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OECD Economic Surveys: Korea

Assessment and recommendations

An adverse world economic environment has slowed growth and boosted inflation…

The Korean economy has faced a number of shocks in 2008, including higher commodity prices, slowing world trade and the global financial crisis. The terms-of-trade shock – Korea is the world's fifth-largest oil importer – weakened the won and heightened inflationary pressures, which have squeezed household income and corporate profits, damping private consumption and investment. In addition, housing market policies contributed to a 5% decline in residential investment over the past year, while the deceleration in world trade took a toll on Korean export growth. With weaker domestic demand and exports, output growth fell from 5% in 2006-07 to 3% in the first three quarters of 2008, at a seasonally-adjusted annual rate. Intensified financial turbulence in September 2008 has further dimmed the economic outlook by accelerating the depreciation of the won and tightening credit conditions. The timing of the rebound depends on an improvement in the world economy, which may not occur until well into 2009. In that event, economic growth is projected at around 3% on a year-average basis in 2009 before rising back to around 4% in 2010.

… creating a difficult task for macroeconomic policies

Faced with a marked slowdown, the government is implementing a supplementary budget and tax rebates totalling almost 1% of GDP, to be followed by cuts in personal and corporate income tax rates in 2009-10. In November, the government submitted revisions to the 2009 budget proposal, adding further stimulus measures. Concerned about high inflation, the Bank of Korea hiked interest rates by ¼ per cent in August 2008, but then reversed course in October as the global financial crisis worsened, cutting rates by a cumulative 125 basis points by early November. The government announced in October that it would guarantee banks' foreign borrowing up to a total of $100 billion. In addition, the authorities intervened in the foreign exchange market in July to stabilise the won and arranged a $30 billion currency swap with the US Federal Reserve in October. Between June and October 2008, Korea's foreign exchange reserves fell by $46 billion, to $212 billion. The won continued to depreciate, falling by 26% in trade-weighted terms between early July and the end of November. Foreign exchange market intervention is likely to be costly and ineffective in the face of global financial turbulence that is driving the won's depreciation and should therefore be limited to smoothing operations. This would also limit any further decline in foreign exchange reserves, which provide a cushion against Korea's short-term foreign debt, which soared from $66 billion at the end of 2005 to $189 billion in September 2008.

Monetary policy faces large challenges

In 2008, inflation significantly exceeded the upper limit of the 2.5% to 3.5% target zone for the first time since the introduction of inflation targeting in 1998. In October, headline consumer prices were up by 4.8% (year-on-year) and core prices (excluding energy and food) by 5.2%, pointing to second-round effects from the commodity price shock. Going forward, with lower commodity prices and slow growth, inflation is projected to fall back within the target zone in the course of 2009. Against this backdrop, monetary policy should for now focus on financial-market stability and supporting activity, until conditions normalise, and then shift its priority to achieving the inflation target. Vigilance is warranted, however, given the sharp depreciation of the won and the fact that the growth slowdown only influences inflation with a sizeable time lag. The course of monetary policy will depend on the extent and duration of the economic downturn, which in turn will be influenced, among other factors, by the amount of fiscal stimulus.

With the strong fiscal position deteriorating…

The implementation of the supplementary budget and tax rebates in the fourth quarter of 2008 may boost output growth by as much as ¼ percentage point in 2009. The budget includes spending to build roads and subsidise utility companies, although this distorts energy prices and encourages excessive consumption. Taking account of the supplementary budget, the central government consolidated budget excluding the social security surplus would record a deficit of around 1½ per cent of GDP in 2008 following a small surplus in 2007. In addition, the stimulus measures planned for the 2009 budget will further boost outlays. It is essential that fiscal stimulus be timely, targeted and temporary. Looking ahead, the government plans to cut personal income tax rates by 2 percentage points by 2010 and the national corporate income tax rate from 25% (close to the OECD average) to 20%. The authorities expect that this will reduce tax revenue by around 2% of GDP. Over the medium term, the priority should be to maintain a strong fiscal position, given future spending pressures associated with population ageing and the development of the social insurance system.

… it is important to restrain the growth of public spending in coming years to prepare for population ageing…

Korea faces a major fiscal challenge with rapid population ageing. The share of the elderly in the population is projected to rise from 10% to 14% by 2018, at which point the working-age population will begin to decline. Korea's elderly dependency ratio, now the third lowest in the OECD, is expected to be the fourth highest by 2050. The limited coverage of the public pension system, which has levelled off at about one-third of the working-age population, and the low level and duration of contributions, especially among the self-employed, creates concerns. The means-tested benefit introduced in 2008 may need to be expanded to limit poverty among elderly people. In addition, greater economic co-operation with

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North Korea may boost government spending. Preparing for these future spending pressures requires maintaining the strong fiscal position by achieving a balanced budget, excluding the social security surplus, over the medium term. Given the tax cuts, this calls for reining in government spending, which has risen by 9% per annum (excluding the cost of financial-sector restructuring) since 2002. It is also essential to implement the October 2008 plan to privatise 38 public institutions and abolish three, while merging 38 into 17.

… and implement a comprehensive tax reform, which would boost revenue through consumption taxes in the longer term…

Government spending, currently one of the lowest in the OECD area as a share of GDP, is likely to rise significantly over the medium term, given the long-term spending pressures, thus requiring additional tax revenue. However, such increases will impose larger economic costs, underscoring the need for a comprehensive reform that sustains Korea's growth potential, addresses rising income inequality and relative poverty and improves the local tax system. The most efficient way to boost revenue is through consumption taxes, which impose fewer distortions than direct taxes. Korea has considerable scope to hike its value-added tax (VAT) rate of 10%, which is well below the OECD average of 18%. At the same time, the base should be broadened by scaling back the scope of exemptions and the special treatment of small and medium-sized enterprises (SMEs). The complicated system of individual consumption taxes on 20 items should be simplified, in part as an effort to reduce the role of earmarked taxes, which account for 14% of tax revenue. Excises should be limited to products with negative health or environmental effects, such as tobacco, liquor and energy. In particular, greater use of environmentally-related taxes would increase efficiency.

… and a broadening of corporate and personal income tax bases

In addition, direct tax bases should be broadened. Cutting corporate tax expenditures, which remain large at about one-fifth of corporate tax receipts, would help to offset the revenue impact of the planned rate cuts, while reducing distortions in the allocation of investment. Introducing a tax expenditure budget, as planned in 2010, and enhancing transparency would help identify tax expenditures whose costs exceed their benefits. In addition, the low rate paid by SMEs does not appear to be effective in addressing the challenges faced by small firms and should therefore be phased out. The relatively minor role of personal income taxes – among the lowest in the OECD area at 4% of GDP – reflects large exemptions and deductions for employees aimed at levelling the playing field with the self-employed. Only half of wage income is taxed, well below the OECD average of 84%, and only half of employees pay income taxes. However, the proportion of self-employed paying income tax has risen from 40% to 63% over the past decade, suggesting scope to cut the exemptions and deductions granted to wage income, while avoiding increases in marginal rates.

The earned income tax credit should be the major tool to address rising income inequality and relative poverty

Increasing the share of workers paying income taxes would have a negative effect on income distribution and relative poverty, which has trended up during the past decade. By the mid-2000s, the rate of relative poverty – defined as a disposable income below 50% of the median – had risen to 15% in Korea, the seventh highest OECD-wide. In 2008, the government introduced an earned income tax credit (EITC), which is likely to boost employment by making work pay for low-skilled persons. However, the EITC will initially cover less than 2% of households. Expanding the credit, which could be financed by broadening the personal income tax base, requires further enhancing transparency about the income of the self-employed. In addition, taxing fringe benefits as individual income would improve equity.

Local property taxes can enhance local government autonomy

The Comprehensive Property Tax (CPT), a highly progressive nationwide tax on property that is paid by 2% of households, aims at redistributing income and stabilising house prices. Its introduction in 2005 was accompanied by a scaling back of the local property tax. However, local governments' tax powers should instead be expanded to allow them to better respond to the preferences of local citizens and help ensure fiscal discipline by making the cost of local services more visible. Property taxes are well-suited for local governments as they are visible, impose discipline on the quality of services and are relatively resistant to tax-base flight. The government should, therefore, follow through on its plan to scale back the CPT by raising the threshold at which it applies and reducing the tax rates, as a first step toward merging it with the local property tax. Greater reliance on local property holding taxes would enhance local government autonomy and facilitate a streamlining of the complicated local tax system, which includes 16 different taxes and thus raises compliance costs. In particular, the heavy reliance on property transaction taxes, which have lock-in effects that reduce the supply of housing, should be reduced.

Direct tax rates should be kept low to sustain output growth

A comprehensive tax reform, which relies primarily on consumption taxes for additional revenue, the EITC for income redistribution and property-holding taxes for local government, would limit the rates of direct taxes, thus promoting growth. OECD experience shows that taxes on personal and corporate income tend to reduce saving and investment, labour supply and demand, inflows of foreign direct investment (FDI), entrepreneurship and education. The government's reforms to reduce direct taxes are in line with international trends and will help support competitiveness. The planned cut in the corporate tax rate should be accompanied by a reduction in quasi-taxes, which include a wide range of administrative fees and user charges, as well as a number of contributions that tend to be levied on firms in a discretionary and non-transparent manner.

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Promoting growth also requires measures to boost productivity in the service sector…

With the slower expansion of the working-age population, sustaining growth depends primarily on increasing productivity, which is currently only 34% of the US level. The large gap mainly stems from Korea's service sector, where productivity has fallen to 60% of that in manufacturing. The problems in services are closely related to the difficulties facing SMEs, which account for 91% of service-sector employment. Extensive public support for SMEs, including financial assistance, has blunted competitive pressure, slowed the pace of restructuring, in contrast to large firms, and reduced the efficiency of resource allocation. Over the longer run, the wide range of government programmes, which numbered 163 in 2007 and cost 0.7% of GDP, should be scaled back and streamlined. Other support, notably policy loans and credit guarantees, should also be cut. Remaining support should be focused more on start-ups than on existing firms. While recent government measures have moved in this direction, more efforts should be made in the longer term to scale back and streamline support for SMEs.

… through regulatory reform and competition policy…

Faster labour productivity growth also requires strengthening competition through regulatory reform and competition policy. Despite progress during the past decade, around one-third of business lines in the service sector remain subject to entry barriers (on top of registration and declaration requirements). International comparisons indicate that entry barriers and product market regulations are relatively high in Korea. The newly-created Presidential Council on National Competitiveness should focus on the key barriers that restrict competition. In addition, competition policy should be further strengthened. *First*, although financial penalties have risen, their deterrent effect is still weaker than in most other OECD countries, indicating a need for further increases. In addition, criminal penalties, which are rarely applied, should be used more frequently. *Second*, the investigative powers of the competition authority, the Korea Fair Trade Commission, need to be expanded. *Third*, the number of exemptions from the competition law, including for SMEs, should be further scaled back.

… and increased openness to international competition…

Greater openness to the world economy is another priority to boost productivity in services. The stock of FDI in Korea is the third lowest in the OECD area and inflows have fallen since 2004. Moreover, the share of inward FDI in services is the third lowest OECD-wide. Consequently, foreign affiliates accounted for only 8% of service-sector turnover and 4% of employment in 2004, well below the OECD averages of 19% and 10%, respectively. Strengthening international competition requires reducing barriers to FDI, including foreign ownership ceilings in key services, and liberalising product market regulations. In addition, it is important to foster a foreign investment-friendly climate by enhancing the transparency of tax and regulatory policies and reforming the labour market. Moreover, the incentives for foreign investment in the Free Economic Zones should be extended more broadly within the service sector. In the area of trade, Korea is negotiating Free Trade Agreements with the European Union, Canada and Mexico. These agreements should be broad-based, including services as well as goods.

… while addressing barriers in key service industries

It is important to address factors limiting productivity in key services that are expanding rapidly:

- *Telecommunications*: the new Korea Communications Commission (KCC) is a step toward separating the ministry setting industrial policy from the organisation charged with fostering competition. The independence and transparency of the KCC's regulatory decisions should indeed be safeguarded in practice in line with the law. It is also necessary to relax entry barriers and foreign-ownership ceilings and to introduce auctions and broaden secondary markets for spectrum.
- *Financial sector:* Korea is introducing a "big bang" in 2009 to reduce segmentation in the securities industry, with a view to becoming a financial hub for Asia. It is critical to ensure that enhanced supervisory capacity, with a functional emphasis, precedes market growth and innovation. Caution is called for in easing ownership restrictions on banks that separate industrial and financial capital.
- *Business services*: constraints on entry, form of practice, advertising and foreign participation have limited the size of this sector and should be relaxed. For example, the decision to cap total enrolment in law schools at 2 000, despite the fact that the number of lawyers per capita in Korea is only a quarter of the OECD average, restricts competition and keeps prices high.

Potential growth also depends on reducing labour market dualism…

The sharp increase in the share of non-regular workers, who now account for more than one-third of employees, has negative consequences for both growth and equity. Such dualism is largely explained by the rising share of temporary workers, from 17% of employees in 2001 to 26% in August 2008, almost double the OECD average. Not surprisingly, temporary workers receive less firm-based training than permanent workers, thus slowing human capital formation and productivity growth. Lower wage costs encourage firms to hire non-regular workers, who earn 30% less per hour than regular workers, with productivity differences explaining only part of the gap. The cost advantage is magnified by the low coverage of non-regular workers by the social insurance system. While three-quarters of regular workers were covered by national health and pension insurance in 2007 in their workplace, the share was only around 40% for non-regular workers. Firms also hire non-regular workers to achieve greater employment flexibility, given the relatively strict employment protection for regular workers. Dualism thus creates equity concerns as a significant portion of the labour force works in precarious jobs at relatively low wages and receives less protection from social insurance.

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… by liberalising employment protection for regular workers and extending the coverage of the social insurance system…

Reducing dualism requires weakening the incentives that encourage firms to hire non-regular workers. One priority is to liberalise employment protection for regular workers so that firms can achieve the necessary flexibility without depending as much on non-regular workers. A second priority is to increase the coverage of non-regular workers by the social safety net, thus improving equity and narrowing the gap in labour costs. The government has introduced reforms to harmonise the collection practices of the four social insurance systems, but the key to greater coverage is to create a unified collection agency. To reduce the use of non-regular workers, a new law, which is being gradually phased in since mid-2007, prohibits "unjustifiable discrimination" against them and states that workers with fixed-term contracts are considered to be regular employees after two years. However, there is a risk that this law will decrease total employment. In fact, the number of non-regular workers has declined since 2007. The law should be closely monitored and revised as necessary as its full impact becomes apparent.

… and increasing labour inputs by boosting the labour force participation rate of women…

Raising the female participation rate would help sustain output growth in the face of a declining working-age population. Although it is on the rise, the rate for women in the 25-to-54 age group is still the third lowest in the OECD area. The measures recommended above to reduce labour market dualism, as well as to move away from seniority-based wages, would support female employment by creating better job opportunities for women who interrupt their careers for family responsibilities. Greater availability of high-quality childcare would help as well. This would require phasing out price controls that discourage private-sector suppliers. Lengthening maternity leave and ensuring that eligible persons are able to take such leave, as well as parental leave, is also important. Another factor discouraging female employment is the extremely long working hours in Korea, which make it difficult to combine employment with family responsibilities. Encouraging the development of family-friendly workplaces would boost female employment and the fertility rate, which currently stands at only 1.3 children per women.

… and youth…

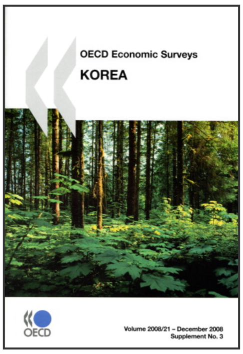
The employment rate of youth between the ages of 15 to 29 has been falling and is well below the OECD average. In addition, the proportion of youth who are neither in education nor training is relatively high, especially for those with higher education, who account for the majority of youth. Labour market dualism is again a factor, as it reduces wages below the reservation wage of many youth. In addition, active labour market policies should focus on facilitating the school-to-work transition, while avoiding employment subsidies, which tend to have high deadweight costs.

… in part by upgrading the education system

Perhaps the key problem for youth employment is the degree of mismatch between skills provided in tertiary education and those required in the labour market. Around 30% of graduates of tertiary education do not find jobs in their field of study. It is important to increase links between universities and companies and to strengthen competition between educational institutions through regulatory reform and more transparency about their performance. In addition, public support for tertiary education could be increased from its exceptionally low level. However, the scope for additional outlays is limited by the fact that education spending is already the third highest OECD-wide, even without including the 2% of GDP spent on private tutoring institutes (*hakwon*). Increasing the quality of education at all levels would lower the demand for such institutes, thus easing the pressure on students and the financial burden on families. Allowing universities more autonomy in the student selection process would also reduce the importance of the standardised exams that make private tutoring useful.

It is also essential to promote the employment of older workers

Finally, it is important to raise the age at which employees leave firms, which is typically around 55, well before the pension eligibility age. Early retirement reflects the seniority-based wage system, which makes older workers expensive for firms. Abolishing mandatory retirement would help to flatten the wage-seniority profile, given that firms accept seniority-based wages on the condition that they can force older workers to leave, and thereby extend the length of employment. In addition, it is important to phase out the mandatory lump-sum retirement allowance, which increases the cost of keeping older workers. The government launched a company pension system in 2005, but less than 9% of firms have adopted it thus far. One stumbling block is that employers and employees must agree on whether to introduce a defined-benefit or a defined-contribution scheme. The generous tax treatment of the retirement allowance system should be reformed to accelerate its phasing out and encourage the introduction of defined-contribution schemes, which would also enhance labour market mobility.



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