Executive summary

Despite the recent slowdown in world trade, Korea is projected to sustain growth of around 3½ per cent during 2012. Given future spending pressures, fiscal policy should target a balanced budget (excluding the social security surplus). However, if the global economy were to experience a serious downturn, Korea has scope to respond with fiscal stimulus, given its strong fiscal position, and monetary policy easing. Looking further ahead, Korea faces two key challenges:

- *Sustaining economic growth in the face of rapid population ageing.*
- *Improving social cohesion by reducing inequality and relative poverty.*

Sustaining Korea's growth potential. *To mitigate the fall in labour inputs as the working-age population starts declining from 2017, Korea needs to raise labour participation. The low female participation rate should be boosted by encouraging better work-life balance and expanding the availability of high-quality, affordable childcare. Such measures would also increase the low fertility rate. Another priority is to extend the employment of older workers, who tend to leave firms by age 55, by introducing more flexible wage systems and moving away from mandatory retirement. Rising social spending, related in part to ageing, should be financed primarily by the VAT and environmental taxes, as well as by property-holding taxes, thereby limiting the increase in labour taxes and maintaining work incentives.*

Sustaining growth also requires boosting productivity, which is only half of the level in the advanced OECD countries, in part by improving the education system. One priority is to upgrade early childhood education and care (ECEC). Korea needs to address the overemphasis on tertiary education, in part by improving vocational education, to reduce the mismatch problem that limits labour participation of youth. The tertiary education sector needs restructuring to improve quality. The scope for productivity gains is especially large in services, where productivity per worker is only about half of that in manufacturing. Narrowing the gap requires greater competition in services and promoting the restructuring of small and medium-sized enterprises (SMEs), which play a key role in services, by removing obstacles inhibiting their expansion and streamlining public assistance to them.

Growth prospects depend as well on the success of the Green Growth Strategy in transforming Korea's energy-intensive economy and implementing the "Low Carbon, Green Growth" vision. The priority is to promptly introduce a price on carbon, primarily through an emissions trading scheme, supplemented by a carbon tax on small emitters. This would encourage green innovation and help achieve Korea's 2020 objective of reducing its greenhouse gas emissions by 30%, relative to a business-as-usual baseline, in a cost-effective manner.

Improving social cohesion. *Well-targeted increases in social spending, in particular for low-income groups, are needed. However, to preserve fiscal soundness, Korea should be cautious, given that population ageing alone would boost social spending to as high as 20% of GDP by 2050 under the current framework. Expanding the earned income tax credit would provide more assistance for low-income households, while encouraging work. Filling the gaps in the safety net requires breaking* *down labour market dualism, itself a major source of inequality, as non-regular workers face significantly lower wages, precarious jobs, less coverage by social security and less training. A comprehensive approach is required, including reduced employment protection for regular workers and improved social insurance coverage and expanded training for non-regular workers. Higher productivity in SMEs would also help narrow wage gaps.*

Education reforms are also needed to promote inclusive growth, notably by: i) improving the access of low-income children to high-quality ECEC; ii) reducing reliance on private tutoring, notably at hagwons, by improving university admission procedures, expanding the quality and diversity of schools and upgrading vocational education; and iii) expanding loans to university students with repayment contingent on income after graduation.

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