his ultimate control in spite of minor stockholding (Bebchuk, Kraakman & Triantis, 2000).

Naturally one question we can ask is why Korea has now corporate governance which differs from Japan or the United States. In this paper, we want to focus on how Korean history has formed these family-owned large business tycoons. Empirical studies usually relate the difference of corporate governance with the legal origin (La Porta et al., 2008; La Porta, Lopez-de-Silanes, Pop-Eleches & Shleifer, 2004; Djankov, La Porta, Lopez-de-Silanes & Shleifer, 2003; Shleifer & Vishny, 1997). Contemporary corporate governance is tested on its historical backgrounds such as legal protection of shareholders and investors. This type of statistical approach may fall into a false conclusion while ignoring the dynamic evolution of institutions. For example, the UK and the US have a similar corporate system as Berle and Means (1932) described. However, the family-owned companies were prevalent even in the first half of 20th century (Roe, 2006). The analysis lack of historical interaction among economic agents is likely to find spurious relationships between irrelevant variables and corporate governance as of now. This paper would mainly follow the institutional approach (Aoki, 2004; North, 2005; Greif, 2006) in order to investigate how Korea has developed *chaebol* system from historical perspective.

In the following section, we will consider three defining epochs that stylizes Korean economic history: Colonial experience, Korean Civil War, and Developmental phase. Out of *chaebols* operating still now, few were established during Japanese colonial time from 1910 to 1945. Most of them were established during or after the Korean civil war from 1950 to 1953. They had grown up during fast economic development directed by a former autocrat, president Park, so they came to appear as huge as now for 1970s (Lee, 2004).

The relationships among workers, owners, and investors are thought to be basic units of study. Here we will reflect on the relationship between polity and business since workers are thought to be major players in late 1980s. The corporate structure of *chaebol* already had been formed and put in place by late 1970s.

The main section is decomposed by important events that changed political and economic conditions. In section 3.1, some prototype *chaebols* for Japanese Colonial times will be introduced. If they were affected by Japanese institution and continued to be huge conglomerates, Korean *chaebol* system could be said to be transplanted by Japan. But indeed they rarely grew to be *chaebols* and their formation hardly appeared to be conglomerate compared to Japanese *zaibatsu* or *keiretzu*.

They both are complex pyramidal conglomerates. The only difference between *zaibatsu* and *keiretzu* is that the former has a holding company with ultimate decision but the latter is prohibited to have that kind of holding company (Hirschmeier, Johanne & Yui, 1975). Section 3.2 studies 1960s when the Independence from Japan, the Korean Civil War, and the Reconstruction occurred sequentially. For this time, observed is the connection between the polity and the business, which was indicating the start of Korean *chaebol*. Section 3.3 describes the development of Korean economy and *chaebol*. Since *chaebols* were the major vehicles of planned development, the success of economic prosperity was thought to be parallel to the success of *chaebol*.

3. Discourse on the Origin of *Chaebols*

3.1. Japanese colonial ruling of Korea (1910–1945)

During the early 20th century, Korea had been subordinate to Japan in the realm of polity as well as economy despite several reformative attempts of *Chosun* dynasty. Japan and Korea declared the unification on August, 1910 and the territory of the former *Chosun* dynasty officially became a part of the Empire of Japan. Putting aside the issue of the legal validity, the agreement of unification opened the path of capital inflow from Japan under the same jurisdiction. However, until 1920, the Commercial Act by the governor of *Chosun* prevented Japanese investment flowing out of mainland Japan so Korea was just exporting agricultural products in exchange for industrial products. Since the repeal of the law, things did not change much. As the theory of comparative advantage maintains, Korea had an advantage in producing agricultural crops while Japan in industrial products and services.

As the Sino-Japanese War started in 1937, Japanese policies on colonial Korea came to change. While the previous policy was a free trade between Korea and Japan in order for the stable supply of food to Japan, new one was to develop industries in Korean peninsula to support the invasion into China. Based on this blue print, heavy industries were built mainly in the northern part of Korea and light industries were established in the southern part. Prototypes of modern firms in Korea could be found at this time, which took advantage of business boom during the war.

Samyang group and *Hwashin group* are two typical examples in this period. Sung-Soo Kim founded a textile company named *KyungSungBangJik* in 1911. His brother Yeon-Soo expanded the business to plantation, land reclamation, and rubber shoes. Even though the quality of products were poor compared to those of Japanese firms, *Samyang group* was able to manage the business thanks to the antipathy against the penetration of Japanese products. As the Sino-Japanese War broke out and lasted long, the demand for cotton in Manchuria soared up. Exporting cotton to and establishing factories in Manchuria, *Samyang group* had been growing up until the end of the World War II.

Heung-Sik Park was doing business in rice, cotton, and printing. Adopting modern management system such as regular work hours, gift certificate, bargain sale, and so forth, he established *HwashinSangHoi* in 1931. Similarly to *Samyang group*, *Hwashin* also profited by the Sino-Japanese War while it is trading canned marine foods, mineral products, agricultural products around Southeast Asia (Lee, 2004).

For this period, some Korean traders evidently emerged as prototypes of *chaebol* running multiple businesses. But they differ from *zaibatsu* in size, finance, and the extent of market. Avoiding competition with *zaibatsu* in mainland Japan, they rather developed niche markets in Korean peninsula or Manchuria and had been gradually gaining economic stakes during the Sino-Japanese War or World War II. So it is hard to classify *Samyang* and *Hwashin group* as the opening of Korean *chaebol* system since they failed to transform these complex traders to the nexus of industrialized firms.

3.2. From the independence to the revolution (1945–1959)

This era was the most turbulent period in modern Korean history. On August 15, 1945, Japanese Emperor surrendered to the Allies unconditionally. Russian army marched to the north of the 38th parallel while American forces were taking control of the south of the 38th parallel. Russian army immediately handed over the power to Il-Sung Kim who led the guerilla combats against Japanese army in Manchurian territory. He established communist government in the north, 1948. In the south, however, American military administration ruled for the same period. Going through the interim period of American military administration, Syngman Rhee, one of the Independence Movement leaders who operated in the States, was getting the political power in effect. He became the first president of the Republic of Korea (South Korea) in 1948. Due to the territorial disconnection between heavy industry of the North and light industry of the South, residents in the South suffered from the lack of powers. Some factories, for instance, producing fertilizers in the South were not able to run lack of power.

On June 25, 1950, the outbreak of Korean Civil War began to devastate remaining industrial facilities and human resources. The war lasted for three years and finally general armistice was declared on July, 1953. Seventy percent of spinning, dyeing, and chemical industries were damaged, 40% of farm machines and implements, 10% of rubber industries. Sixty eight percent of factories were devastated overall. Worse than that, as of May, 1952, the dead was 236,000, the kidnapped 83,000, the injured 256,000, and the massacred 123,000. In total, the loss of human resources had increased up to 956,000 (Lee, 2004).

One of the notable measures enforced by the new government was the "disposal of enemy property." At the end of the World War II, American military administration undertook the factories, industrial facilities, houses, and land left by Japanese. Taking over these properties, the government set up a policy for the distribution: Large factories would be owned by the state or be controlled by the state. Factories in medium or small size would be sold to the private. Based on the ability of manage-

ment, priority went to the shareholder, the manager, and the worker who were related to the property directly or indirectly. Unless there was an appropriate person, the asset went to the government officials during colonial times, bankers, and businessmen (Lee, 2004).

Since this law was enforced with many financially beneficial favors right after the outbreak of the Civil War when prices were hyper-inflating, lots of people applied for the "disposal of enemy property." Candidates lobbied to win the property using connections to influential figures in the government and American military administration. It was the beginning of the strong bond between the government and the business. Majority of *chaebols* still operating achieved the "enemy properties" with which they kicked in for the path of huge conglomerate (Lee, 2004).

After the armistice of the Civil War, economic restoration was mainly supported by foreign aid. Funds were delivered from different sources such as UNKRA (United Nations Korean Reconstruction Agency), ICA (International Cooperation Administration), and PL-480 (US support for overseas food aid formalized in the Agricultural Trade Development and Assistant Act of 1954). The amount of aid is as follows:

<Table 1> Foreign Aid after the Armistice (in US\$ million)

Year	Aid	Aid/GNP	Consumption Good/Aid (%)
1953	194.2	11.2	98.5
1954	153.9	8.4	83.2
1955	236.7	12.5	58.3
1956	326.7	17.1	72.5
1957	382.9	18.5	73.5
1958	321.3	14.5	70.5
1959	222.2	9.5	69.4

Source: Lee (1984, p.471)

Ironically, government supported the import substituting industries with the foreign aid. Firms with connection to the government were able to get financed at an extremely low interest rate. The government guided them to invest in the industry substituting major imports. Once they made investments, their businesses were protected by high tariffs.

This pattern of foreign aid distribution can be interpreted as an endogenous equilibrium. Government officials could get side-payment for giving privilege to some businessmen or foster the industrialization alleviating antipathy among people. Admittedly, patrons financed by foreign aid could easily back up the expansion of the business under the umbrella of low cost money and governmental protection.

However this equilibrium was self-undermining. As shown in the <Table 1>, foreign aid was inevitably decreasing while economy was restoring and developing. Protection by tariffs would be criticized by trading countries as the economy cut back and soaring up. In fact, the annual growth rate had been plunging from 8.7% in 1957 to 1.9% in 1960 and unemployment rate

soared up to 45% according to Korean National Statistical Office, which shows this economic system was self-undermining. Deteriorating economic conditions set a fire of political revolution in the end. On March 15 of 1960, Liberty Party led by President Rhee committed a fraudulent election for the presidency and vice-presidency. On April 19, so called 'Bloody Tuesday,' President Rhee's dictatorship tumbled by the force of people nationwide. Considering wealthy businessmen as corrupted political capitalists, people called for penalizing them. Changes in economic policy seemed imperative.

3.3. Developmental dictatorship (1960–1980)

The revolution of 1960 saw the overflowing of social demand for changes. However, chronic poverty, inequality, and corruption seemed too far to be resolved, though. The opposing party, Democratic Party, taking over the power from the former ruling party was incompetent to cope with this social distress.

On May 16 of 1961, a major general Cheong-Hee Park, who became a president later in 1963, carried out a military coup. Based on the successful coup, he formed the "Military Committee of Revolution" which transcended administrative, legislative, and judicial powers. The main economic policy declared by the Committee was to establish strongly planned economic system to overcome underdevelopment and to promote balanced growth. It was the prelude to the fast growing economy.

The Committee made a law penalizing "illicit fortune makers." Thirty owners of big business were classified as "illicit fortune makers" and their shares in big five banks were totally confiscated and immediately reverted to the National Treasury (Lee, 2004). As of 1960, fledgling *chaebols* were holding banks as follows: *Samsung* was the ultimate holder of *Hanil Bank* and *Choheung Bank Samho* had *Cheil Bank*. Among thirty illicit fortune makers, Byung-Chul Lee of *Samsung*, In-Hoi Koo of *LG*, and Joo-Young Jeong of *Hyundai* were classified as criminals according to the law. During the arrest, Byung-Chul Lee fled into Japan but declared to donate his total wealth to the society. Following him, almost all imprisoned vowed to donate their wealth unconditionally.

On the verge of dismantling, Byung-Chul Lee of *Samsung* asked to meet General Park confidentially. In the meeting, he insisted "economic depression will be followed by the punishment of illicit fortune makers, which leads to the reduction of tax revenue and troubles your management of the state. It's better for the state to give them opportunities to act on behalf of the economy" (Lee, 1986). Anyhow, the arrested were released and minor penalty was imposed after this meeting. Since the military governance led by General Park put the economic growth top on the lists of his public pledge, it would be better using entrepreneurs rather punishing them in order to achieve planned economic system. Probably, the law of "illicit fortune makers" might be an empty threat to subdue them for government-led economic system.

This way of resolving conflicts between the dictator and the powerful industrial leaders had paved the path to *chaebols* in two ways: First, confiscation of shares in banks separated fi-

nance capital from industrial capital. Looking back the history before the coup, owners of rising firms were fast expanding their business with the help of banks they owned. They might have configured companies in similar fashion of Japanese *zai-batsu* or *keiretsu*. All of sudden, the military government took away banking sector and monopolized it. No matter whether it is deliberate design or not, it strengthened the bond between polity and business in the end. Firms could get funded compromising with governmental plan whereas the government could direct and manage economic growth easily wielding monopolistic power of fund. So the reliance of the firms on political relation was beefed up again. Second, the 'Federation of Korean Industries' was established as a constant entity between the government and the owners of big business. Therefore the safety of business came to be guaranteed through this organization of negotiation.

The basic strategy for economic growth shifted from "import-substituting" to "export-driving" industries. In early 1960s, Korea was abundant in the cheap labor but lack of the capital. To overcome the shortage of domestic saving, foreign loans were needed desperately. In 1965, Korea and Japan made an agreement on the wartime reparation and the recovery of amity since 20 years severance of relationship. The amount of reparation was not known, but the recovery of relationship between two countries ensured that the pool of foreign loans became larger including the most capital intensive Asian country. No matter how the agreement was unfair, it was one of the main factors leading to the sizzling economic growth.

Now the government borrowed the money abroad and distributed it through the banks it had full control of at low rate of interest. Moreover, if a firm attracted a foreign loan for export oriented industry, the loan was automatically guaranteed by the government as well as financial favors. During 1960s, the interest rate of private foreign loan was adjusted around 5-6% while the market interest rate was 25-30% (Cho, 1990). Incumbent fledgling *chaebols* were motivated to rush to the export oriented industries such as tungsten, cement concrete, cuttlefish, tuna, wig, raw silk, silk fabrics, radio, sweater, etc. The leaders were *Samsung*, *Hyosung*, *LG*, *DongA*, *Chunwoo*, *SamDo*, *Banglim*, *ChoGwang*, etc.

One more interesting policy introduced in this period was 'export-import link' which gave monopolistic permission of importing embargoes to the firm finding new export market. So exporting firms strongly supported by the government could also enjoy domestic monopoly in different business field. It was one of the reasons that prototype *chaebols* started to have unrelated multiple subsidiaries.

In 1966, the government decided to send Special Forces as well as engineers to Vietnam. In exchange for dispatch of troops, many part of the war material provision was allocated to Korea. *Hanjin* took part in the conveyance of war supplies in Vietnam and *Hyundai* received an order of construction. Many Korean firms were following to profit special demand due to the Vietnamese War.

Beginning with political upheaval, 1960s saw great changes in the formation of *chaebol*. The military coup in the position of

power took the autonomy of economy but it devised an incentive system in which budding *chaebols* were capable of holding their advantages and actively looking for business opportunities abroad. The change still favored a few incumbent *chaebols*, but it came to increase the total size of economic stakes enough to pacify complaints of people. They had been growing up in size by earning profits under the protection of the government. Next 1970s would see the completion of modern formation of *chaebol*, say, encompassing many subsidiaries related or unrelated to the original business.

The beginning of 1970s was full of uncertainty. Developed countries suffered from stagflation and the first oil shock (1973–1974) shackled the Korean economy which heavily depended on raw materials to export.

Facing the uprising uncertainty, the government announced the 'Emergency Order for the Economic Stability and Growth by the President' which stopped payment for corporate bonds for a while and reduced the return of corporate bonds compulsorily. This measure was to help *chaebols* in bankruptcy due to the excessive expansion of business (Kim, 1990). *Chaebols* in trouble were saved once again by the government. However, in the middle of 1970s, many firms in medium size couldn't endure the low profitability without strong help of the government. In stead of helping them out, the government induced *chaebols* to integrate them. By frequent merger and acquisition, *chaebols* came to have huge complex of companies as we see for now. *Daewoo* was the most astonishingly growing *chaebol* purely depending on this sort of M&A. Table 2 shows the changes of some *chaebols* (Lee, 2004).

<Table 2> Changes in subsidiaries of top 10 *Chaebols* in 1970s

<i>Chaebol</i>	Representative	Number of Firms 1972	Number of Firms 1979
<i>Hyundai</i>	Joo-Young Jeong	6 (5)	31 (15)
<i>LG</i>	In-Hoi Goo	18 (14)	43 (24)
<i>Samsung</i>	Byung-Chul Lee	16 (15)	33 (26)
<i>Daewoo</i>	Woo-Joong Kim	2 (3)	34(20)
<i>Hyosung</i>	ManJe Cho	4 (4)	24 (15)
<i>KookJe</i>	JungMo Yang	3 (5)	22 (16)
<i>Hanjin</i>	Joon-Hun Cho	8 (10)	15 (15)
<i>SSangyong</i>	Sung-Gon Kim	6 (7)	20 (13)
<i>Hanwha</i>	Jong-Hui Kim	7 (8)	18 (16)
<i>SK</i>	Jong-Hyun Choi	5 (6)	14 (16)

Source: Lee (2004, p.244)

Note: The numbers in the parentheses stand for the number of industries each *chaebol* participates in.

Scarcely saved from the bankruptcy and passing through unprecedented M&A's, *chaebols* faced good business opportunities abroad. The boom of construction in the Middle East invited *chaebols* such as *Samsung*, *Daewoo*, *Hyundai*, *SK* and so on. Earning profits in the Middle East construction, they could get away from financial distress gradually.

While 1960s were the cultivation for *chaebol*, 1970s were the completion of *chaebol*. The rise of new military dictatorship didn't abolish the tight tie between business and polity. On the contrary, it strengthened the connection depriving a few firms' potential to manipulate economic decisions nationwide but giving them incentive to be big in the direction the government wanted. Based on the results of rapid growth, governmental planning was successful. But this path of development unavoidably brought about economic concentration on *chaebols*. As 'moral hazard' theory says, decentralized firms would have been a burden for the government in order to enforce the economic plan. In this sense, developmental dictatorship can be described as 'Corporate Korea' in which the government on the top makes an order to *chaebols* which took risks under the protection against insolvency.

4. Conclusion

After the World War II, industrial facilities left by Japanese were the seeds for the system of *chaebol*. Since the properties lacked of appropriate managers, the pro-Japanese group would best serve the use of 'enemy property' despite of people's antipathy. Disposing 'enemy property,' personal connection to the government was the most valuable asset to primitively accumulate the capital to be *chaebol*. With the immense support of foreign aid, this tacit collusion between the polity and the business was sustainable without aggravating people. However, this equilibrium could not exist for a long time as the foreign aid had subsided.

Military coup was a result of the deteriorating economic condition. The new government of General Park, later President Park, enforced planned economy based on the relationship between the polity and the business again. In stead of promising their stakes, the government induced them to plunge into the export, which succeeded in fast economic growth. Many prototype *chaebols* were able to get big, but sometime excess investment in unproductive sectors was the problem. Whenever this problem occurred, the government intervened to save *chaebols* in trouble. Asymmetrically, mediocre firms with few connections to the government should be merged to *chaebols* inevitably during economic slump. Enjoying the profit for making them big during boom and acquiring small businesses during depression, *chaebols* came to form what they are during 1970s.

Since the government deprived banking sector of *chaebols* at the outbreak of coup and kept the bonds between its power and *chaebols* by the use of banks, Korean *chaebols* followed the different path from Japanese *keiretzu* in which financial company is playing a role of holding company.

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