Trust in Subcontracting Relations between the Large Enterprises and Small-Medium Enterprises in Korea: With Implications for Economic Development

HAERAN LIM

School of International Studies, The Catholic University of Korea

This study is designed to explore the link between trust and economic development by focusing on the subcontracting relations between the large enterprises (LEs) and the small and medium enterprises (SMEs) in Korea. In this study, trust is regarded as a product of institution rather than a reflection of culture. The institutional view of trust is interested in creating the level of trust when there is none. Korea grew fast under a lack of trust before it faced the 1997 economic crisis. During the mass production period, cheap price rather than trust was the most important factor for surviving international competition. However, during the reflexive manufacturing period, the issue of trust plays a crucial role in increasing innovation and efficiency. One of the reasons for the recent economic bottleneck could be attributed to the lack of trust between the LEs and the SMEs. Trust and law are compatible, and the latter may contribute to developing and strengthening the former. To raise the level of trust in subcontracting relations, monitoring and sanctioning systems need to be established. Establishing an institutional framework requires a genuine interest match among the government, the LEs, and the SMEs.

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1. INTRODUCTION

Recently, a great deal of literature has appeared analyzing the relationship between trust and economic development (Fukuyama 1995; Coleman 1990). The literature treats trust as an important factor that could explain why some countries develop while others lag behind, and often concludes that societies with a high level of trust grow faster and those with a low level of trust grow slower and have a tendency to experience political instability..

A problem with these studies is that they take a static view; they compare developed countries and less developed countries and explain the contrast by the different levels of trust. This approach has merit by carrying out a cross level-comparative analysis. But it has difficulties in explaining a dynamic change over time; why has a country grown rapidly for some time and then tumbled down at a later time? If we are to explain the role of trust in the change of a society over time, we need to take a dynamic approach and focus on the variation of trust relationships among main actors.

There are some studies that take a dynamic approach to explain the rapid development of Korea. They center on the relationship between the government and the large enterprises (LEs) over time (Evans 1995; E.M.Kim 1993; J.E.Woo 1991), and mostly conclude that public and private cooperation, i.e., the cooperation between the government and the LEs, was a main factor for rapid economic growth (Onis 1991). However, focusing on the mutual interest between the government and the LEs tends to ignore the role of the private sector in Korea's development, and doesn't fully explain why rapid growth has been accompanied with a fragile structure, which led to the economic crisis.

To understand the structural bottlenecks in the Korean economy, we need to examine the interest relationship among private actors along with the cooperation between public and private actors. Such a relationship is best represented by the subcontracting relationship between the LEs and the small-medium enterprises (SMEs). Empirical studies of the link between trust and economic development, focusing on subcontracting relations have multiplied in industrialized countries such as Japan, the United States and the European countries (Gambetta 1988; Lane and Bachmann 1998). However, empirical studies of subcontracting relations in Korea are rare. This study will focus on the nature of subcontracting relations in Korea, to draw some implications for the role of trust in economic development and crisis.

Trust may be seen as a by-product of culture or as a product of institution. If we regard trust as a product of culture, we could suppose that culture, as a source of trust, does not change rapidly. In this case then, we could not explain the transformative process of economic development and crisis over time with low or no variation in culture. Also, if we see trust as a reflection of culture, it may be difficult to create trust when there is none. To avoid this problem, we will focus on the institutional view of trust, which is interested in creating a level of trust when there is none.

What makes the research question puzzling is that the analysis of trust in sub-

contracting relations seems to face an ironic phenomenon: Korea experienced fast growth under a lack of trust in the subcontracting system before it faced an economic crisis. This study attempts to explain how a low level of trust affects economic performance during the transformative period of capitalist production and suggests some possible ways to build trust.

The remaining of this paper is organized as follows. The next section critically reviews various perspectives of trust and suggests a theoretical framework for this study. The third section examines the empirical case of Korea, focusing on the subcontracting relationship between the LEs and the SMEs to explore the effect of trust on economic development. The fourth section suggests several ways of building trust through which an uncooperative subcontracting relationship can be transformed into a cooperative one. The final section concludes with a brief summary and some comments.

II. THEORETICAL FRAMEWORK

Concept and Origin of Trust

Trust provides a way to cope with risk or uncertainty in exchange relationships. Risk and uncertainty are seen to be inherent in social relationships, due to problems of time and information. Trust, therefore, is a mechanism, which overcomes the problem of time and bridges uncertainty in the face of imperfect information. Also, trust is a mechanism by which actors reduce the internal complexity of their system of interaction (Luhmann 1988). Various definitions of trust have two core elements: an agent's acceptance of risk from the actions of others; and the expectation that the partner will not take advantage of the opportunities opened up by the agent's acceptance of risk. Trust is viewed as accepted vulnerability to another's possible but not expected ill-will toward one.

One may argue that the different levels of trust among various societies could be attributed to their specific culture, social norm and values (Granovetter 1985). Fukuyama (1995) argues that trust comes from shared values, and norms, and believes that economic actors support each other when they share a community of trust. Fukuyama suggests cross-cultural differences in social capital to explain cross-national differences in forms of economic organization. He connects a high level of trust with development and a low level of trust with underdevelopment.

Some scholars claim that Confucianism has functioned as an important culture for fostering trust and cooperation in East Asia, especially in Korea (S.C.Lew 1997; M.H.Kook 1997). According to S.C.Lew (1997), the ethics and culture of Confucianism influenced Korean society so much that the social ties such as family, school, and region functioned as an important basis of networks in society. The existence of social networks decreased the transaction costs of economic and social activities, therefore contributing to economic development in Korea. Lew also argues that there was

limited predatory behavior under the extensive use of social networks. Although Fukuyama and Lew disagree with the issue of whether Confucianism fosters trust or not, they are in agreement with the idea that trust is a by product of culture.

However, the cultural perspective of trust seems to include several problems. First, if trust is seen as a reflection of culture, societies without trust are doomed to suffer from the negative effects of low trust, and it may seem difficult then to create trust in such an environment. However, empirical work tells us that trust can be built even between people from different cultural backgrounds or between individuals who share no values beyond their narrow business goals (Lane and Bachmann 1998). Second, if we suppose that culture does not change rapidly, it may be difficult to relate the rapid transformative process of economic development with slow cultural change.

Yamagishi, Cook and Watabe (1998) conducted a cross-societal experimentation to compare the level and origin of trust in Japan and the United States. According to a simplistic view of culture (the individualistic view), Japanese people prefer to be part of a group and they are by nature collectivists, while Americans are more individualist and value independence from the group. Contrary to this simplistic view of American and Japanese culture, the results of their experiment showed that the tendency to remain in a group was much stronger among Americans than among the Japanese.

This paradoxical result can be explained using the institutional view of trust. According to this view, the Japanese often prefer to belong to groups and place group interests above their own individual interests not because they intrinsically like to do so, but because it is in their own long term interest. Japanese society has developed systems of mutual monitoring and sanctioning to curtail free-riding in a collective work group. In such a laboratory situation where mutual monitoring and sanctioning do not exist, Japanese tend to prefer not to stay in the group. Yamagishi's (1988) cross-societal experiments also show that once opportunities for monitoring and sanctioning are removed, the Japanese are in fact less cooperative in achieving group goals than are Americans. External social control is strong in collectivistic Japanese society, where mutual monitoring and sanctioning are exerted through feelings of shame. However, an internal guilty feeling is more important in an individualistic American society. From these experiments, we find out that the cultural difference disappears once these factors are experimentally controlled.

Kim and Son (1998) replicated Yamagishi's experiment (1988) in Korea and showed that sanctions were an important factor in inducing cooperation in Koreans and the Japanese. In general, American students had the highest levels of trust, while Koreans and Japanese were similar in terms of low level of trust. The introduction of sanctions induced non-cooperators to cooperate, especially in Korea and Japan. However, the level of cooperation may drop when the sanctioning system is withdrawn.

The institutionalistic view regards institution such as sanctioning as an important basis for trust. However, when we rely highly on sanctions to induce cooperation, cooperation will suddenly drop if the system of sanctions collapses due to government failure. The institutional view of trust is interested in creating a general level of trust

when there is none. It could explain why individual social actors are more inclined to trust each other under the conditions of a certain institutional environment, why they tend to distrust one another in other circumstances, and how trust is created and reproduced through various institutional orders. Since Korean society is generally characterized as one with a low level of trust, this study takes the institutional view of trust and explores the institutional mechanisms through which trust could be built and maintained.

Linkage between Trust and Economic Development

The link between trust and economic development¹ can be analyzed through a macro perspective, focusing on system trust, or through a micro perspective, narrowing the scope of analysis to trust among firms and organizations.²

Macro analysis is interested in explaining how the structure of society affects economic performance. Gambetta's study of the Mafia in Italy shows us this perspective well (1988). Members of society are forced to choose certain types of activities between rent seeking and investment for competitiveness. People are inclined to behave in a rational way not to be excluded by the structure (Lee, Jae-Hyuk 1998). To choose to obtain Mafia protection can hardly be considered irrational from an individual perspective. From these individually rational premises, though the collective disasters such as lower incentives for technological innovation and poorer quality of goods and services are likely to follow (Gambetta 1988, 173). Thus, rational individual behavior can give rise to irrational economic inefficiency, and people's rent-seeking activities are related to a lack of trust in the government. Rose (1998) also explains how Russians use informal social networks to insulate themselves from exploitative organizations. They debureaucratize their relations, relying on personal contacts, barter or bribes. There is an absence of credible or effective systems of justice and law enforcement, and people do not trust the government.

Studies of Korea also show that the structure of society affects economic performance through its effect on public and private trust: a high level of public trust is associated with high economic performance and a high level of private trust with low economic performance. Korean society is seen as having high private trust and low public trust. High private trust resides in the networks of family, school, and region. Strong trust exists within the boundaries of personal ties. The level of trust, however, is very low outside of these close ties and networks. In Korea, exclusive private ties between the government and *chaebol* created rents. Rationing foreign exchange, restricting entry through licensing producers, and tariffs or quantitative restrictions on imports were ways of creating rents. High returns from directly unproductive profit-seeking activities

¹ For classical theoretical literature on the connection between trust and economic development, see Arrow (1974) and Fukuyama (1995).

² Lane and Buchanan (1998, 14-19) distinguish trust into four different levels: system trust, institutional trust, interpersonal trust (trust at the micro level), and societal trust.

dominated productive activities, and economic efficiency and dynamism declined.³ The exclusive ties between the government and the chaebol resulted in structural corruption, which led to the recent economic crisis. The existence of rent-seeking activities is likely to produce public distrust of the government. In such a society, people do not believe in law and government; rather they try to gain safeguards by building personal networks and relying on bribes.

However, a macro-analysis fails to explain the causal link between trust and economic development over time. From a macro perspective, we can expect that high economic performance is associated with high public trust and low economic performance with high private trust. But as we saw, government-business networks in Korea functioned well in inducing economic efficiency for some time, but not for other times. We cannot explain the variation of economic development and bottleneck by solely focusing on a macro level of trust.

Another way of analyzing the connection between trust and economic development is to focus on trust within and between organizations through a micro perspective. More specifically, we can explore the impact of trust among firms, especially between suppliers and customers, and on business performance. Sako (1998) argues that interorganizational trust may enhance business performance in a few ways: first, trust could reduce transaction costs; second, building trust in itself is an investment; and third, trust gives rise to more rapid innovation and learning. Granovetter (1985) also argues that a high level of trust removes the need for any contractual and monitoring devices, therefore reducing transaction costs. A high level of trust makes it possible for exchange partners to share information. An easy exchange of information makes them more open to each other, which inclines them to explore new opportunities for collaboration, such as the improvement of product quality.

Let's examine the Korean case. The difficulty of exploring the empirical link between system trust and economic development led us to study the level of trust between organizations, especially trust in subcontracting relations between the LEs and the SMEs in Korea. Korea passed through a rapid growth period and then faced an economic crisis. The analysis of trust in subcontracting relations also seems to face an ironic phenomenon: How did Korea grow fast under a lack of trust in subcontracting relations? One explanation is that during the mass production period, cheap price was the most important factor in competing internationally. Therefore, trust was not a principal issue, and the exploitative subcontracting relationship was utilized by customers to push costs down.

However, as the economy grew more sophisticated, trust in subcontracting relations became prominent. Whereas the Fordist production system is characterized by producer-driven manufacturing, the reflexive manufacturing system is regarded as demand-

³ Fukuyama (1995, 89-103) also argued that the lack of public trust contributed to the recent economic crisis. Unlike this argument, H.J. Chang (1993) says that the rent-seeking structure in Korea does not necessarily lead to social waste by diverting entrepreneurial activities from productive activities to unproductive activities, like lobbying.

driven manufacturing (Hamilton 1999).⁴ In the flexible specialization period, the nature of demand becomes more sophisticated and pluralized. To respond to rapidly changing demands, firms need to be flexible and swift. This type of manufacturing requires backward engineering, in which the coordination between merchandisers and sub-contractors, and trust among various firms, become important. Since the 1980s, the Korean economy faced structural obstacles due to the decreasing competitiveness of firms based on the mass production system. The persistent existence of exploitative relations between the LEs and the SMEs produced structural obstacles for upgrading technological capabilities and continuing innovation. The lack of trust in subcontracting relations functioned as one of the causes for the recent economic crisis.

III. SUBCONTRACTING RELATIONS BETWEEN THE LEs AND THE SMES IN KOREA

To explore the link between trust and economic development, we need to discuss the characteristics of subcontracting relations in Korea. Before we discuss the nature of subcontracting relations, let's first look at the historical and political origins of the development of strong LEs and weak SMEs.

The LEs and the SMEs in Korea's Growth

LEs emerged during Korea's the post colonial and post war period (1948-61). After colonization, former large scale Japanese industrial facilities were sold to a few private enterprises at concessionary prices. At the same time, distribution of American aid after the Korean War favored a few large capitalists. However, a spontaneous development of SMEs also emerged. The SMEs' share of Korea's manufacturing employment and their share of manufacturing value added were 66.4 percent and 47.2 percent, respectively, in 1965 (Table 1).

Korea's industrial policy in the 1960s basically emphasized selective export promotion, and the firms involved in exports could receive state support. Selective export promotion did not benefit the SMEs, which were structurally domestic market oriented and neither equipped nor prepared for exports (Regnier 1992, 110). Although the LEs in those export-oriented sectors were more favored and the SMEs were relatively disadvantaged, the policy per se was not against the SMEs. Although industrial policy in the 1960s did in fact favored the LEs over the SMEs, the main purpose of the policy was to promote exports, and it did not provide a policy base for the LEs to take over existing SMEs.

⁴ This type of manufacturing started with the demand side, with what would sell, with products whose qualities were purposefully constructed for carefully selected segments of the mass market, emphasizing the product themselves, as opposed to how, where, or by whom the products were made, created an awareness of niche markets and an awareness of demand. This shift toward demand responsiveness led to the creation of the reflexive manufacturing system (Hamilton 1999, 51).

TABLE 1. SHARE OF SMES IN MANUFACTURING, 1965-1998

(%)

Year	Number of Firms	Employees	Value-added
1965	98.7	65.4	47.2
1970	97.1	49.0	28.5
1975	96.7	45.2	28.0
1980	96.6	43.6	32.2
1985	97.5	55.1	37.6
1990	98.5	61.7	44.5
1995	99.0	68.9	46.5

Source: KFSB, *The Current Status of the SMEs*.

However, during the 1970s, the inclination of industrial policy to favor LEs shrank the SMEs further. Export-led strategy led to the development of large assemblers by providing an incentive for them to import and thereby avoid the need to domestically produce parts and components. Export firms received various subsidies such as tax exemptions for importing parts and components.

During the mid-1970s, large assemblers began to experience pressure to buy domestic parts and components, and tried to produce them internally and even took over small suppliers. This trend further deteriorated the trust between the LEs and the SMEs because subcontracting between them was not based on a cooperative but on an exploitative relationship. As a mechanism to promote their export-led strategy, the Korean government established the General Trading Companies (GTC) in 1975. There were export subsidies and many privileges for the designated GTC. Thus the LEs began to build a vertical integration of production by taking over the SMEs in order to become qualified for the GTC, and tried to produce parts and components within their groups. As a result, in the 1970s, many LEs eagerly took over the SMEs, as shown in Table 2.

TABLE 2. CHANGE OF SUBSIDIARIES IN THE TOP 10 L&Es

Year	64	65-69	70-74	75-79	80-84	85-88
Establishment	17	23	32	40	19	37
	4	3	19	66	17	6
Overtaking	-	-	12	12	49	16
Sell Off	-	-	-	-	-	-
Subsidiaries	21	26	39	94	13	27

Source: Hong, Jang Pyn, 1993:45

In the 1970s and early 1980s, the SMEs themselves were not willing to make an investment in the localization of parts and components for several reasons. First, foreign competitors such as Japanese parts makers lowered their costs whenever Korean parts suppliers developed new parts. Secondly, large assemblers in Korea did not want to buy parts produced by domestic makers. Finally, as mentioned above, the

LEs in Korea merged domestic parts firms into their subsidiaries through vertical integration.

As a result, the growth of the SMEs was restrained and the number and the value added of the SMEs stagnated. The SME share of Korea's manufacturing employment dropped from 66.4 percent in 1965 to 49.0 percent in 1970 and then to 46.2 percent in 1975. The SME share of manufacturing value added dropped from 47.2 percent to 28.5 percent and then to 28.0 in the same period (Table 1).

While SMEs deteriorated, There was a continued accumulation and concentration of the LEs during the period. Overseas borrowing by the government channeled priority loans to the LEs with low interest rates. Also, there existed many promotion policies related to the SMEs, which were not designed to promote the SMEs but to mainly benefit the LEs, especially through the controlled subcontracting relationship. On the contrary, the SMEs in Korea had limited access to financial loans. The SMEs were competing for survival, and did not have enough resources for collective action.⁵ The Korean government did not pay adequate attention to SMEs, whereas it was sensitive to the problems of the LEs. The authoritarian government regime forced labor and the SMEs to bear the costs of economic adjustments.

In 1975, the government enacted the SME "Gye-yol-hwa" Promotion Act. It was designed to strengthen and stabilize vertical relations between large firms and smaller suppliers by guaranteeing at least three year contracts. This policy was expected to provide the SMEs with a stable market. However, it resulted in hierarchical and dependent characteristics of subcontracting relations because trust between the LEs and the SMEs did not exist.

Whereas the earlier economic period in Korea reflected the expansion of the LEs at the expense of the SMEs, the period since the 1980s shows the quantitative development of the SMEs. The subcontracting rate of the SMEs increased during the 1980s. Out of total sales, subcontracting sales almost doubled from 25.6 percent in 1980 to 46.6 percent in 1988. Whereas the LEs strengthened its vertical integration of production by taking over SMEs and increased in-house production in the 1970s, the LEs have been forced to increase subcontracting with the SMEs since the 1980s. The "Gye-yol-hwa" subcontracting policy contributed to the rate of increase in subcontracting.

Chaebol have been forced to increase their reliance on domestic subcontractors for other reasons besides this policy. First, demand for local suppliers has increased as Korea's industrial production became more advanced and sophisticated. Second, ever since the proliferation of labor strikes in 1987, the chaebol have been eager to shift the burden of increasing labor costs onto the shoulders of formally independent domestic suppliers (Ernst 1994). Although the internal and external changes of the 1980s could have been an opportunity for trust building between the LEs and the SMEs and for

⁵ Shafer (1990, 127-149) explains the difficulty in organizing light manufacturing labor as follows: dispersion of workshop, little job security, high turnover rates, and low skill are the obstacles to organizing labor unions. See also (Deyo 1982).

technological upgrading unfair behavior such as burden-shifting by the LEs deteriorated rather than improved relationship.

In the 1980s, the trend of LEs absorbing SMEs suppliers by the LEs has been reduced somewhat. However, LEs did not provide the SMEs with a stable market through trust, and dumping attacks by foreign firms as well as an insecure market for new products still posed obstacles for the SMEs to invest in innovation of parts and components. This shaky situation gave rise to persistently weak and dependent SMEs.

Since the end of the 1980s, Korea's growth has slowed. The primary causes for the sluggish growth at the turn of the 1990s was a wide world economic downturn, increased protectionism in developed countries, loss of price competitiveness due to rising wages, and weak technological capabilities in various industrial sectors. The reasons for Korea's failure to deepen and upgrade its technological capabilities include lack of sophistication, high dependence on imported parts and components, underdeveloped labor management and the lack of trust and cooperation in subcontracting relationships. In particular, the lack of trust was often considered the primary obstacle for firms to upgrade their technological capabilities.

Lately, Korea large assemblers have realized the importance of a cooperative subcontracting relationship with their own suppliers. However, according to the interviews with several electronics parts suppliers, it seems to be the case that large assemblers still want to strengthen hierarchical and dependent relationships with subcontractors (Lim 1998).

TABLE 3. COMPARISON OF THE SMEs IN MANUFACTURING

(%)

	Japan ('97)	Taiwan ('97)	Korea ('98)
Number of Firms	99.0	97.8	99.2
Number of Employees	72.0	81.3	70.5
Value-added	55.2	34.4	48.0
Export	51.8	50.6	39.6

Note: The SMEs are defined as firms with 5~299 and 4~299 in Korea and Japan, respectively. In Taiwan firms with capital below 60million Taiwanese yuan are included in the SMEs. The Export data is for 1995

Source: Administration of SME, SME Statistics

As Table 3 shows, the SMEs in Korea are characterized as weak and inferior in terms of the number of employees and the level of production. Korean SMEs lag far behind Taiwanese SMEs in the level of competitiveness, represented by the percentage of exports. The contrasting industrial structure between Korea and Taiwan results in the different response to the recent economic crisis. Korea's LEs-based structure, lacking trust with weak SMEs, reflected exclusive base of coalition that was unable to adjust to the rapidly changing domestic and international environment. The SME-centered structure

in Taiwan, however, basically showed inclusiveness in its coalition base, and was therefore flexible in adjusting to the changing environment. Korea and Taiwan responded differently to similar international challenges due to their different domestic structures (Lim 1999).

Characteristics of Subcontracting Practices

The overall trend of subcontracting in Korea has been expansionary, although it has been stagnating in recent years. Subcontracting rates have increased from 30.0 percent in 1980 to 73.4 percent in 1992, and recently experienced a small decrease of 71.7 percent in 1997 (Table 4). The "Gye-yol-hwa" Promotion Act, was intended to strengthen and stabilize the vertical relation between assemblers and suppliers enacted by the government in 1975, the number of designated sectors and products initially increased from 6 and 71 in 1980 to 44 and 1553 in 1984, but has decreased since 1985 (Table 5).

TABLE 4. RATIO OF SUBCONTRACTING SMES TO TOTAL MANUFACTURING SMES (%)

	80	84	88	92	96	97
SME total	30.0	41.7	55.5	73.4	73.6	71.7
5-9	17.8	31.7	48.5	73.4	72.3	65.6
10-19	27.4	42.1	56.1	74.1	71.6	74.1
20-49	38.6	50.0	63.3	72.3	77.6	78.2
50-99	51.2	52.9	57.7	74.9	77.7	82.9
100-199	49.8	50.9	54.2	71.1	73.9	78.7
200-299	50.2	44.4	40.9	70.8	77.6	83.2

Source: KFSB. The Current Status of the SMEs.

TABLE 5. DESIGNATION OF GYE-YOL-HWA PLAN

	80	85	90	95	96	97	98	99
Sector	6	40	41	36	36	36	24	24
Products	71	1256	1256	1053	1053	1053	838	838

Source: KFSB. The Current Status of the SMEs

The development of the subcontracting structure since the 1980s is characterized by a pyramid and multilayer structure. In the 1970s, the relative importance of subcontracting among the SMEs decreased, and instead subcontracting between the SMEs and the IEs began to increase. However, since the 1980s, subcontracting among the SMEs accelerated. As Table 4 above shows, small-sized enterprises participated in subcontracting. The ratio of SME subcontracting has increased since 1980, regardless of the size of firms. This shows that there has been an increased multilayer subcon-

tracting relationship among the SMEs.

However, the basic characteristics of Korean subcontracting relations have been exploitative, noncooperative, and vertically integrated. Also, the customer-supplier relationship was irregular and unstable. To institutionalize a cooperative relationship, the Subcontracting Cooperative Association (SCA) was organized. In the beginning, the technical and financial support from the parent firms centered on the suppliers, who were members of the SCA, but that number gradually decreased.

Although the subcontracting rate has increased, it does not imply an improvement of trust between the LEs and the SMEs. On the other hand, collaboration between them seems to have been limited. Most subcontractors are locked into a fairly closed production network controlled by a particular large assembler. Since the end of the 1980s, the closed production network has transformed into a more opened one. The average number of assemblers from which SME suppliers are subcontracted to is 5.9 in 1997. The other side of the coin, however, is that assemblers increased the number of suppliers in order to get a secure supply of products since the labour strike of 1988. This made suppliers compete with each other, further weakening them.

The subcontracting relations between customers and suppliers reflect unequal exchange terms, in that suppliers have very limited decision autonomy (Ernst 1994, 53). The price of subcontracting products is decided against the preferences of SME suppliers. According to one survey, the percentage of the cases in which the preferences of suppliers were reflected in decision making process as was only 7.3 percent in 1990 (Baik, et al. 1995, 41) and it is believed to still be the case. During economic expansion, the subcontracting price is decided through the consultation of assemblers and suppliers. However, during economic downturn, the price is in most cases decided by assemblers. This implies that assemblers shifted the burden of costs of economic adjustment on to suppliers.

Delaying payment by assemblers has been the major unwarranted business practice. In 1997, payment in cash accounted for 28.2 percent while the remaining 71.8 percent was paid in credit, including promissory notes. This behavior of delaying payment aggravated the financial condition of the SME suppliers. In the past, unwarranted business practices such as delaying payment by assemblers were the most important problems in the subcontracting relationship. But since the 1980s, the pressure of low cost has become the principle issue in the subcontracting relationship (Table 6). In an exclusive relationship with parent firms, suppliers are discouraged from having multiple customers. Thus, the suppliers are forced to lower their prices. The distribution of profits between assemblers and suppliers also became a critical issue. Squeezing profit margins left no room for suppliers to reinvest in technology development (Kenney 1995).

The exploitative subcontracting relationship between the LEs and the SMEs made the LEs feel cooperation with the SMEs was not beneficial, and so they retarded only trust building measure with the SMEs such as stake sharing. For example, capital investment by the LEs in SMEs suppliers could increase the level of trust. This investment decreases the possibility of opportunistic behavior by assemblers. In 1997,

the percentage of capital investment by the customers was only 2.8 percent among the total surveyed firms. Capital investment would reduce SME's risk in developing new technology for domestic production of parts and components. One of the reasons for the LE's low level of capital investment was the fear and suspicion that the SMEs' decision autonomy would be lessened (Baik, et al.1995).

TABLE 6. COMPLAINTS OF SUBCONTRACTING SMES REGARDING ASSEMBLERS

	80	84	88	92	96	97
Harsh Quality Inspection	8.1	12.6	11.5	13.7	32.0	33.1
Pressure of Low Cost	36.1	38.3	46.4	38.5	68.4	61.3
Delaying Payment	37.4	22.3	18.9	23.1	44.9	52.3
Unstable Order	14.7	19.6	13.7	15.3	48.3	41.5

Note: Since 1993, the survey system has changed from single choice to multiple choice. This table includes only manufacturing SMEs.

Source: KFSB, The Current Status of the SMEs

While financial support from customers to suppliers has increased, the level of support is still very low. The percentage of financial support to SME suppliers by customers increased from 4.2 percent in 1987 to 12.7 percent in 1997. Technical assistance has been regarded as the most important way through which customers and suppliers could enhance competitiveness and produce value-added products. Suppliers complained that they usually receive more technological support and training from Japanese firms than from domestic assemblers (Yoon et al. 1989, 95). During the mass-production period, however, technical assistance was not a significant issue. But in the more sophisticated production period, the production system requires closer cooperation from design to production between customers and suppliers.

IV. INSTITUTIONS AND TRUST BUILDING

Causes of the Lack of Trust in Subcontracting Relations

Although the subcontracting relationship has improved recently, it is still based on unfair exchange terms and considered hierarchical and non-cooperative. We suggest several reasons for the persistent lack of trust in subcontracting relations.

First, subcontracting relations have lacked enforcing laws and a sanctioning system. A monitoring system to regulate the unjust behavior of the assemblers does not exist. The government enacted the Monopoly Regulation and Fair Trade Law in 1980, which was designed to regulate the LEs' activity and to build just practices in subcontracting relations. However, the expansion of the LEs did not stop and unwarranted business

practices have not been reduced. Also, there have been many SME promotion policies to establish strong SMEs, but there has not been an willingness by the government to implement these policies. For example, there was a lack of legal checks to implement the policy of compulsory lending to the SMEs in bank loans. Therefore, it had only limited effect. We should ask why these laws have not been implemented with success, which bring us to the discussion of the next factor.

Second, there has existed a close political coalition between the government and the LEs. The LEs have been the major coalition partners and beneficiaries of many subsidies and privileges. Most SME promotion policies seem to have originated in electoral calculations by the government, simply as a lip service. There has been a lack of willingness among political leaders to seriously implement the SME promotion policies. In this sense, there was no interest match between the government and the SMEs. We could then ask whether there may be an institutional organization for SMEs to pressure the government. This question is related to the third factor.

Third, according to corporatist theory, the state plays a major role in the creation of interest groups, whereas the pluralist theory emphasizes the voluntary creation of interest groups within society. Although the corporatist argument could not generalize across different industrial sectors and over time, the case of the SME interest groups in Korea seems to fit the corporatist view. From the corporatist perspective of the Korean state, interest groups have been mobilized and created by the active role of the government. Interest groups of the SMEs were not established by the voluntary participation of the SMEs themselves but through the financial assistance of the government. In this case, the organization does not have appropriate institutional mechanisms through which the preferences of the SMEs can be correctly articulated and aggregated to pressure the government. It may be hard to regard the opinion of the interest organization as the genuine and general interest of the SMEs.

The Korea Federation of Small-Medium Business (KFSB) has not functioned well enough to achieve their original purpose. In principle, the KFSB was supposed to be run by the membership fees provided by the SMEs. However, the government has continued to subsidize the main budget of the organization. Only 10 percent of the budget comes from the SME members, 50 percent is subsidized by the government, and 40 percent by its business such as rents, the service charge for executing government procurement policy and financial subsidy (Lim 1998). Therefore, it is hard for the KFSB to have its own voice on SME policies, and it is difficult to regard the opinions of the organization as the voices of the SMEs. Because of its dependence on government subsidies, the organization as an agent has become ignorant of its principal interest, the SMEs.

Another reason for the non functioning of the KFSB has to do with corruption within the organization. There is a procurement policy by which the government buys certain products of the SMEs to guarantee a stable domestic market. The secure market provided by the government has made SMEs less competitive and less efficient. The organization is more concerned with the distribution of benefits among powerful firms

than with the original purpose of putting pressure on the government. Whereas the size of the KFSB is much larger than that of the FKI (Federation of Korean Industries), an LE interest organization, the KFSB's activities have never been significant enough to compete with the FKI's (Park, Moon-Kyu 1987).

Fourth, the LEs did not regard the SMEs as equal partners for cooperation. The main motive for subcontracting came from the low costs of the SMEs. There was no interest match between the LEs and the SMEs. However, since the late 1980s, the LEs began to realize the fact that their competitiveness depends on the efficiency of the SMEs. To build a high level of efficiency among the SMEs, the cooperative network in subcontracting becomes important, win-win strategy becomes more important in a technology-driven period.

Trust Building through Institution

Deakin and Wilkinson (1994) developed a case for the proposition that trust and law are compatible, and that the latter may contribute to developing and strengthening the former. Legal regulation is conceptualized as being part of a societal institutional framework. In a sense, building laws and monitoring systems is necessary to building the general level of trust in subcontracting relations in Korea. To build a monitoring system, the government should also realize the importance of the development of SMEs for further economic development, and show a strong willingness to implement and check SME promotion policies and regulation policies for cooperative subcontracting relations. Also, political institutions through which the SMEs could be strengthened need to be established.

Another framework is related to the positive incentive system. This includes the genuine match of interest between the LEs and the SMEs. In a more sophisticated and competitive economy, the network based on trust between firms becomes more important in competing internationally. Therefore, the LEs need to regard the SMEs as a trustable partner in order to cooperate in technology innovation. Capital investment by the LEs in SME suppliers could increase the level of trust by making them share interests, and decrease the possibility of opportunistic behavior by the LE assemblers.

Besides, to create trust, there should be a change of attitude from focusing on safeguards against the abuse of trust to thinking about enhancers of trust. Trust enhancers may take the form of customers' technical assistance to suppliers. Information sharing is also likely to enhance trust. While law may help jumpstart trust relations in business, eventually trust has to be built not only by resorting to law but also through learning by-interacting. The unilateral provision of information and technical assistance by customers, regardless of whether suppliers reciprocate or not, will enhance trust.

V. CONCLUSION

The purpose of this study was to explore the effect of trust on economic development by focusing on the subcontracting relationship between the LEs and the SMEs in Korea. This study adopted the institutional view of trust, which states that trust is regarded as a product of institution. Whereas the cultural view of trust cannot explain the transformative process of economic growth and downturn, the institutional view explains the variation of development over time, with the variation of trust among actors in the economy. This study regarded the LEs and the SMEs as the main actors and examined their subcontracting relations to explain the process of growth and bottleneck.

The subcontracting relations between the LEs and the SMEs in Korea have been exploitative, and non cooperative. It is argued that the existence of trust between the LEs and the SMEs induces innovation and efficiency. However, during the mass-production period when Korea had a comparative advantage in cheap price and low value-added products, the issue of trust may not have been a principle issue. Thus, the LEs took advantage of their strong position in exploitative subcontracting relations and pushed supplier costs down. Korea grew fast during this mass-production period under exploitative subcontracting relations, but as the capitalist production system transformed from mass production to reflexive manufacturing system, the issue of trust became more important in achieving national comparative advantage. The existence of trust between firms reduces transaction cost and increases innovation and efficiency. As the nature of demand becomes more sophisticated and the life cycle of demand is shortened, the flexibility of firms and trust among firms become necessary. The recent economic bottlenecks can be attributed to the lack of trust between the LEs and the SMEs. For further economic development, the creation and maintenance of a general level of trust in subcontracting relations is required.

There are many reasons for the lack of trust in Korea's subcontracting relations: there were no monitoring or sanctioning systems in subcontracting relations; there was no interest match between the LEs and the SMEs and between the government and the SMEs; and the KFSB as an interest groups for SMEs was established and operated by the financial assistance of the government, and the SMEs were unable to translate their preferences into government policy.

To create and increase the level of trust in subcontracting relations, a monitoring and sanctioning system needs to be established first. Establishing an institutional framework requires strong legal enforcement by the government. In order for the laws to be seriously implemented, the government should realize that SMEs need to be strengthened to overcome the structural bottleneck of the economy. Also, a genuine coalition between the government and the SMEs needs to be established: the SMEs should organize themselves voluntarily to pressure and check the behavior of the government. The LEs should change their perspective from short-term interests to long-term interests. The normative prescription may not be realistic. As mentioned before, capital investment by the LEs in the SMEs could increase the level of trust by creating an

incentive for cooperation.

As Nishiguchi (1994) argues, subcontracting can be explained as the evolutionary product of a complex historical interaction among socioeconomic, technical, and political factors. Trust could be increased by the establishment of institutional frameworks such as a sanctioning system. However, building institutions requires mutual interest between the government and societal actors. An interest match is calculated not only by rational choice, but also by a genuine understanding of interests.

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