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OECD Economic Surveys: Korea

Chapter 1

Facing the key challenges ahead in Korea

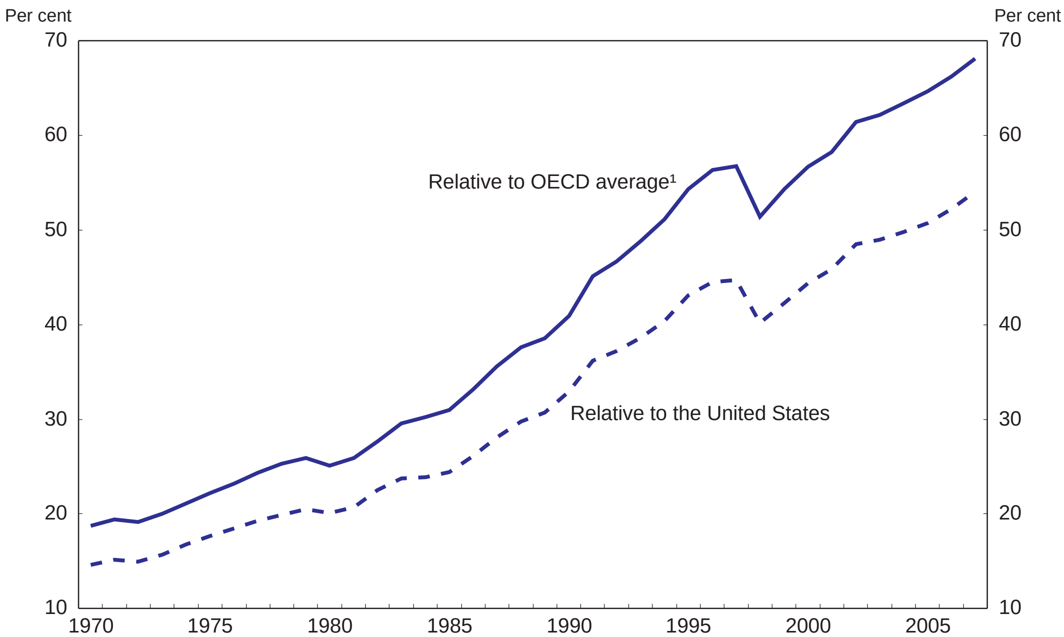
Korea has been adversely affected by soaring oil and commodity prices, which led to a spike in inflation and slowed the pace of economic activity. Moreover, the global financial crisis accelerated the depreciation of the won and clouded the economic outlook. Output growth is likely to remain subdued until the world economy improves, which may not happen until well into 2009. Korea faces a number of challenges, both in the short and long run. This chapter looks at four key challenges: i) *setting an appropriate macroeconomic policy to cope with the severe external shocks;* ii) *raising additional tax revenue as rapid population ageing puts upward pressure on public spending;* iii) *promoting the development of services, where productivity growth and levels lag significantly behind manufacturing; and* iv) *reforming the labour market and the education system to address the growth and equity problems related to labour market dualism and population ageing.*

With output growth at an annual rate of 4.4% between 2002 and 2007, Korea's per capita income has risen to two-thirds of the OECD average (Figure 1.1). While Korea remains one of the fastest-growing economies in the OECD area, the performance over the past five years was a marked slowdown from the 6.4% rate during the period 1999 to 2002 (Table 1.1). In terms of the composition of growth, the external sector accounted for nearly one-half between 2002 and 2007, while domestic demand was relatively subdued. The combination of buoyant exports and sluggish domestic demand has exacerbated a number of imbalances in the economy; *i)* export-led growth has primarily benefited the manufacturing sector, thereby widening the productivity gap with services; *ii)* the gap between large companies and small and medium-sized enterprises (SMEs), which are predominant in services, has also widened; and *iii)* labour market dualism has become more entrenched, with the share of non-regular workers rising to more than a third, leading to higher income inequality and relative poverty.

The government that took office in February 2008 is committed to raising potential growth through "business-friendly policies", thereby accelerating the doubling of per

Figure 1.1. **Korea's per capita income is converging to the OECD average**

Gross domestic product per capita in 2007 purchasing power party exchange rates



1. The OECD average is based on 26 countries (excluding the Slovak Republic, Poland, Czech Republic and Hungary) from 1970 to 1990, 29 countries (excluding the Slovak Republic) from 1991 to 1992 and all 30 countries from 1993.

Source: OECD Economic Outlook Database.

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Table 1.1. **Economic growth trends in Korea**

	Average annual growth rates		Contribution to growth	
	1999-2002	2002-07	1999-2002	2002-07
Private consumption	7.1	2.2	3.8	1.1
Government consumption	4.1	4.9	0.5	0.6
Residential investment	4.5	2.0	0.2	0.1
Business investment	6.8	4.1	1.4	0.8
Public investment	4.4	0.4	0.2	0.0
Gross fixed capital formation	6.1	3.2	1.8	0.9
Final domestic demand	6.4	2.8	6.2	2.7
Stockbuilding	–	–	0.0	–0.2
Total domestic demand	6.4	2.7	6.2	2.5
Exports	9.5	13.5	0.1[1]	1.9[1]
Imports	9.8	10.9		
GDP	6.4	4.4	6.4	4.4

1. Contribution of net exports.
Source: Bank of Korea.

capita income from its current level of $20 000 (at market exchange rates) to $40 000.[1] However, short-term growth prospects have been dimmed by the oil shock and the global financial crisis, while rising inflation, slowing employment growth and high household debt have undermined consumer confidence. This chapter first discusses the economic outlook through 2010 and then examines Korea's growth potential over the longer term, taking into account expected demographic changes. The following sections outline the key challenges facing Korea – macroeconomic policy, tax reform, enhancing productivity in the service sector and reforming the labour market and education system.

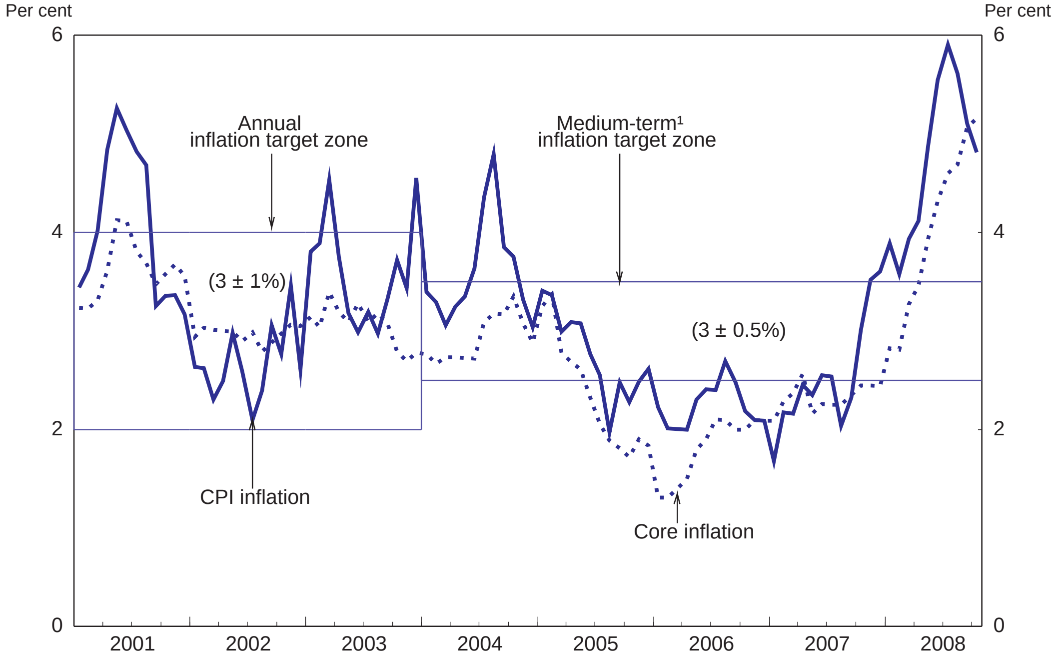
The current economic situation and outlook

The pace of output growth slowed markedly from 6.4% during the latter half of 2007 to 3% in the first three quarters of 2008 at a seasonally-adjusted annual rate, indicating that the economy had slowed markedly even before the global financial crisis intensified in mid-September. The main factor was the terms-of-trade shock, which resulted in a spike in consumer price inflation, the first time since the introduction of inflation targeting in 1998 that inflation has significantly surpassed the target zone, which has been set at 2.5% to 3.5% since 2004 (Figure 1.2). In October 2008, headline consumer prices were up 4.8% (year-on-year), and core prices by 5.2%, pointing to second-round effects from higher import prices. In contrast, core inflation in the OECD area as a whole has not accelerated from a rate close to 2% despite a pick-up in headline inflation similar to that in Korea. The oil price hike also put the current account on track for a deficit in 2008 for the first time since the 1997 crisis (Figure 1.3). The deficit, combined with net outflows of both direct and portfolio investment, has increased downward pressure on the won, further intensifying inflationary pressures. Moreover, with the intensification of the global financial crisis in September 2008, won depreciation quickened. By the end of November, the effective exchange rate was down 36% compared with the beginning of the year.

Higher inflation has squeezed household income, thus damping private consumption. Indeed, national income in real terms declined by 1% in the first half of 2008 (Figure 1.3, Panel B). Although wage growth for regular workers picked up to 7.5% in nominal terms in the second quarter of 2008, it has slowed in real terms. At the same time, employment growth has decelerated in 2008, further constraining household income. Weaker income

Figure 1.2. **Inflation targets and outcomes**

Year-on-year percentage changes



1. Since 2004, the target has been a medium-term objective and, in 2007, it was changed from core to overall CPI.

Source: Bank of Korea.

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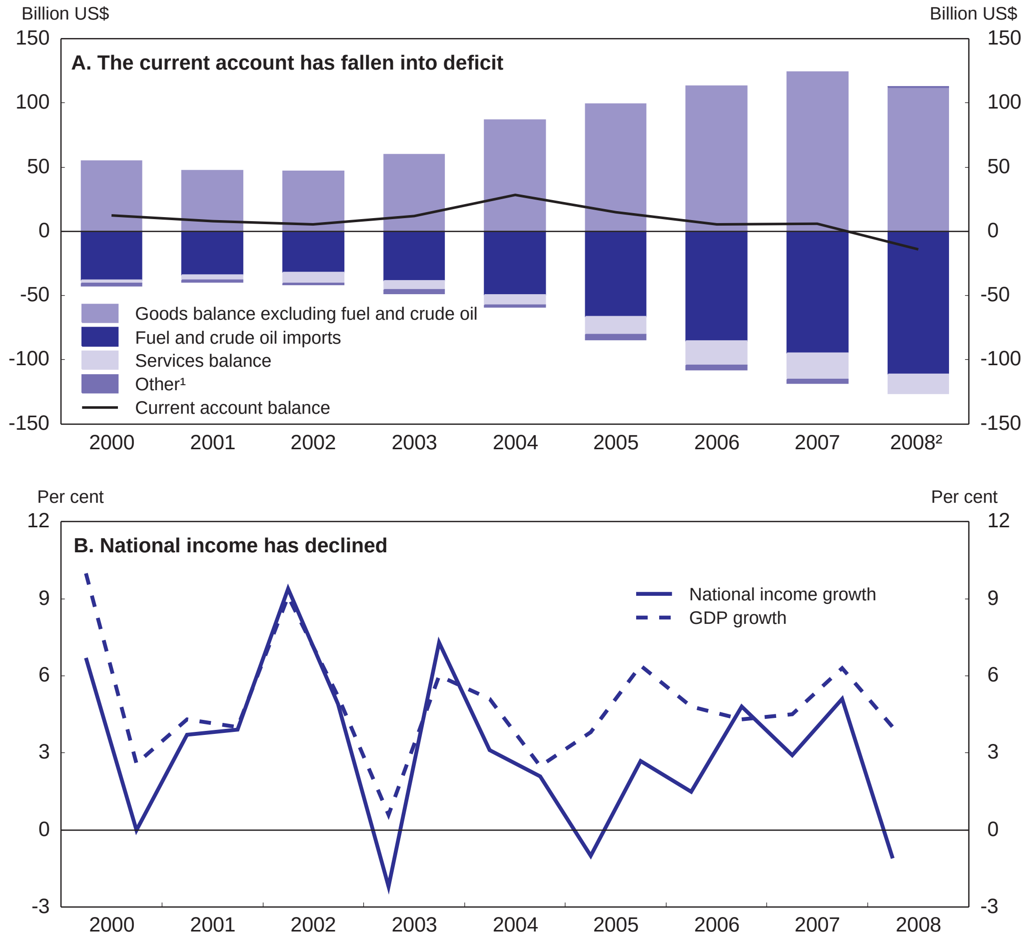
growth, combined with negative wealth effects from the declining stock market, in part due to net capital outflows, and a steep drop in consumer confidence (Figure 1.4), slowed private consumption growth to a 0.5% annual rate in the first three quarters of 2008.

The terms-of-trade shock also squeezed corporate profits. Combined with a marked decline in business confidence (Figure 1.4, Panel B) and a deceleration of exports, this slowed fixed investment growth to less than 0.5% at an annual rate during the first three quarters of 2008. Residential investment has also been a drag on output, reflecting the impact of past government housing policies. During 2005-07, the authorities introduced five policy packages, which imposed price ceilings on new apartments, reduced the price of publicly-built housing, raised taxes on capital gains and property holding and limited bank lending for mortgages (*OECD Economic Surveys: Korea*, 2007). While real estate prices have been stable, residential construction has declined 9% in volume terms since the first quarter of 2007, and the stock of unsold homes has reached a record high. Moreover, in the first half of 2008, the area of new housing starts fell more than 50% from a year earlier. In sum, the weakness in private consumption and residential and business-sector investment slowed domestic demand growth to around 1% in the first three quarters of 2008.

The slowdown in world trade led to a moderation in Korean export growth to 3% in the first three quarters of 2008. Exports were sustained by strong demand from China and ASEAN – which account for nearly one-half of Korea's total – with growth of 34% (in value terms, year-on-year) and the Middle East. In contrast, exports to the OECD area were subdued. At the same time, import growth was close to zero, thereby maintaining the positive contribution from net exports to economic growth.

Figure 1.3. **The terms-of-trade shock in Korea**



1. Investment income and transfers.
2. Through September.

Source: Bank of Korea and OECD *Economic Outlook Database*.

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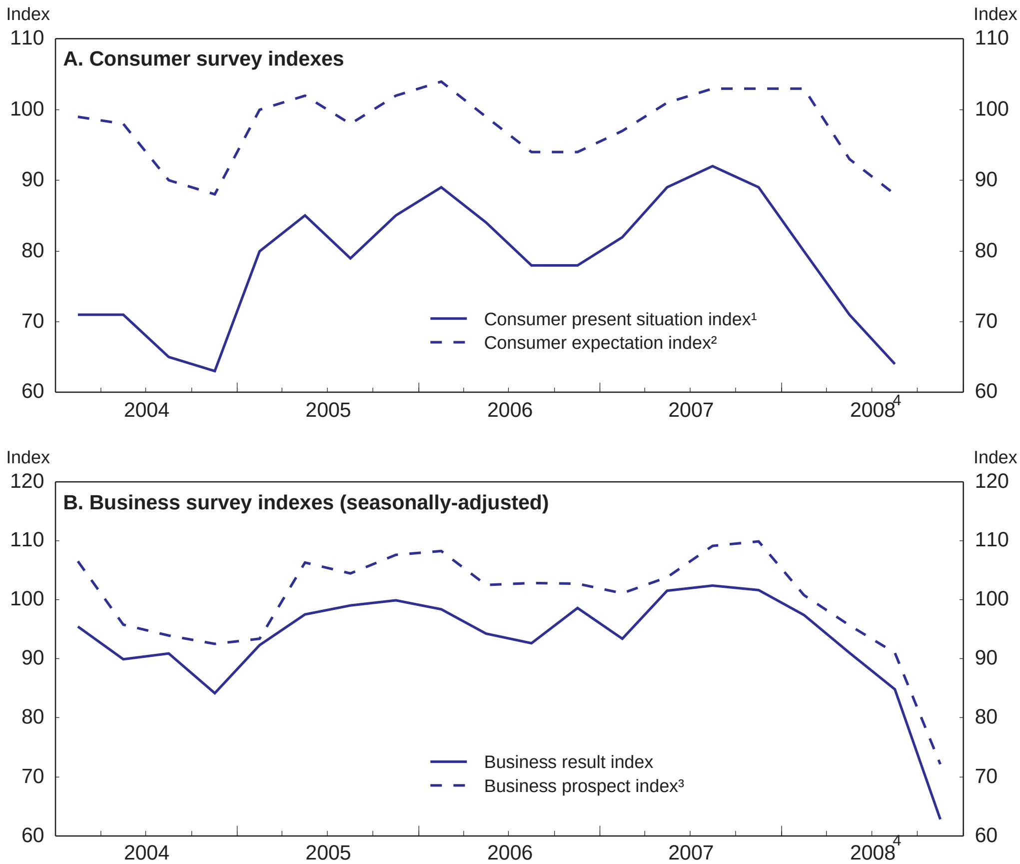
Prospects through 2010

The global financial crisis is sharply depressing activity as the large depreciation of the won squeezes income and undermines confidence, and as credit conditions tighten and losses from hedging contracts mount. As a result, GDP growth may fall below 3% in 2009 (Table 1.2), despite some fiscal stimulus. Tax rebates in the fourth quarter of 2008 will boost household disposable income by about 0.4% of GDP, which is likely to support private consumption even though some of the additional income may be saved in the context of weak confidence, high household debt and the low household saving rate. In addition, the September 2008 supplementary budget includes additional spending of 0.5% of GDP. Cuts in personal and corporate income tax rates beginning in 2009 will also cushion the downturn in domestic demand. Moreover, in November 2008, the government announced a package of measures to overcome the economic downturn (see Box 1.1). Nevertheless, output growth is likely to remain subdued during the global crisis, helping to

Figure 1.4. **Consumer and business confidence has declined significantly**



1. A score below 100 indicates that the current situation is worse than that six months ago.
2. A score below 100 indicates that a deterioration is expected over the next six months.
3. A score below 100 indicates that a decline in production is expected during the following month.
4. For the consumer surveys, the third quarter of 2008 is the average of July and August. For the business surveys, the prospect index for the fourth quarter of 2008 is the average of October and November and the business result index is October.

Source: Bank of Korea and Federation of Korean Industries.

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bring inflation back to the target zone during 2009 and pushing the current account balance back into surplus.

Growth is projected to pick up to slightly above 4% in 2010. Assuming that the won remains at its current level, Korea would be well-placed to expand its share of world trade as the global economy rebounds. A projected return to double-digit export growth in 2010 would make for a gradual pick-up in investment and household income. In addition, the recent measures to boost the housing market, by reducing taxes on capital gains and property holding, may end the decline in residential investment.

However, the economic outlook is highly uncertain given the severity of the shocks to Korea and the problems facing the world economy. Although the large depreciation of the won may lead to a sharper and earlier-than-expected upturn led by buoyant exports, most of the risks to this outlook are on the downside. Continued world financial stress may undermine the health of Korean financial institutions, resulting in a credit crunch in the corporate sector.

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Table 1.2. **Short-term economic outlook for Korea**[1]

Percentage changes, volume (2000 prices)

	2005	2006	2007	2008	2009	2010
Private consumption	3.6	4.5	4.5	1.7	–1.1	0.4
Government consumption	5.0	6.2	5.8	3.8	3.8	3.7
Gross fixed capital formation	2.4	3.6	4.0	0.6	0.2	1.1
Final domestic demand	3.4	4.4	4.5	1.7	0.0	1.1
Stockbuilding[2]	–0.2	–0.2	–0.4	0.5	0.0	0.0
Total domestic demand	3.2	4.2	4.1	2.3	0.0	1.1
Exports of goods and services	8.5	11.8	12.1	9.1	6.4	11.3
Imports of goods and services	7.3	11.3	11.9	6.8	2.7	8.3
Net exports[2]	1.3	1.3	1.3	2.1	2.7	3.2
GDP at market prices	4.2	5.1	5.0	4.2	2.7	4.2
Memorandum items						
Consumer price index	2.8	2.2	2.5	5.0	3.9	2.9
Core consumer price index	2.3	1.8	2.4	4.3	4.2	3.0
Unemployment rate	3.7	3.5	3.2	3.2	3.6	3.6
Household saving ratio[3]	4.7	3.4	2.5	3.7	4.2	4.7
Current account balance[4]	1.9	0.6	0.6	–1.1	0.8	1.0
Exchange rate (won per dollar)	1 024	952	929	1 091	1468	1468
Export market growth[5]	9.9	10.0	7.8	5.3	3.9	6.9

1. OECD projections published in *Economic Outlook* No. 84 in November 2008, based on exchange rates of 28 October. This projection was finalised on 31 October 2008, and thus does not include the fiscal stimulus package and other measures announced in Korea in November 2008 (Box 1.1).
2. Contributions to changes in real GDP (percentage of real GDP in previous year).
3. As a percentage of disposable income.
4. As a percentage of GDP.
5. Weighted import growth in volume terms in Korea's trading partners.

Source: *OECD Economic Outlook Database* and Bank of Korea.

Box 1.1. **Measures announced in November 2008 to overcome the economic downturn**

The Korean authorities have responded to the financial crisis and the economic slowdown with a broad range of policy measures, including macroeconomic stimulus and regulatory reform.

Fiscal policy

The government announced a 14 trillion won (1.4% of GDP) fiscal package, which includes 11 trillion won of additional public expenditure in 2009. The biggest increase in spending will be for public infrastructure (4.6 trillion won), with about 90% allocated to help regional economies. The expenditure package also contains 3.4 trillion won for SMEs, farmers and fishermen, 1.1 trillion won for local governments and 1 trillion won for low-income households. In addition, public enterprises will expand their investment by 1 trillion won. The package also provides 3 trillion won in tax reductions by extending the Temporary Investment Tax Credit until the end of 2009. The fiscal stimulus measures will be submitted to the National Assembly by the end of 2008.

Monetary policy

The Monetary Policy Committee of the Bank of Korea reduced its policy interest rate by 25 basis points, from 4.25% to 4%, on 7 November, the third cut in a period of one month. As a result, the policy rate has fallen by 125 basis points from its level at the beginning of October (see Chapter 2). The cuts are aimed at preventing "a sharp contraction of real economic activity against the backdrop of large swings in the exchange rate and stock prices" and a domestic credit crunch. The central bank also intends to provide additional liquidity to financial institutions through open market operations, which will be broadened to include bank bonds and certain public corporation bonds, including the Korea Housing Corporation.

Box 1.1. **Measures announced in November 2008 to overcome the economic downturn** *(cont.)*

Policies to revitalise specific sectors

Some of the restrictions imposed on real estate in recent years will be eased. In particular, regulations on the reconstruction of apartment buildings will be relaxed and the number of "speculation zones" will be sharply reduced. At present, there are 92 such zones covering 37% of Korea's regional districts. Housing purchases in the zones are strictly monitored by the government and the loan-to-value ratio on bank lending for housing is subject to a 40% ceiling. The government will also provide tax benefits for the purchase of homes outside metropolitan areas, ease capital gains taxes and provide additional liquidity to construction companies. As part of its effort to improve the current account balance, the authorities will strengthen policies to promote exports, in particular by expanding the limit on export insurance. The government is also planning a number of initiatives to ease the financial distress of SMEs (see Chapter 4).

Regulatory reform

The government has announced a number of policy changes intended to promote investment and employment:

- The government has announced a comprehensive plan to ease regulations on building and expanding industrial complexes in the capital region.
- Environmental regulations "deemed excessive compared to those of competing countries will be reviewed and streamlined".
- The government will also make efforts to enhance labour market flexibility, in part by improving the system for temporary and dispatched workers (see Chapter 5).
- The government "plans to encourage new investments and facilitate job creation through service sector regulatory reform" (see Chapter 4).

There is also a risk that high inflation will become entrenched, eventually requiring forceful and costly monetary policy tightening to bring it back within the target zone.

Another risk is related to household debt, which has risen to 158% of disposable income (Figure 1.5), above the US level (142%) and close to that in the United Kingdom (185%). Rising debt reflects a number of factors, including falling real interest rates on loans to households and the expanded use of credit cards. In addition, the decline in borrowing by large firms as they reduced debt levels following the 1997 crisis prompted banks to expand lending to households, as well as to SMEs. Household interest payments climbed from 6% of disposable income in 2004 to 9% in 2007, despite declining interest rates. Most debt is at variable rates, shifting risk from financial institutions to households. The high leveraging of the household sector makes it more vulnerable to the global credit crunch. However, the risk of a sharp downturn in private consumption is mitigated by the increase in household financial assets in line with debt. In addition, the high level of bank capitalisation and low level of non-performing loans suggest that banks are well-prepared for some increase in bad loans from the household sector.[2] Moreover, mortgages account for only 40% of household liabilities, compared to the US and UK shares of around 75%, making Korean households and banks less vulnerable to a decline in housing prices. Nevertheless, the high level of debt poses a downside risk as it could affect private consumption. In addition, business investment could weaken as the high level of household debt is partly related to business-related borrowing by the self-employed.[3]

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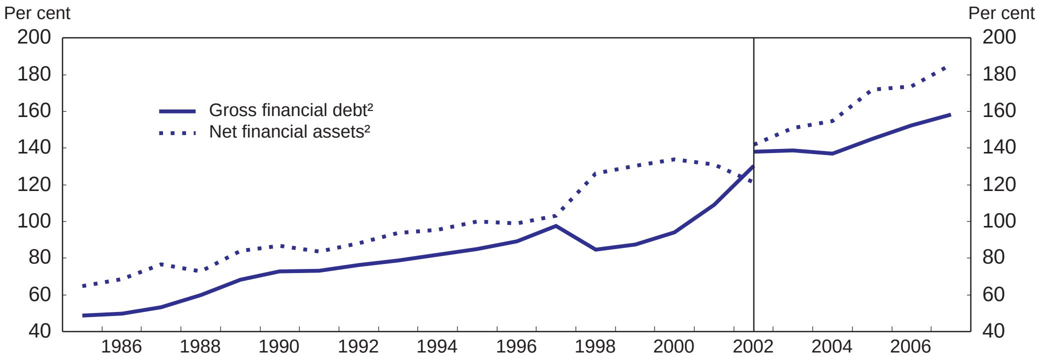
Figure 1.5. **Household financial assets and liabilities**

As a per cent of household disposable income[1]



1. For the "Individual Sector" in the Bank of Korea's flow of funds data.
2. Based on SNA68 until 2002 and SNA93 thereafter.

Source: Bank of Korea and *OECD Economic Outlook Database*.

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Korea's growth prospects over the longer term

Labour inputs in Korea are very high, at 20% above the US level (Figure 1.6). In contrast, labour productivity per hour worked is only 34% of the US level, suggesting significant scope for continued productivity gains. Indeed, the OECD projects that potential labour productivity growth will increase 3½ per cent a year through 2014, well above the OECD average of 1½ per cent (Table 1.3). The slowing growth of the working-age population, however, is projected to reduce Korea's potential growth from 4¾ per cent over the period 2005 to 2009 to 4¼ per cent between 2010 and 2014. Looking further ahead, the working-age population will begin to shrink from 2018, further pushing down output growth.

Table 1.3. **Potential output growth**

Annual averages, percentage points

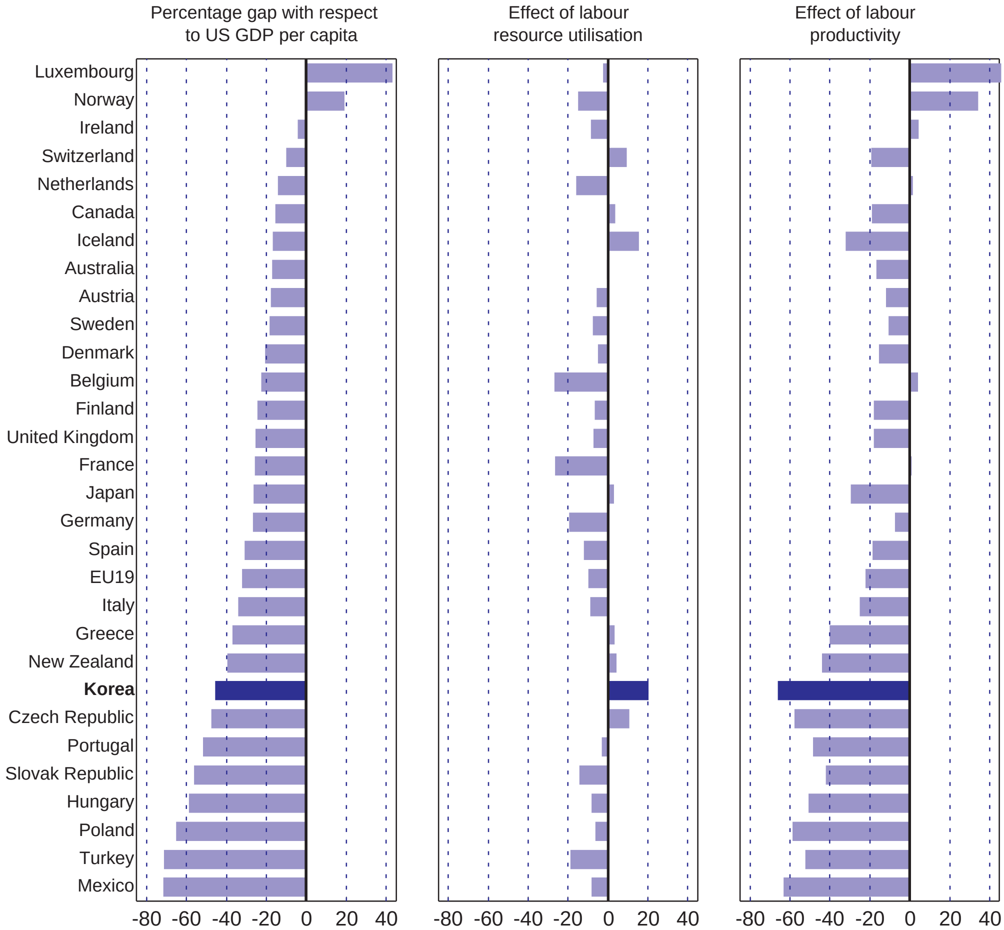
	Potential GDP growth		Potential labour productivity growth[1]		Potential employment growth	
	2005-09	2010-14	2005-09	2010-14	2005-09	2010-14
Australia	3.2	2.8	1.1	1.4	2.0	1.4
Canada	2.8	2.0	1.2	1.4	1.6	0.6
Japan	1.5	1.2	1.9	1.9	–0.3	–0.7
New Zealand	2.7	2.2	1.0	1.4	1.7	0.7
United Kingdom	2.7	2.1	1.8	1.9	0.9	0.3
United States	2.5	2.1	1.8	1.7	0.7	0.4
Euro area	2.0	1.7	1.1	1.3	0.9	0.4
Korea	**4.7**	**4.3**	**3.5**	**3.7**	**1.2**	**0.6**
OECD total[2]	2.3	1.9	1.5	1.6	0.7	0.3

1. Output per employee.
2. Excluding Czech Republic, Hungary, Luxembourg, Mexico, Poland, Slovak Republic and Turkey.

Source: OECD, *Economic Outlook 83* (June 2008), OECD, Paris.

Figure 1.6. **Explaining differences in income**

Percentage point differences in GDP per person in USD (PPPs) relative to the United States in 2007[1]



1. The gap in GDP per capita is equal to the sum of the two components shown. The effect of labour utilisation is based on total hours worked per capita. Productivity is measured on a per-hour basis.

Source: OECD (2009), *Going for growth*, OECD, Paris.

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Rapid population ageing in Korea

Korea's population is projected to peak at 50 million in 2020 and then decline about 15% by 2050 (Table 1.4). The share of Korea's total population over the age of 65 is expected to double from 7% in 2000 to 14% by 2018, a transition that is likely to take at least 40 years in European countries, and to reach 20% by 2026 (Table 1.5). The rise in the elderly dependency ratio between 2007 and mid-century will be the highest in the OECD area, boosting it from the third lowest to the fourth highest (Figure 1.7). Population ageing is driven by the increase in life expectancy by 21 years, from 55.3 in 1960 to 75.9 in 2000 (Table 1.4), the largest in the OECD area. A second factor is the fall in the fertility rate from six in 1960 to 1.1 in 2005, before edging up to 1.3 in 2007. The low rate can partly be ascribed to heightened economic uncertainty since the 1997 financial crisis. Fearing that the fall in the fertility rate will have negative consequences in the long term, the government set an objective of raising it to the OECD average of 1.6.

Table 1.4. **Population indicators and projections for Korea**[1]

	Population (in millions)	Growth rate (Per cent)[2]	Fertility rate[3]	Life expectancy (in years)	Median age (in years)	Share of elderly[4] (Per cent)
1960	25.0	2.3	6.0	55.3	19.9	2.9
1970	31.5	1.8	4.5	63.2	19.0	3.1
1980	37.4	1.5	2.7	65.8	22.2	3.8
1990	43.4	0.6	1.6	71.3	27.0	5.1
2000	46.1	0.6	1.5	75.9	31.8	7.3
2010	49.2	0.1	1.2	79.1	37.9	10.9
2020	50.0	–0.1	1.2	81.0	43.7	15.7
2030	49.3	–0.5	1.3	81.9	49.0	24.1
2040	46.7	–1.0	1.3	82.6	53.1	32.0
2050	42.3	..	1.3	83.3	56.2	37.3

1. Projections by the Korea National Statistical Office for the period 2005 to 2050.
2. The annual average growth rate for the decade. The figure in 1960, for example, shows the rate for the decade 1960 to 1970.
3. The average number of children that a woman can expect to bear during her lifetime.
4. The number of persons over the age of 65 as a percentage of the total population.

Source: Korea National Statistical Office.

As a result of these demographic changes, the labour force is projected to peak in 2020 and then fall to 18 million – 24% below its current level – by 2050 if participation rates for each age group were to remain at their current levels (Figure 1.8). In contrast, if the rate for women were to increase to the same level as for men by mid-century, the labour force would fall by only 9%. Moreover, the 24% decline could be limited to 18% if the participation rate for the 50-to-64 age group were to increase to the maximum level recorded in the OECD area in 2000. On the other hand, the labour force would decline 36% from its current level if the participation rate for older workers were to decrease to the OECD average. Immigration, which was discussed in detail in the 2007 *OECD Economic Surveys: Korea*, is another important means of coping with population ageing.

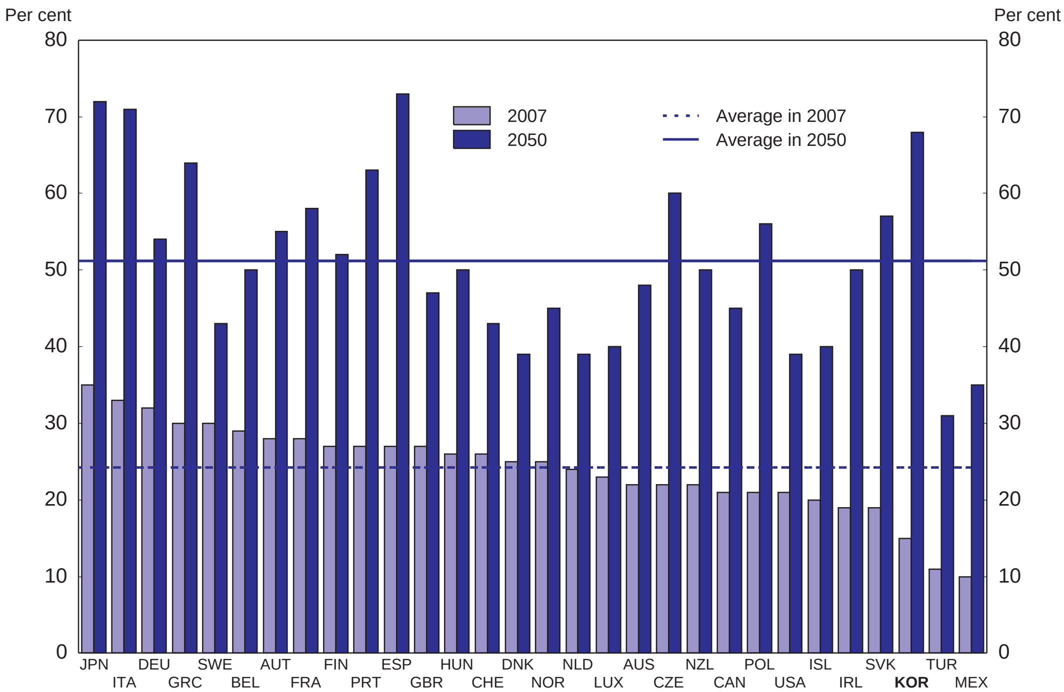
Table 1.5. **Speed of ageing in selected OECD countries**

	Year when the share of elderly (over 65) makes up:			Years elapsed	
Country	7% of population	14% of population	20% of population	7 to 14%	14 to 20%
Korea	**2000**	**2018**	**2026**	**18**	**8**
Japan	1970	1994	2006	24	12
Germany	1932	1972	2012	40	40
United Kingdom	1929	1976	2021	47	45
Italy	1927	1988	2007	61	19
United States	1942	2013	2028	71	15
Sweden	1887	1972	2012	85	40
France	1864	1979	2020	115	41

Source: United Nations.

Figure 1.7. **Population ageing in OECD countries**

Population aged 65 and over, relative to the population aged 20-64



Source: OECD (2006), *Society at a Glance: OECD Social Indicators*, OECD, Paris.

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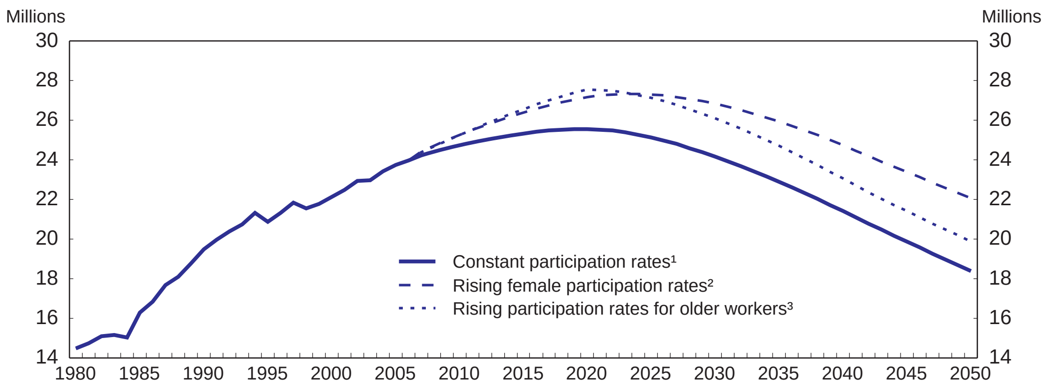
Figure 1.8. **Long-term projections of the labour force**



1. The participation rates for men and women remain at their current levels for each age group.
2. Female participation rates reach current male rates in each age group by 2050.
3. The participation rates converge by 2030 to the maximum value in the OECD for each gender and age group over 50, while the rates for younger workers remain at their current levels.

Source: OECD calculations based on population projections by the Korea National Statistical Office.

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Key challenges to sustaining rapid growth

Korea faces a number of challenges, which are addressed in the following chapters, to sustain its high growth potential:

- In the short run, Korea faces difficult macroeconomic policy choices in the context of the global financial crisis and the sharp depreciation of the won (Chapter 2).
- Rapid ageing and the development of the social insurance system will put long-term upward pressure on public spending, creating a need for greater tax revenues. Reforming the tax system to promote growth while expanding its revenue-generating capacity is thus a priority (Chapter 3).
- The level and growth of productivity in the service sector lags significantly behind manufacturing. Sustaining high output growth requires measures to boost productivity in services, given that they account for three-fifths of the economy (Chapter 4).
- The high share of non-regular workers creates both efficiency and equity concerns. In addition, raising the participation rate is essential to mitigate the impact of population ageing. In particular, the low youth employment rate points to the need for education reform (Chapter 5).

Implementing appropriate macroeconomic policies

Faced with inflation well above the target zone, Korea hiked the policy interest rate in August 2008. This was reversed beginning in October in the context of cuts in many countries troubled by the financial crisis. 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. However, they remain significantly above Korea's short-term foreign debt, which has soared from $65 billion at the end of 2005 to $189 billion (21% of GDP) in September 2008. Around 45% of this debt belonged to the local branches of foreign banks. The won continued to depreciate, falling by 26% in trade-weighted terms between early July and the end of November.

On the fiscal side, the September 2008 stimulus package amounted to almost 1% of GDP. Still, it does not threaten Korea's strong public finance position, based on one of the lowest levels of government spending in the OECD, a sizeable general government budget surplus and low public debt. Moreover, Korea is one of three OECD countries in which the government is a net creditor, with net financial assets amounting to a quarter of GDP. Nevertheless, the consolidated central government budget, excluding the social security surplus, is projected to record a deficit of around 1½ per cent of GDP in 2008. Moreover, the reductions in tax revenue resulting from the planned cuts in personal and corporate income tax rates are expected to lower revenue by 2% of GDP by 2012. Maintaining a sound government financial position by balancing the central government budget (excluding social security) is essential in light of future spending pressures related to population ageing and the potential cost of economic integration with North Korea.

Improving the tax system to promote economic growth and cope with population ageing

While government outlays and tax revenue are low as a share of GDP, the rising spending pressures noted above create a need for higher taxes. Reform should address a number of challenges:

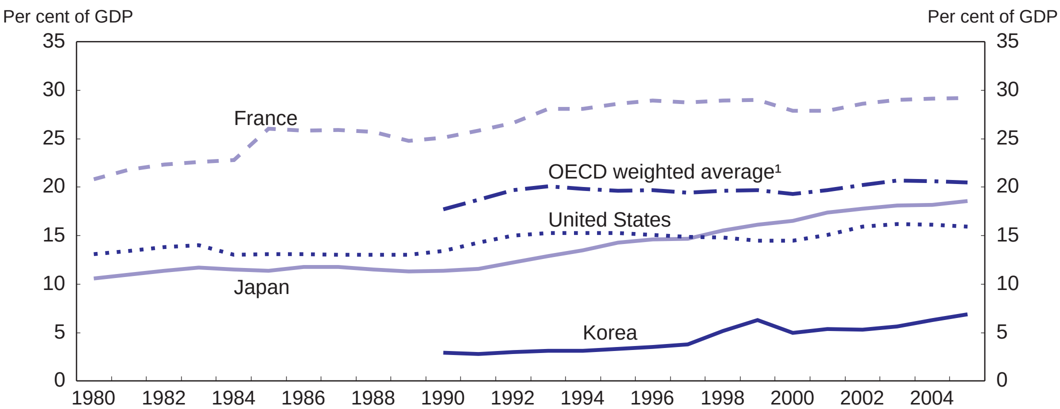
Supporting economic growth in the context of rapid population ageing and globalisation

A number of studies, including by the OECD, suggest that raising the overall tax burden can reduce growth.[4] In addition, the structure of the tax system determines its effect on economic choices and the size of its burden on the economy. In particular, a high tax wedge on labour can price low-skilled persons out of employment, thus reducing labour inputs and discouraging human capital formation, thereby slowing technological progress. Similarly, firms have become more sensitive to cross-country variations in the corporate tax system in the context of globalisation and heightened competition. High tax rates on corporate income make a country less attractive as a location for investment and for reporting profits.

Meeting the long-term need for additional revenue

The small government in Korea reflects limited public social spending, which at 7% of GDP is the lowest in the OECD area (Figure 1.9). This is due to the relatively recent launch of a social safety net and Korea's comparatively young population. However, population ageing will put upward spending pressure on the National Pension Scheme, National Health Insurance and Long-Term Care Insurance. According to OECD simulations, Korea's public spending on health and long-term care might rise by 6 to 9 percentage points of GDP by 2050, the largest increase in the OECD area (Oliveira Martins and de la Maisonneuve, 2006), while pension outlays could add another 8 percentage points or more.[5] In addition, the cost of greater economic co-operation with North Korea may also call for more revenue. Economic deterioration and chronic food shortages in the North during the past decade suggest that the cost of integration may be enormous. Indeed, it is likely to be far heavier than in the case of Germany, given that the population of North Korea is half that of the South, while its per capita income is only about 6% as large.[6] Early action on the revenue side would limit the long-term cost from the higher fiscal burden.[7]

Figure 1.9. **Public social spending in Korea remains low relative to other OECD countries**



1. The OECD average does not include Hungary and the Slovak Republic for lack of data. The national data are converted to US dollars using 2005 PPP exchange rates.

Source: OECD Social Expenditure Database.

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Coping with widening income inequality and rising relative poverty

Korea has experienced a significant rise in income inequality since the 1997 crisis. The ratio of the top income quintile to the bottom one rose from 4.1 in 1997 to 5.7 by 2006 and the Gini coefficient has been trending up (Table 1.6). The increase in income equality since 1997 is related to the expanding share of non-regular workers, who are paid about 30% less than regular workers, to more than one-third of employment (see below).

Table 1.6. **Income inequality in Korea has trended up**

For urban salary and wage-earner households[1]

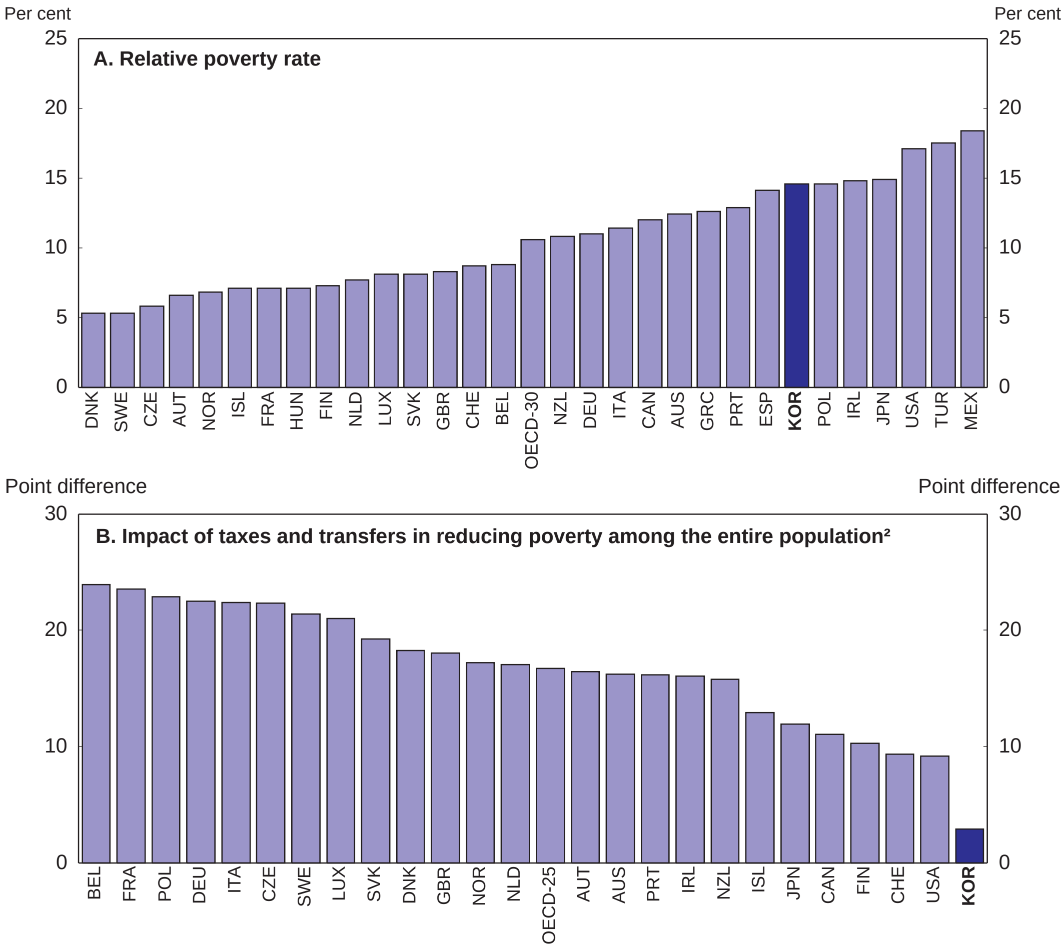
	Gini coefficient[2]	Quintile ratio[3]
1990	27.4	4.1
1995	26.8	4.1
1996	27.2	4.2
1997	26.8	4.1
1998	29.5	4.9
1999	30.3	5.1
2000	28.6	4.6
2001	29.9	4.9
2002	29.8	4.9
2003	29.5 (30.4)	5.1 (5.5)
2004	30.1 (31.0)	5.2 (5.6)
2005	30.4 (31.3)	5.4 (5.8)
2006	31.3 (32.0)	5.7 (6.1)

1. Data for the entire population, available since 2003, are shown in parentheses.
2. The Gini coefficient is defined as the area between the Lorenz curve (which plots cumulative shares of the population, from richest to poorest, against the cumulative share of income that they receive) and the 45-degree line, taken as a ratio of the whole triangle. The values, which range from 0 in the case of perfect equality to 1 in the case of perfect inequality, are multiplied by 100 to give a range of 0 to 100.
3. The ratio of the top to the bottom quintile.

Source: Korea National Statistical Office.

Rising inequality has contributed to an increase in the rate of relative poverty to 14.6% in the mid-2000s, the sixth highest in the OECD area and well above the OECD average of 10.6% (Figure 1.10).[8] As in other countries, population ageing and changes in household structure – more single-person and female-headed households – have played a role. However, increased poverty among families headed by a couple accounted for most of the rise, suggesting that higher income inequality was the key factor. High relative poverty also reflects the weak impact of the public sector: the tax and social welfare systems reduced the relative poverty rate only slightly in Korea, from 17.5% to 14.6% in the mid-2000s (Panel B). In contrast, the average reduction in the OECD area was 16 percentage points. This suggests a need to use the tax system, together with a further rise in social welfare spending, which has quadrupled in absolute terms since 2000, to reverse these trends. However, strengthening the redistributive function of the tax system needs to be weighed against any negative impact on work incentives, which would reduce potential growth. The challenge is to devise a tax reform that addresses income inequality while minimising the negative impact on growth.

Figure 1.10. **International comparison of relative poverty**[1]



1. Poverty rates are defined as the share of individuals with equivalised disposable income below 50% of the median for the entire population.
2. In percentage points. In Korea, taxes and transfers reduced the relative poverty rate from 17.5% to 14.6%.

Source: OECD (2008b).

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Improving the local tax system

Local governments account for about a third of government expenditure, and local educational governments, which are independent of local governments, account for another 15%. Despite their size, local autonomy is limited, reflecting the legacy of centralised control. The functions of central and local governments are not clearly defined by law and many policy decisions are made at the central level (KRILA, 2007). With tax and non-tax revenues covering only half of their outlays, local governments rely heavily on transfers from the central government. The Local Share Tax, a general grant set at 19.2% of national "internal tax" revenue (excluding earmarked taxes and customs duties), funds about one-fifth of local expenditure and earmarked grants account for another fifth. The detailed conditions attached to earmarked grants give the central government effective control over a wide array of local policies.

Aligning revenues with spending responsibilities would allow local governments to better respond to the preferences of local citizens and help ensure fiscal discipline by making the cost of local services more visible for local taxpayers. Increasing local autonomy, however, is complicated by wide regional variation in the financial autonomy of local jurisdictions. While Seoul is virtually self-financing, 12% of local governments cannot even fund the salaries of local officials from their own revenues. Reforms that increase local autonomy would therefore tend to boost regional inequality unless they were accompanied by a re-allocation of central government transfers, which would limit local government autonomy. A major challenge, therefore, is to provide local governments with sufficient revenue-raising autonomy to make them accountable to local citizens and encourage fiscal discipline, while ensuring that all have sufficient revenue capacity to provide at least a minimum level of core public services.

The complicated local tax system, which accounts for about 20% of total tax revenue, encompasses 16 local taxes, thus compounding compliance and administrative costs. This contrasts with much leaner local tax systems in the Nordic countries for example – at most four local taxes in Finland, Iceland, Norway and Sweden. The local tax system has a number of other weaknesses. *First*, the heavy reliance on local property transaction taxes acts as a barrier to liquid property markets and efficient land use. Moreover, the volatility of this tax source undermines the stability and predictability of local revenues. *Second*, local governments rarely use their power to change tax rates, although they are allowed to adjust 11 of them by as much as 50% above or below the standard rate. This reflects the reluctance of local governments to diverge from norms set by the national authorities. It is believed that lowering tax rates would lead to reductions in grants, although there is no direct link between them, according to the central government (*OECD Economic Surveys: Korea*, 2005). When local authorities want to raise expenditures, they tend to ask for increases in intergovernmental grants because it is politically easier than raising taxes.

Boosting productivity in the service sector

Labour productivity growth in services slowed from an annual average of 2.6% during the 1980s to 1.2% between 1997 and 2007 (Table 1.7). In contrast, it has risen by nearly 9% per annum in manufacturing since 1990. Services accounted for only a quarter of the growth of value added per person employed between 2000 and 2006, compared with the OECD average of 39% (Figure 1.11). The poor performance of services has widened the

Table 1.7. **Labour productivity growth in manufacturing and services**

A. Annual growth rate of value added per employee in per cent

Industry	ISIC code	1980-1990	1990-1997	1997-2007
Manufacturing	15 to 37	6.4	8.7	8.7
Market services	50 to 74	4.3	1.6	2.6
Non-market services	75 to 99	–0.2	1.7	–2.0
Total services	50 to 99	2.6	1.5	1.2
Total economy	1 to 99	5.5	4.4	3.3

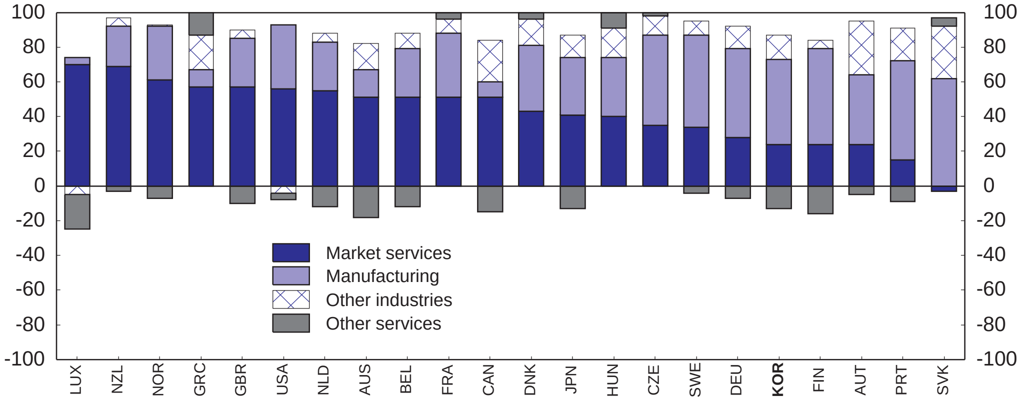
B. Output growth by sector

Industry	ISIC code	1980-1990	1990-1997	1997-2007
Manufacturing	15 to 37	11.9	7.5	7.7
Market services	50 to 74	9.5	8.1	4.1
Non-market services	75 to 99	5.7	5.0	2.7
Total services	50 to 99	7.9	7.1	3.7
Total economy	1 to 99	8.5	6.8	4.3

Source: Bank of Korea, National Accounts.

Figure 1.11. **Contribution by sector to growth in OECD countries**

Contribution to growth of value added per person employed in percentage points during 2000-06



Source: OECD (2008c), *OECD Factbook 2008*, OECD, Paris.

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labour productivity gap between sectors; productivity in services fell from 76% of that in manufacturing in 1997 to 60% in 2005, the largest gap in the OECD area, where productivity in manufacturing and services is roughly equal.

The problem in services is linked to the weakness of SMEs, which play a dominant role in this sector, accounting for 79% of output and 91% of employment, with particularly high shares in such areas as hotels and restaurants (97%), wholesale and retail trade (95%) and personal services (95%). SMEs have consistently lagged behind large firms in terms of profitability and other financial indicators. By 2005, productivity per employee at SMEs in services was only 45.2% of that of large companies (Table 1.8).

Table 1.8. **Value-added per person employed in the service sector by firm size**

In 2005 in million won

	Average	SMEs	Large firms	Productivity in SMEs as share of large firms (%)	Share of SMEs in output (%)
Wholesale and retail trade	38.1	35.5	89.2	39.8	95.2
Hotels and restaurants	17.7	17.2	51.3	49.9	97.2
Telecommunications	180.2	160.9	377.8	42.6	91.1
Financial intermediation	133.8	72.9	175.6	41.5	40.7
Business services	35.0	34.1	37.6	90.7	74.2
Education	22.6	21.8	33.1	65.9	93.0
Healthcare and social services	36.2	36.0	38.2	94.2	89.7
Personal services, etc.	20.9	20.4	31.9	63.9	95.6
Service sector	**32.6**	**29.4**	**65.1**	**45.2**	**91.1**

Source: Korea Federation of SMEs (2008) and Korea National Statistical Office, *National Statistics.*

Reforming the labour market and improving the education system

A major problem in the labour market is the rising degree of dualism: the share of non-regular workers exceeds one-third of employees (Table 1.9). The largest category of non-regular employment is temporary workers (Panel B), despite long-standing restrictions on fixed-term contracts. The increase in the share of temporary workers, from 16.6% of employment in 2001 to 29.7% in 2004, was the fastest in the OECD area and

Table 1.9. **Non-regular and temporary workers in Korea**

A. Non-regular workers as a per cent of total employment by age and gender in 2005

	15-19	20-29	30-39	40-49	50-59	60 and over	Total
Males	78.3	32.0	25.3	29.2	35.0	60.0	31.5
Females	64.1	33.4	40.1	46.7	55.2	75.7	43.7

B. Temporary workers as a per cent of total employment

	2001	2002	2003	2004	2005	2006	2007
Workers with a fixed-term contract of:							
Less than one month	5.6	5.2	6.7	5.6	5.5	5.2	3.2
Between one month and one year	2.8	2.7	4.9	4.7	4.8	4.9	4.7
One year	1.5	1.9	3.3	4.4	5.3	5.0	5.4
Between one year and three years	0.6	0.6	1.3	1.7	1.8	1.7	1.4
Over three years	0.5	0.6	0.7	0.8	0.8	0.9	1.2
Sub-total	11.0	10.9	17.0	17.1	18.2	17.7	15.9
Workers with open-ended contract but who could be dismissed against their own will	2.9	3.8	4.3	7.6	5.9	5.9	6.4
Temporary agency workers (dispatched workers)	1.0	0.7	0.7	0.8	0.8	0.9	1.1
On-call workers	2.2	2.9	4.2	4.6	4.8	4.3	5.3
Total[1]	16.6	18.1	25.9	29.7	29.4	28.3	28.2
Ratio of fixed-term contract workers to total	66.3	60.2	65.6	57.6	61.9	62.5	56.4
Total wage workers (1 000 persons)	13 540	14 030	14 149	14 584	14 968	15 351	15 882

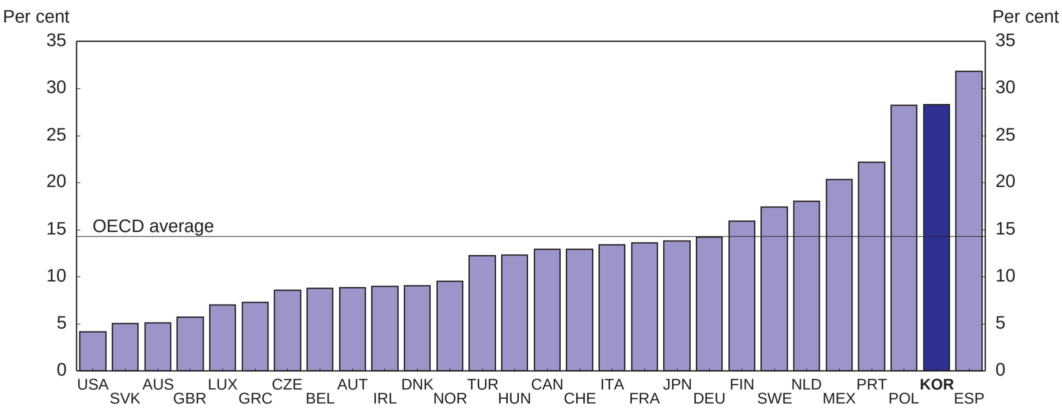
1. The total is adjusted for overlapping between sub-categories. Hence, it is not equal to the sum of the sub-categories.

Source: Korea National Statistical Office, EAPS Supplementary Survey by Type of Employment (every August).

its share was the second highest in the OECD in 2007 (Figure 1.12). The high proportion of temporary workers is a drag on growth as it increases worker turnover and hence reduces firm-provided training, which plays a very important role in Korea (Chung and Lee, 2005). It also raises equity issues as non-regular workers face precarious jobs, wage discrimination and less social protection.

Figure 1.12. **International comparison of temporary employment**

As per cent of total employment in 2007[1]



1. Reference year is 2004 in Mexico, 2005 in the United States and 2006 in Australia.

Source: OECD Employment Outlook Database.

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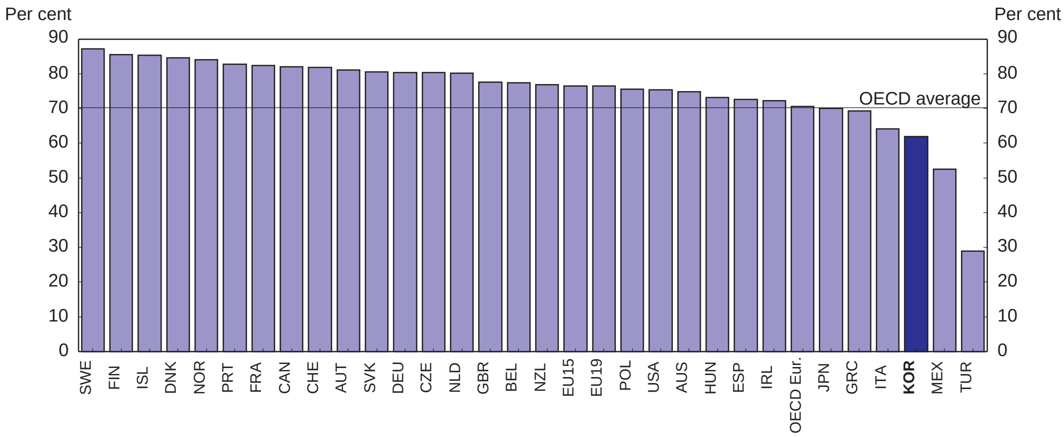
The participation rate for prime-age women (25 to 54) is the third lowest in the OECD area, at 62%, and well below the OECD average of 70% (Figure 1.13). Moreover, female employment rates lag behind those for males in each category, leading to an employment gender gap that is the seventh highest in the OECD area. Boosting female employment is a key to mitigating the impact of rapid population ageing. The total female participation rate rose from 49% in 1990 to 55% in 2007, mainly due to the changing behaviour of younger women. In particular, the rate for the 25-to-29 age group has doubled from 32% for women born during the first half of the 1950s to 65% for women born during the second half of the 1970s, reflecting the trend toward later marriage. However, the female participation rate is limited by the fact that a significant share of women withdraw from the labour force at the time of marriage or childbirth, although many later return, resulting in an M-shaped participation curve. A related issue is the significant drop in the fertility rate, which has fallen as the participation rate for young women has risen.

Figure 1.13. **International comparison of female labour force participation rates**

Rates in 2007 for women aged 25 to 54



Source: OECD (2008a), *Employment Outlook 2008*, OECD, Paris.

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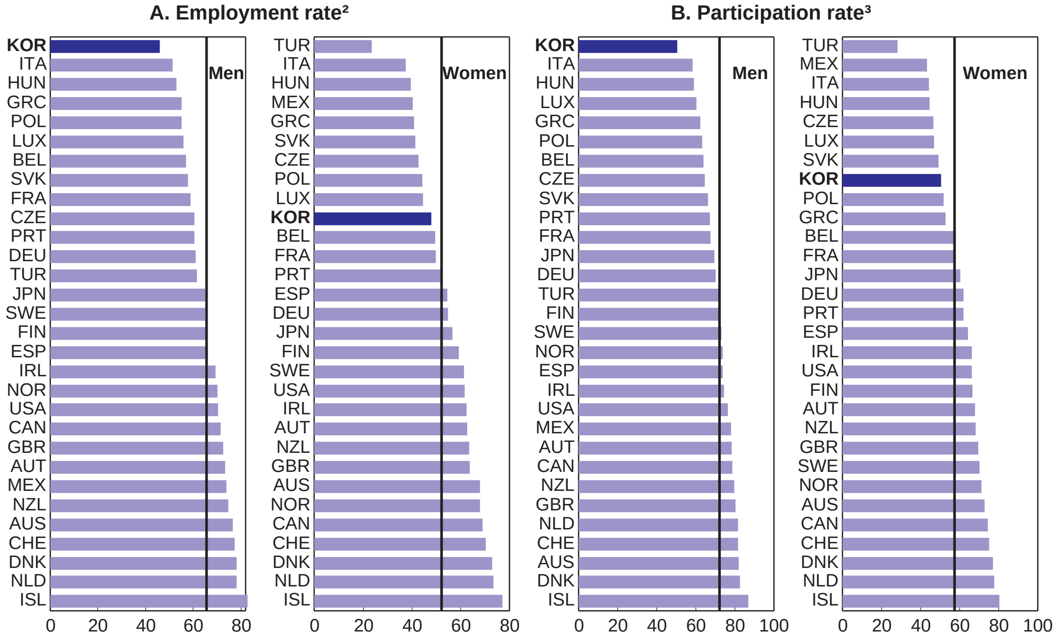
The fall in the youth employment rate, from 51% in 1995 to 47% in 2007, has focused attention on their integration in the labour market. Indeed, the rate for young men in 2007 was the lowest in the OECD area (Figure 1.14). This is explained to some extent by high enrolment in tertiary education, limited possibilities to combine school and work and the 30-month military service obligation for men. The problem is most severe for persons with less educational attainment. Only 53% of those with less than an upper secondary education and 68% of upper secondary graduates could find jobs within a year of leaving school, as against 81% of tertiary graduates. In addition, more than half of new employees between the ages of 15 and 29 quit their first job during the first year and another third quit before the end of three years. One reason for the low employment rate is the mismatch between the skills provided by tertiary education and those needed by firms. Some 35% of university graduates in natural and social sciences do not find jobs in their field of study. More generally, there is a need to upgrade the quality of university education, which has not kept pace with its rapid quantitative expansion.

The unemployment rate for youth (7.5%) is below the OECD average (9.6%). However, this reflects weak incentives for unemployed youth to remain in the labour market, given

Figure 1.14. **International comparison of employment and participation rates for young people**

As a per cent of youth aged 15 to 29 by gender in 2007[1]



1. For France and Germany, data are available only for 2006. The vertical lines indicate the OECD average.
2. Employed as a percentage of the population in the age group.
3. Labour force as a percentage of the population in the age group.

Source: OECD Employment Outlook Database.

StatLink http://dx.doi.org/10.1787/513261838248

that there are few welfare benefits for individuals without a record of social security contributions. Moreover, a large number of youth are neither in employment nor in education or training (the so-called NEETs). In 2004, NEETs accounted for 17% of the 15-to-29 age group, slightly above the OECD average. The share of NEETs among youth with tertiary education is around three times higher than the OECD average, while the rate among youth with less than upper secondary education is significantly below.

Conclusion

Korea remains one of the most dynamic economies in the world with high levels of investment in fixed capital, R&D and education and a comparative advantage in many high-technology areas. While its potential growth rate is one of the highest in the OECD area, demographic changes will exert more and more of a drag on economic growth. Further progress in reform is key to sustain growth and promote the convergence of per capita income to levels in the most advanced countries (Annex 1.A1). In addition, Korea needs to meet specific challenges related to the global financial crisis, tax reform, enhancing productivity in the service sector and reforming the labour market and education system. The following chapters analyse these challenges.

Notes

1. Using purchasing power parity exchange rates, per capita GDP is around $25 000, 55% of the US level.
2. According to a stress test of household debt by the IMF, a 100 to 300 basis-point rise in interest rates would boost distressed household debt by 8.5 to 17 percentage points, while a drop in housing prices by 10% to 30% would add another 4 percentage points (IMF, 2008).
3. The self-employed account for one-third of total employment in Korea, the fourth highest in the OECD.
4. An increase of about one percentage point in the tax-to-GDP ratio could be associated with a direct reduction of about 0.3% in output per capita in the long run. If the investment effect is taken into account, the overall reduction would be between 0.6% and 0.7% (Bassanini and Scarpetta, 2001). Given that Korea has an exceptionally low tax-to-GDP ratio, the impact may be less.
5. For example, the government's *Vision 2030* plan in 2006 projected that public social spending would rise from 6% of GDP in 2004 to the current OECD average of 21% by 2030.
6. In contrast, East Germany's population was only a third of the West's at the time of German re-unification, while the per capita income gap was significantly smaller, with that in the East around half of the West.
7. If capital markets perceive that the government has not done enough to address the rising revenue needs, Korea may face lower debt ratings and higher capital costs than otherwise. This may outweigh the negative impact of early increases in tax rates.
8. Korea National Statistical Office reported a relative poverty rate of 15.2% for 2005.

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ANNEX 1.A1

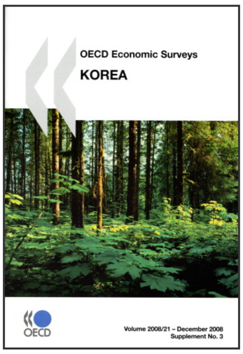
Taking stock of structural reforms

This annex reviews actions taken on structural policy recommendations in the 2007 *OECD Economic Surveys: Korea*. Recommendations made in this *Survey* are shown in the boxes at the end of each chapter.

Recommendations in the 2007 *Survey*	Actions taken or proposed by the authorities
A. HOUSING AND REGIONAL POLICIES	
Housing policy	
Phase out policies aimed at controlling short-term price fluctuations, such as price caps and the requirement to disclose construction costs.	Price regulations will be eased by broadening the scope of allowable costs used for setting prices of residential and commercial buildings and privately-owned housing.
Maintain the focus on increasing the supply of housing, particularly in the capital region.	The government announced a plan in September 2008 to build an average of 0.5 million new homes annually for the next ten years, of which 0.3 million units, supplied by both the public and private sectors, will be in the capital region.
Reduce regulations on construction and land use to facilitate a stronger private-sector response to demand.	Procedures for reforming land-use restrictions have been eased, while continuing the transfer of urban planning authority to local governments.
Focus the role of the public sector on making more land available for private-sector housing projects.	The amount of land supplied for housing by the public sector rose 41% in 2007 to 65 km^2 (0.1% of Korea's area).
Phase out restrictions on the reconstruction of existing apartments to upgrade their quality or size, particularly in areas where prices are rising.	The government's August 2008 plan will ease restrictions by halving the reconstruction period to 18 months and allowing owners to sell their homes during that period.
Relax regulations on mortgage lending by the private sector without undermining prudential supervision.	The maximum loan-to-value ratio on unsold apartment units in non-speculation zones was boosted from 60% to 70% if the price is reduced.
Encourage the development of the private-sector mortgage market, in part by developing the long-term bond market.	The amount of mortgage-backed securities (MBS) issued by the Korea Housing Finance Corp. and banks has risen and other financial institutions will be able to issue MBS.
Continue to lower property transaction taxes.	The special deduction from the capital gains tax for long-term ownership will be increased from 4% to 8% every year (up to a maximum of 80%).
Hike property holding taxes, while not using such taxes to control property prices or redistribute income.	The government plans to scale down the comprehensive property tax and to gradually merge it with the local property tax.
Avoid high taxes on capital gains to limit the extent of distortions and lock-in effects.	The price at which the owner of a single house is subject to the capital gains tax was raised from 600 million won to 900 million won and the rates will be cut in line with the income tax.
Regional policy and fiscal decentralization	
Transform regulations that limit construction in the capital region into market-based instruments.	No action taken.
Streamline initiatives aiming at balanced regional development and give local government more autonomy in local development plans.	No action taken. The construction of three additional enterprise cities is planned in 2009.
Further pursue fiscal decentralisation by granting greater autonomy to local governments, including more responsibility for providing local services.	The central government has transferred authority on 201 items to local governments since 2007.

Recommendations in the 2007 *Survey*	Actions taken or proposed by the authorities
B. PUBLIC SOCIAL SPENDING IN THE CONTEXT OF AGEING	
Remove obstacles that limit the fertility rate	
Reduce reliance on private tutoring institutions and lower the out-of-pocket education costs for families.	A March 2007 plan included a number of measures such as creating centres in schools and TV programmes to teach English and expanding after-school programmes.
Promote fertility and female employment by ensuring an adequate supply of high quality childcare and encouraging more family-friendly policies in firms.	Parental leave, available for those with children up to one year of age, was extended to the age of three. A certification system for firms with family-friendly policies was developed.
Encourage private-sector supply of childcare, in part by removing price caps on private-sector suppliers.	Price caps have not been removed. The government plans to introduce an electronic voucher system for childcare services.
Encouraging labour force participation	
Increase female employment by reversing the trend toward greater non-regular employment and the importance of seniority in determining wages.	The government has been promoting a shift to performance-based pay systems by providing information to workers and employers.
Promote the participation of older workers by raising or eliminating mandatory retirement ages.	The government introduced a subsidy to firms that increase their retirement age by one year or more to age 56 or above.
Replace employment subsidies with high deadweight costs by more emphasis on lifelong education.	The government has launched a detailed analysis of the effectiveness of subsidy programmes to guide reform.
Ensuring adequate income for elderly persons	
Raise the means-tested benefit from 5% of the average wage to reduce poverty among the elderly, given the low coverage of the NPS.	The share of elderly receiving the benefit is to be raised from 60% to 70% in 2009 as planned.
Reform the pension schemes for the civil service, military and private-school teachers to cut public subsidies and introduce portability with the NPS.	A civil service pension reform plan with higher contributions and lower benefits was announced in September 2008.
Accelerate the transition from the lump-sum retirement allowance to company pensions and promote the use of defined contribution schemes.	No action taken.
Improving the healthcare system	
Avoid overall cuts in co-payment rates to limit the rise in public healthcare expenditures.	The lump-sum co-payment of 3 000 won for fees of less than 15 000 won was changed to a 30% co-payment.
Lower the ceiling on co-payments over a six-month period in order to ensure greater access for low-income persons and patients with chronic illnesses.	The government lowered the ceiling on the amount of co-payments over a six-month period from 3 million won to 2 million won in July 2007.
Reduce the burden on the working-age population by requiring the elderly to contribute more to the NHI.	No action taken.
Allow domestic and foreign for-profit firms to provide healthcare and permit a greater role for private insurance for services not covered by the NHI.	No action taken.
Make the unified NHI a more effective purchaser of healthcare and consider payment systems other than fee-for-service to limit spending pressure.	The daily flat-rate has been applied to long-term care beds from 2008.
Promote "healthy ageing" to avoid longer periods of disability as life expectancy increases.	The government has expanded screening of the elderly to identify health problems as part of the Health Plan 2010.
Improve the framework for the provision of pharmaceuticals to reduce their relatively large share in healthcare spending.	The number of insured drugs was decreased, cost-benefit analyses for drugs were introduced in April 2007 and drug prices are now determined by negotiation.
Providing long-term care for the elderly	
Expand the capacity for long-term care, thus lowering the burden on the healthcare system.	The government established 224 and 183 long-term facilities in 2007 and 2008, respectively, bringing the total to 1 428.
Reduce reliance on public-sector institutions by encouraging the entry of private-sector suppliers.	The Long-term Care Insurance introduced in July 2008 will encourage the participation of the private sector.
Control the increase in demand for long-term care by ensuring an effective gate-keeping function and favouring home-based care.	The co-payment rate for institutional care is 20% compared to 15% for home-based care services.
Addressing rising inequality and relative poverty	
Expand the National Basic Livelihood Security System to ensure that all households have an income that at least matches the minimum cost of living.	The minimum cost of living for a family of four was increased by 5% in 2008.
Increase the coverage of non-regular workers by the social insurance programmes for pensions (NPS), health (NHI) and employment (EIS).	A 2008 law will raise the coverage of EIS at firms with less than ten workers. The conditions under which daily construction workers can be covered by the NPS at workplaces were eased in 2007.
Ensure that the new labour law provisions to prevent discrimination against non-regular workers do not discourage the hiring of such workers.	No action taken.

Recommendations in the 2007 *Survey*	Actions taken or proposed by the authorities
Reduce employment protection for regular workers to reverse the rising proportion of non-regular workers.	The legal procedures against employers violating provisions against dismissing regular workers were replaced by a fine.
C. INCREASE THE INTEGRATION OF KOREA IN THE WORLD ECONOMY	
Removing obstacles to inflows of foreign direct investment (FDI)	
Foster a foreign investment-friendly environment.	Korea has adopted a number of measures, including reducing corporate taxes and the time required to establish an industrial complex and simplifying immigration procedures.
Develop the M&A market, including cross-border M&As, by relaxing related regulations.	No action taken. Measures against predatory M&As are being considered.
Further liberalise FDI restrictions, in particular by reducing or removing foreign ownership ceilings.	No action taken.
Reduce product market regulation, especially in services, to encourage FDI.	The Presidential Council on National Competitiveness was established in 2008 to take the lead on regulatory reform.
Phase out the regulations on construction in the capital region.	Foreign investors have been allowed to construct high-tech plants in the capital region since December 2007. In November 2008, the government announced a plan to ease regulations on building and expanding industrial complexes in the capital region.
Enhance the transparency of tax and financial supervision and limit the scope for discretionary interpretation, application and enforcement.	Measures to improve the use of administrative guidance and provide interpretations and explanations on financial laws and regulations have been introduced.
Resolve the issues in the labour market, including labour-management relations, which discourage FDI.	The Ministry of Labour has initiated several programmes to help foreign companies deal with labour–related matters.
Extend the regulatory reforms introduced in the Free Economic Zones (FEZs) to other parts of the country.	The government designated three new FEZs in April 2008.
Streamline the various zones created to encourage FDI inflows and provide equal treatment of the manufacturing and service sectors.	Responsibilities for the zones were merged into one ministry (Ministry of Knowledge Economy) in March 2008.
Increase transparency by limiting the scope of special incentives, such as cash grants, for foreign firms.	No action taken.
Avoid preferential fiscal and regulatory treatment, which distorts the locational decisions of foreign investors.	All local governments are represented on the "Foreign Investment Committee", to prevent the distortion of location decisions. The central government plays the role of mediator.
Do not allow the emphasis on special zones to distract the authorities from the fundamental objective of improving the business climate.	The government has created the Presidential Council on National Competitiveness to address the key problems facing firms and advance regulatory reform.
Review special zone schemes regularly to ensure that the economic benefits exceed the costs.	No action taken.
Improving the climate for international trade	
Pursue the liberalisation of trade barriers through multilateral trade negotiations.	Korea is actively participating in all negotiation groups, including market access, at WTO/DDA negotiations.
Further harmonise regulations and standards with international standards to reduce barriers to imports.	The share of Korean standards harmonised with international standards rose from 58.8% in 2006 to 61.4% in 2007.
Pursue WTO-consistent regional free trade agreements (FTAs), covering substantially all products.	Korea signed a FTA on services with ASEAN in July 2007 and a CEPA with India in September 2008. FTA negotiations with the Gulf Co-operation Council were launched in 2008.
Strengthen market principles in the agricultural sector, in part by reducing market price supports.	The Korea-US FTA will lead to the eventual liberalisation of all agricultural products except rice.
Limit moral hazard in policies used to support industries and workers negatively affected by FTAs.	No firms have qualified for such support thus far.
Promoting the inflows of human resources	
Reform the Work Permit System (WPS) to reduce the number of unregistered workers and allow a sufficient number of foreign workers to ease labour shortages.	The number of unregistered workers is to be cut from 19% of total foreign workers to 10% in five years. The number of foreign workers is to be set every year to meet labour demand.
Allow low-skilled foreign workers to be employed in the service sector, in addition to manufacturing.	No action taken.
Increase the inflow of high-skilled workers by improving the immigration control system, as well as the business and living environment.	The maximum residence period for professionals was extended from two to five years in July 2008. Work permits for professionals were introduced in September 2008.



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