

State-owned Enterprise Reform and Corporate Governance Reform in Korea

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Outline of Presentation

I Corporate Governance and SOEs

II Strategic Management of Privatization

III SOE Reform in Korea

IV Performance Evaluation System in Korea

V Policy Implications



- I. Corporate Governance and SOEs
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I. Corporate Governance and SOEs

- ❖ Corporate Governance: the entire set of institutions through which the objectives of the firm is set and executed and the performance of the firm is monitored
- ❖ Public provision: “public interest” set through political process
- ❖ Private provision: “profit”
- ❖ Both public and private provision, the most effective incentive mechanism is to link managerial rewards to performance



I. Corporate Governance and SOEs

- ❖ The Essence of SOE reform and privatization is to establish this type of effective incentive mechanism

**Type of
effective
incentive
mechanism**

- 1** minimize political interference (personnel and pricing)
- 2** clarify the firm's objectives, using performance indicators
- 3** increase managerial autonomy to meet these objectives
- 4** evaluate managerial performance
- 5** link reward to performance



I. Corporate Governance and SOEs

- ❖ Problems of Corporate Governance when ownership and control are separated
- ❖ Problematic for both public and private institutions = incomplete contract & asymmetric information
- ❖ Incentive Schemes under Public and Private Provision
- ❖ The superiority of private provision depends on capital market efficiency and product market competition → privatization alone does not guarantee improved performance



I. Corporate Governance and SOEs

- ❖ SOEs in developing nations have room to adopt market-based incentives without resorting to full privatization : corporatization and listing shares on the stock market
- ❖ Another policy choice concerns corporate governance reform and performance evaluation system (PES)
- ❖ Policy options and the sequence of reform
- ❖ Need to develop a consistent & coherent strategy of SOE reform + country-specific program



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II. Strategic Management of Privatization

❖ Privatization implies a change in objective: “public interest”
→ “**profits**”

❖ Privatization Decision:

- 1) exhaustion of the firm’s “public interest” functions
- 2) replacement by other means
- 3) whether it will lead to increased consumer welfare



II. Strategic Management of Privatization

- ❖ Privatization policies face political problems when overall consumer welfare declines due to “tunneling” or any other acts of malfeasance or gives rise to monopoly rent due to the lack of competition
- ❖ The result of Privatization depends on the existence of competitive and efficient markets
- ❖ Privatization = A part of comprehensive program of market-oriented reform



II. Strategic Management of Privatization

- ❖ Institutional requirements for efficiency improvements through privatization in developing nations are complex: need a comprehensive program designed to remove various entry and exit barriers and enhance the operations of market forces
- ❖ Room for a traditional type of SOE reform including corporate governance reform under continued state ownership while the institutional infrastructure to support for privatization is shored up
- ❖ Such reform also requires a political economy environment that places a priority on economic efficiency
- ❖ Russian Oligarchs
- ❖ Korean SOE Reform and Lessons



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III . SOE Reform in Korea

1. Government-Invested Enterprise (GIE) Act of 1983

- ❖ introduced a German-type dual board at each GIE, establishing a supervisory board made up of non-standing directors (except the CEO) who were essentially representatives from ministries and a executive board composed of internally promoted executives
- ❖ the separation was designed to reduce “parachute appointment” of outsiders to executive position in SOEs
- ❖ streamlined government control to increase managerial autonomy
- ❖ established an inter-ministrial council to evaluate SOE performance and link reward to performance
- ❖ based on the efficiency principle, a set of performance indicators devised by experts had the effect of increasing efficiency and realigning goals of managers, bureaucrats, and politicians



III . SOE Reform in Korea

2. Privatization Program(1983-97)

- ❖ With liberalization and economic growth + maturation of market, the “public interest” argument for SOEs began to weaken and privatization began to emerge as realistic policy options in the late 1980’s
- ❖ Due to bureaucratic inertia as well as general concern about the increasing concentration of economic power in the hands of the chaebol, the government exercised a caution in pushing ahead with privatization
- ❖ The Government took measures to improve corporate governance of SOEs and partially sold its share in SOEs while retaining control



III . SOE Reform in Korea

3.The 1997 Act on the Managerial Structure Improvement and Privatization of SOEs

- ❖ Sought to improve managerial efficiency and pushing ahead with privatization while preventing economic concentration
- ❖ A Shareholding cap of 7% to prevent the chaebols from acquiring controlling interests
- ❖ Envisioned an Anglo-Saxon style corporate governance structure, involving active participation of institutional investors with significant but non-controlling interests
- ❖ An alternative to chaebol-dominated privatization, but without a credible divestiture plan



III . SOE Reform in Korea

4. Privatization Program(1997-2002)

- ❖ The Economic Crisis in 1997 provided a new sense of urgency to privatization policy
- ❖ The implementation of institutional reforms to reduce moral hazard, improve corporate governance, and enhance competition supported privatization drive
- ❖ Most large-sized privatization plans were drafted with a view toward establishing Anglo-Saxon style corporate governance (KT, POSCO, and KT&G)
- ❖ Increased awareness of the importance of competition and regulation in the process of privatization
- ❖ Of 11 SOEs targeted for privatization in 1997, only 3 (power, gas, and district heating) remain as SOEs
- ❖ In order for privatization plan to improve efficiency and consumer welfare, it should be a part of a comprehensive program to enhance the operation of market forces.



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IV . Performance Evaluation System in Korea

1. Theoretical Issues

- ❖ Dealing with the Agency problems in SOEs
- ❖ Aligning objective functions of principal and agents by linking agents' incentive schemes
 - Management control + evaluation + incentive system
 - Government-SOE contract / formalization of relationship
 - Establishing managerial accountability and autonomy
 - Objectives:
 - (1) to depoliticize & formalize SOE management,
 - (2) to improve managerial autonomy & accountability,
 - (3) to set new roles for boards of directors,
 - (4) to clarify managerial objectives, and
 - (5) to realign expectation levels of employees, senior executives, other stakeholders, and government



IV . Performance Evaluation System in Korea

2. Previous Management Control System (1962-84)

- ❖ Ministry-controlled system: Lack of flexibility & accountability
- ❖ No linking of performance with rewards
- ❖ Overall Control over strategic planning, budgeting, personnel, procurement, and other operational areas
- ❖ Little role for boards of directors
- ❖ Over 53% of directors appointed by the government
- ❖ Needed to obtain government approval 33 times + reported 37 times a year on average
- ❖ A combination of bureaucratic intervention and politicization of process



IV . Performance Evaluation System in Korea

3. The New System at Work

- ❖ Ex-ante performance evaluation: based on comparison of achievements against agreed targets
- ❖ Managerial Performance system vs. Enterprise Performance Evaluation:
Exogenous factors
- ❖ Formal agreements
- ❖ Correlation between planning and implementation
- ❖ Coordination among involved government ministries
- ❖ Performance evaluation-incentive-information-competition all linked



IV . Performance Evaluation System in Korea

- ❖ Performance Indices: quantitative and qualitative indices
- ❖ Ministries-SOE Council-Independent evaluation committee





IV . Performance Evaluation System in Korea

- ❖ Measuring performance in three managerial areas: management planning and strategies, operational (business) goals, and management system
- ❖ Incentive schemes: 200-500% bonus + department / individual performance linked
- ❖ Mix of high-powered and low-powered incentive schemes
- ❖ Difficulties of measuring relevant dimensions of organizational (and managerial) performance
- ❖ Performance contracting: work with SOEs



IV . Performance Evaluation System in Korea

❖ Grading

- Quantitative indices (40%): Seven year regression trend or beta-weighted distribution or targets set by the enterprises' corporate plan
- Qualitative indices (60%): 9 grades based on (1) improvements over past performance, (2) overall soundness of the system
- Collective decision making

❖ Incentive System

- Managers' incentive: 200-500% of monthly salary
- CEO: 0-200% of monthly salary



IV . Performance Evaluation System in Korea

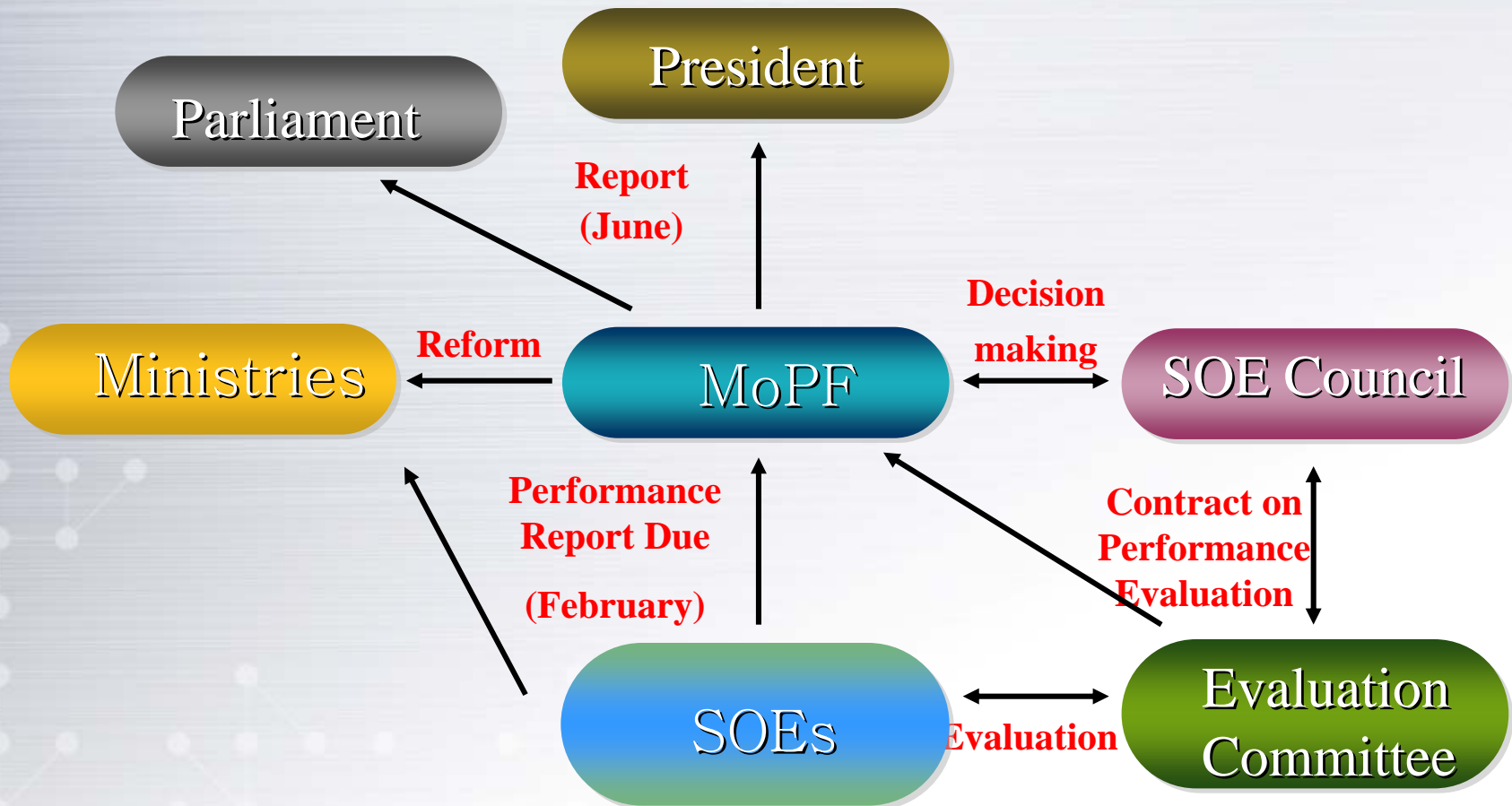
❖ Penalty System

- Bottom 3 SOEs receive minimum bonus + asked to submit turn-around plans
- Possible termination of tenure for CEOs and senior management
- Reputation and public perception

❖ **PES** = a market proxy but should accompany other reform measures



IV . Performance Evaluation System in Korea





IV . Performance Evaluation System in Korea

6. Outcome of the System

- ❖ Found that the PES have had a positive effect on the SOEs' organizational performance:

(1)

a strong impact on curbing labor increases

(2)

a moderate impact on containing labor costs, sales costs, and financial costs

(3)

little impact on the ratio of debt to asset.



IV . Performance Evaluation System in Korea

- ❖ Found that the PES have had a positive effect on the SOEs' organizational productivity:
 - a strong impact on labor productivity,
 - a moderate impact on fixed-capital productivity,
 - a moderate impact on profitability measures such as the net income and the value-added output

- ❖ Also, significant differences in SOEs' overall performance in comparison to the control group (8 local SOEs without PES)

- ❖ Ex-ante and motivational performance management through systematic evaluation system in SOE sector can be more conducive to organizational performance



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V . Policy Implications

- ❖ Formalization of relationship between government and SOEs
- ❖ Performance management +control system
- ❖ Strategic planning and development of organizational objectives
- ❖ Constant Monitoring and Review
- ❖ Prerequisite: Infrastructure in place including accounting and other managerial information system + parallel reform to increase managerial autonomy + adequate skills to supervise and evaluate + political will to sustain
- ❖ Technical competence
- ❖ A joint project between the two parties: Government & SOEs



V . Policy Implications

- ❖ Information requirements
 - Multiple objectives
 - Quantitative information
 - Qualitative information
 - Management-by-objectives
- ❖ Proven track records
- ❖ Congruence of government + SOE objectives
- ❖ Linking performance and reward
- ❖ A part of more comprehensive effort to reform SOEs



Junki Kim



Thank You !

