State Intervention and Foreign Direct Investment in South Korea

Richard Luedde-Neurath

Introduction
The literature on South Korea’s development has generally recognised the importance of ‘promotional’ economic policies by the Korean Government. I shall argue here that ‘directive’ interventions have been very important as well.

The argument will be made through a case study of South Korea’s foreign direct investment policy, which is widely believed to have been extremely liberal. Indeed, has been described as ‘one of the most liberal investment laws in the world’ [Kim 1979:viii; Westphal et al 1979:365-6]. Such characterisations may be found among orthodox and radical economists alike, though they differ widely over its consequences for the Korean economy. Whereas orthodox economists generally emphasise the beneficial effects to which such investments gave rise [Krauss 1983:89], radical economists often refer instead to the resulting ‘denationalisation’ of the Korean economy — the passing of effective control over the economy to outside agents, who operate it as a cheap labour export-platform [Luther 1981:161; Sunoo 1978:334-5].

This article reconsiders the nature and consequences of Korea’s policy towards foreign direct investment (FDI). It aims to show first, that radical claims with respect to the ‘denationalisation’ of the Korean economy are unconvincing; second, that there has been a substantial amount of directive state intervention with respect to FDI in Korea, contrary to earlier claims; and finally, that South Korea’s relatively successful interaction with FDI is due at least in part to ‘directive’ policies.

Foreign Direct Investment: Inflows and Impact
Arrivals of FDI in Korea were very small during the 1960s, and have remained at modest levels throughout most of the 1970s (with the possible exception of the 1973-74 period). From 1972 to 1982 inclusive, average annual arrivals of FDI were US$108 mn per year. Total cumulative arrivals as of mid 1983 stood at US$1,342 mn [Jeong 1983:4]. On a per capita basis, FDI in Korea is the lowest among the four East Asian newly industrialising countries (NICs), though it has to be said that Korea is one of the largest borrowers of loan funds in the world.

Data on FDI flows to Korea — by sector or country of origin — have been readily available throughout the last decade, as have discussions of such data and outlines of the relevant laws and policies [Sano 1977; Darton 1982; Jeong 1983]. In short supply, however, are studies which attempt to discover how the policy has operated in practice as opposed to on paper, or to assess how FDI has affected the economy. Whereas literature on the former issue is still lamentably rare, a number of studies have recently been done on the latter [Cohen 1972, 1975; Jo 1976; Ahn 1980; Lee 1980; Koo 1981, 1982; Park 1982]. By surveying their findings, it is possible to throw light on the extent to which foreign firms do or do not dominate the Korean economy. We begin by considering the aggregate picture.

We can see from Table 1 that the overall impact of foreign firms is limited. Their role in Korea’s exports stabilised at around 23 per cent throughout most of

1 Promotional measures are defined here as those which aim to restore market forces to their proper functioning — such as incentives, educational or infrastructural investments — whereas directive measures are defined as those which aim to direct or constrain market forces.

2 Nevertheless, all foreign borrowing has been strictly supervised and controlled by the government to date so that in this area also, any ‘liberal-market’ contentions can be challenged through the identification of extensive ‘directive’ state intervention.

3 Many of the latter may be involved in international ‘subcontracting’ arrangements [Sharpston 1975; Hone 1974; Berthomieu and Hanaut 1980]. Whether these amount to de facto ‘foreign control’ is debatable. The view taken here is that subcontractors are generally more autonomous than foreign invested firms, but that analytically the ‘control’ issue should not be prejudged. Certainly some initially ‘passive’ subcontractors in Korea have over the time become much more active in the marketing of their own products, thus decreasing the scope for foreign control over them [Wortzel and Wortzel 1981].
1970s [see Jo 1980:144-5 for earlier figures], which is to say that over three quarters of Korean exports are accounted for by firms which are wholly Korean-owned.¹

Table 1
The role of foreign invested firms in Korea: selected indicators for 1974 and 1978

<table>
<thead>
<tr>
<th>year weight of foreign firms in</th>
<th>unit</th>
<th>per cent 1974</th>
<th>per cent 1978</th>
</tr>
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<tbody>
<tr>
<td>Export value</td>
<td>23.0</td>
<td>22.8</td>
<td></td>
</tr>
<tr>
<td>GNP (total)</td>
<td>2.9</td>
<td>5.6</td>
<td></td>
</tr>
<tr>
<td>(manufacturing)</td>
<td>9.9</td>
<td>18.9</td>
<td></td>
</tr>
<tr>
<td>Gross domestic capital</td>
<td>2.9</td>
<td>0.7</td>
<td></td>
</tr>
<tr>
<td>formation</td>
<td></td>
<td></td>
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<tr>
<td>Employment (total)</td>
<td>1.4</td>
<td>2.3</td>
<td></td>
</tr>
<tr>
<td>(manufacturing)</td>
<td>7.6</td>
<td>9.5</td>
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¹ Foreign firms are defined in official statistics as those which are not wholly-owned by Koreans. The unusually broad scope of the definition needs to be borne in mind when making international comparisons.

Source: Koo 1981:38-43

Foreign invested firms accounted for 18 per cent of manufacturing GNP in 1978 and 5.6 per cent of overall GNP. True, their role has been rising rapidly between 1974 and 1978, but arguably it is not excessive, even in manufacturing. The role of FDI in gross domestic capital formation meanwhile has declined from 2.9 per cent in 1974 to a negligible 0.7 per cent in 1978. And finally, the role of foreign invested firms in total employment for 1978 stood at below 10 per cent in manufacturing and at a mere 2.3 per cent for the economy as a whole.

It can be argued that the above figures overstate the role of foreign firms. This is because the definition employed considers all firms with any foreign equity as foreign firms, whereas arguably only those where management control is effectively in foreign hands should be counted.

The difficulty lies in determining precisely at what level of participation control effectively slips into foreign hands. The rule of thumb often used is that of a majority foreign ownership, where foreign equity exceeds 50 per cent. By the middle of 1981, according to such criteria, 41.6 per cent of the cumulative foreign direct investment in value terms was majority-foreign owned, whereas 58.4 per cent was either majority-Korean owned or 50/50 co-owned. But even such a rule is not entirely satisfactory, given that according to Korean Commercial Law, a 33.33 per cent equity holding is sufficient to veto major corporate policy changes such as capitalisation or articles of incorporation [Business International Corporation 1983:9].

It is impossible to resolve the control issue here: suffice it to say that the data used above are likely to overstate the role of foreign companies in Korea, though it is impossible to specify by how much. In any case, on the basis of the above indicators at least, it would appear difficult to sustain any denationalisation thesis.

Naturally there are significant sectoral variations: within manufacturing, the chemicals (including petroleum), and the electronics (including electrical machinery) sectors stand out as the major areas of FDI. If we add to these the 'hotels and tourism' sector, we have already accounted for over half of total cumulative FDI in value terms as of mid 1983 [Jeong 1983:7]. Only in chemicals and electronics do foreign firms have a major role in the economy (in terms of share of output, employment and exports). Data on the changing role of foreign firms over time suggest that their dominance is being increasingly eroded by domestic firms in these two sectors [Luedde-Neurath 1984]. None of these data are consistent with the 'denationalisation/export platform' thesis.

On the basis of the above evidence, we would suggest that whereas the role of foreign invested firms is significant in a number of respects and sectors in Korea, it is by no means overwhelming. As for Sunoo’s claims that 'nine out of ten major trading companies in South Korea are owned and operated by the Japanese' [Sunoo 1978:323], and that 'more than half of the foreign banks in Korea belong to Japan' (335), they are contradicted by all serious empirical evidence available [KEB: August 1978 and April 1982; Smith 1979:v]. Denationalisation arguments are therefore not convincing.

State Screening and Control over FDI
Now it is the turn of those writings which characterise Korea’s policy towards FDI as highly liberal. The Korean Government has indeed actively promoted a 'liberal' image of its economy and its investment laws. The 'liberal policy' thesis has fitted in nicely with the theoretical preconceptions of both orthodox and radical economists alike. Thus orthodox economists found this characterisation useful given that to them, 'successful' cases of export-oriented development must be based on market forces, and hence on liberal policies. Radical economists — predicting doom for

¹ Source: Jeong 1983:10. Figures are based on approvals. The breakdown is as follows: out of a total amount of US$1,221.8 mn., 23.3 per cent was majority-Korean owned, 35.1 per cent co-owned, 11.4 per cent majority foreign owned, and 30.2 per cent was wholly-foreign owned.
ldcs which interact with multinationals — readily accepted the ‘liberal’ view because it enabled them to dismiss Korea as merely a denationalised export-platform of multinational capital. However convenient, such characterisations are false.

A review of the Foreign Capital Inducement Law and its various enforcement decrees quickly casts doubt on the liberal nature of Korea’s FDI policy. We find that considerations with respect to management control, the balance of payments, technology transfer and employment loom large in the screening process. We also find an emphasis on ensuring the complementarity between FDI and domestic firms in both export and domestic markets, and on ensuring the compatibility of such investments with Korea’s development requirements and plans [Republic of Korea 1979]. It also transpires that Korea uses a ‘positive list’ system with respect to FDI, according to which all sectors are closed to foreign investment unless otherwise specified [Business International Corporation 1983; Ministry of Finance 1982].

But are Korea’s regulations anything unusual by international standards, are they actually enforced in practice? The evidence is scant, but revealing.

Some years ago the UN Centre on Transnational Corporations conducted a survey of investment...
legislation in selected Idcs. It found that:
- out of 37 countries considered, only Korea and 10 others explicitly emphasised balance of payments considerations among their screening criteria;
- out of a sample of 36, only Korea and eight others explicitly granted preferential consideration to joint ventures [UN 1978:36-7];
- out of 27 countries, only Korea and two others considered all investment areas closed unless otherwise specified. Indeed, 11 countries did not explicitly specify any restricted areas [39-40].

We suggest therefore, that by international comparison Korea's legislation towards FDI does not stand out as particularly liberal, even it is true that some types of investment have been granted very generous incentives.

Turning to the question of policy enforcement, a comparative survey of 187 US multinationals in 66 countries [Curham, Davidson and Suri 1977:315] suggests that Korea has been relatively strict in enforcing its policy with respect to local participation in FDI. Out of all the investments made by these firms in Korea as of January 1976 (37 cases), only 29.7 per cent took the form of wholly owned subsidiaries. The corresponding share in Japan was 33.1 per cent and the average ratio for all countries in the sample was 69.1 per cent. Indeed, Koo calculates that Korea has the lowest share of wholly owned subsidiaries in the entire sample [1982:38].

A case study of a major US pharmaceutical firm which considered but then abandoned plans to invest in Korea suggests that a major stumbling block was precisely the tough negotiating stand taken by the Korean Government [United States Council of the International Chamber of Commerce 1979:214-16]. The firm confronted — in some cases unacceptable — demands with respect to:
- local participation
- management control
- product specification
- exports
- technology transfer
- duration of service fees

Instructive is also the 'look behind the rhetoric' of Korea's investment policy by Coolidge, a businessman with extensive practical experience there. He argues that Korea made the 'eye of the needle' for FDI rather narrow, thereby making it fit with national priorities [Coolidge 1980:376]. Foreign investors were expected by their partners and by the Korean Government to make a continuing contribution to Korean development, one which was complementary to, rather than at the expense of domestic manufacturing interests.

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Unless a foreign investor can be a continuous source
of new technology and markets, his position can only
decline regardless of what the Korean government's
written or unwritten guidelines might be [383]. On
the whole, Coolidge's assessment is that the Korean
Government has been 'consistent and successful' in
attracting the FDI it considered desirable.

Meanwhile, informal interviews conducted by the
author in Seoul during February-March 1982, and
internal documents made available by foreign
businessmen, suggest as basic realities of foreign
investment in Korea:
- tight investment screening
- extensive government interference
- extensive reporting requirements and control

Tight screening
In Korea there indeed exists a gap between the law on
paper and the law in practice. But more often than not,
this works against the foreign investor rather than in
his favour. Not only are many areas of the Korean
economy closed to FDI, but those which are
supposedly open are not as open as they may appear.
This often becomes apparent only during the
screening process.

Most investment applications, though officially
handled by the Ministry of Finance (formerly by the
Economic Planning Board) as the 'one stop' clearing
agency, require the approval of various ministries.
These in turn base their decisions not merely on the
Foreign Capital Inducement Law and its enforcement
decrees, but also on a number of unpublished internal
regulations and guidelines. The latter are often more
important and more restrictive than the law itself.

Moreover, Korean bureaucrats at the working level
enjoy a considerable degree of 'administrative
freedom' with respect to how they interpret a given
law. The 'rule of men not law' is a concept deeply
imbedded in Korea's bureaucratic tradition [Hahm
1967:21], as is the basic — and historically correct —
view that foreigners come to Korea essentially to take
something away. Investment applications are therefore
considered very carefully, and the bureaucrat, viewing
patriotism as his personal duty, will raise objections to
applications he does not believe to be in the best
interest of Korea, even if the law or senior officials
label such investments as permissible. Problems of this
kind are aggravated by the fact that there exist no
formal procedures to appeal against the rejection of
applications.

Finally, there is the problem of disagreement and strife
among ministries. Quite regularly, banner headlines
announce policy liberalisations in Korea. Uninitiated
foreigners take these at face value, assuming that they signal the successful conclusion of interministerial negotiations. In fact, given the rivalries, jealousies and limited contacts among ministries, such announcements often signal only the beginning of the debate among them. Gradually and rather quietly the original proposals are watered down — often beyond recognition — in response to domestic opposition, while no serious effort is made to dispel the myth generated by the original announcement.

The net result of these factors is not only considerable confusion and uncertainty among potential foreign investors but also a foreign investment regime which is much stricter in practice than it appears. The question of course is whether such administrative obstacles are intentional, or merely a reflection of bureaucratic inefficiency. Most people interviewed felt that there was considerable method behind the witnessed obstruction, precisely to stall foreign interests and to protect domestic ones.

**Extensive government interference**

Foreign firms regularly complain about the high degree of restrictions and interference to which they are subject while operating in Korea.

Manufacturing enterprises, for example, are often given precise instructions as to which products or product lines they may produce and what share of these may be sold on the domestic market. Guidelines on pricing (eg of export inputs) are not uncommon. Foreign banks are effectively barred from providing export financing, competing for local currency deposits, from buying real estate or from taking out mortgages on it. Foreign insurance and leasing firms are also severely restricted. This is done through limitations in the ‘scope of business’, which must be officially approved.

Foreign enterprises are often also denied the service and support functions they consider necessary. Samples, spare parts, training aids and business technology are importable only with great difficulty, if at all. Thus, contrary to the impression that might be generated by some policy proclamations, foreign firms can generally not compete on equal terms with local firms on the domestic market.

Another areas of interference with foreign investors in Korea relates to the ‘sanctity of contract’. When negotiating joint ventures or contracts with local partners, foreign firms often assume that once an agreement with them has been reached and signed, the contract can be considered final. Not so. In Korea, the government reserves the right to review and — where necessary — demand changes in agreed contracts.

This is known as ‘round two’ of the negotiations. In 1982 for example, the Economic Planning Board reviewed 599 contracts between foreign and local firms falling under the revised Fair Trade Law. It ruled that 37.9 per cent of these would have to be revised in favour of domestic interests involved [ACCKJ January 1983:11-12].

Such attempts to renegotiate signed contracts occur not only during the pre-investment phase, but on occasion also once an agreement has been operating for some time. Foreign firms may be asked to increase their exports, raise the domestic content of their output, to expand output, or even to restructure their operations entirely. Laws affecting foreign investors may be changed suddenly and in some cases applied retroactively. Contracts may be unilaterally abrogated when the assumptions underlying them change, and Korea’s extremely tight Foreign Exchange Control Laws have in some cases been used to block the payment of agreed service charges.

In this decade alone, the Korean Government has already been engaged in some major disputes over contractual issues, involving such eminent companies as General Motors, Bechtel and Dow Chemical. Even where the government ultimately climbed down, it tended to reaffirm its basic right to demand changes in contract. The basic government attitude appears to be that business (whether domestic or foreign) should serve the government and not vice versa.

**Extensive reporting requirements and control**

Foreign firms further complain about the reporting requirements and bureaucratic control to which they are subjected.

Foreign firms are required to disclose considerable amounts of ‘sensitive’ information about their accounts, products, projects, general operations and their customers to Korean officials and screening agencies. On several occasions such information has ended up in the hands of domestic competitors or has otherwise been used against the foreign firm. The laws governing the protection of technology, particularly with respect to industrial/intellectual property, copyrights and trademarks are weak, and ‘pirating’ is common. A related difficulty is that only processes, not products can be patented in Korea. In such an environment, foreign firms are naturally reluctant to supply sensitive information to the authorities, or to transfer advanced technology to Korea.

Tax and customs officials in particular have a number of independent means of monitoring company activities. The statutory auditor, whose mission is to check annually the integrity of company accounts,
acts as a powerful independent watchdog over all major companies operating in Korea. Under proposed
revisions to the Commercial Code, his function is to be
expanded substantially to that of constant (rather than
of annual) supervision of general (rather than of
strictly financial) aspects company activities [Birnbaum
1983:21-2]. Tax officials are known to conduct
independent assessments of company tax-liabilities
and to compare them against submitted accounts.

Customs officials meanwhile have at their disposal not
only very detailed international price lists, but detailed
records of virtually all international commercial
transactions involving Korea. A list is compiled daily,
by individual letter of credit, stating its number, the
nature of product, its country of origin, its supplier, its
purchaser, the volume involved and - perhaps most
importantly of all — the unit price of the transaction.
This detailed monitoring is said to be extremely
effective in curbing transfer pricing in Korea.

We do not wish to suggest that all investors are at all
times confronted with problems of the kind discussed.
But the problems are sufficiently common to support
the proposition that foreign investors in Korea do not
operate in a liberal environment. One can only agree
with Koo that 'the government was able to exert
comprehensive influences on the patterns of foreign
investment in Korea . . . competition with domestic
firms was seldom allowed, both in domestic and
export markets, and Korea became one of the few
countries with very restrictive foreign investment
regulations' [Koo 1981:8].

As for the much publicised liberalisations of Korea’s
investment regime, a US banker recently summed up
the feeling shared by many foreign bankers, investors
and traders: 'It’s one thing to say that barriers are
coming down . . . it’s another to see to it that foreign
bankers don’t keep stumbling over them' [AWSJ, 28
March 1983].

Conclusion
Korea has not been denationalised by foreign
investors. It has not followed a liberal policy towards
FDI, but a highly selective one involving considerable
levels of directive state intervention.

How one evaluates such findings is largely a matter of
perspective. If one takes the view that all foreign
investment is good investment, one is likely to lament
the fact that artificial restrictions were imposed. If one
takes the opposite view, one is likely to lament the fact
that it was admitted at all. Such 'universalist' positions
are not helpful, however.

Foreign direct investment is essentially 'double-
edged': it has the potential to benefit and to harm ldc
development. There are many reasons why ldc’s must
and should resort to foreign direct investment, but the
dangers this option entails must be recognised.

Three things follow: firstly, the central issue is not
whether FDI is introduced into ldc’s, but precisely how
it is done. Secondly, directive state intervention is
necessary so as to insure the complementarity between
FDI and the domestic economy. Thirdly, the quality
of such directive intervention will be a crucial
determinant of whether FDI advances or retards ldc
development.5

If this position is accepted, a connection can be made
between the fact that rapid industrial development in
Korea was not based primarily on foreign firms, and
the fact that Korea pursued a policy of directive state
intervention with respect to FDI. The view taken is
that Korea was essentially on the right track when it
screened, restricted and controlled FDI, thereby
integrating it into its wider development strategy, and
that the development of Korean firms may owe much
to precisely such directive state intervention. That is
not to suggest that the policy was perfect, or that it is
not currently in urgent need of reform, only that it
appears to have served Korea rather well to date.

The policy implication for Korea is that the
widespread and unqualified calls often made for the
liberalisation of its foreign investment regime are
fundamentally misconceived. The solution for Korea
lies not simply in a reduction of directive state
intervention, but in its modification to root out
current inefficiencies and inconsistencies, and in its
adaptation to suit the requirements of the Korean
economy during the 1980s and 1990s.

For ldc’s, the implication is that the Korean experience
supports rather than contradicts the view that
directive state intervention is necessary if FDI is to
play a constructive role in national development. But
directive state intervention is itself a potentially
problematic phenomenon. As orthodox economists
will correctly point out, misconceived, partial or
inefficient state intervention might be worse than none
at all. What such critics fail to recognise is that
governments are 'damned' not only if they intervene,
but also if they do not intervene. Since it is almost
impossible to change the reality of foreign investment
as a 'double-edged' phenomenon, it is the quality of
government intervention which will have to be
improved.

5 The need to select and guide foreign investment is by now widely,
though by no means universally accepted [United Nations Centre
on Transnational Corporations 1983; OECD 1977; Lall and
Streeten 1977].
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