



INCOME-LED GROWTH AND INNOVATIVE GROWTH POLICIES IN KOREA: CHALLENGES, REBALANCING, AND A NEW BUSINESS ECOSYSTEM

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Abstract

The Moon Jae-in administration in South Korea has taken a two-pronged approach to ensure urgently needed job creation and inclusive growth. Although measures towards each set of economic policies have been implemented since Moon took office in May 2017, what's often referred to as "income-led growth" has been prioritized over innovative growth. The income-led growth model is largely driven by domestic consumption through pro-labor distributional policies including a wage hike to raise the disposable income of low- and middle-income individuals, thereby triggering equity with growth. Focused more on the supply side, the innovative growth model encourages startups to create jobs and innovate. It is a great challenge for Korea to pursue growth and equity through both sets of policies. After a year in office, the Moon administration's economic agenda, often referred to as J-nomics, has not fully produced the intended policy objectives in terms of job creation and growth. To mitigate a declining potential growth rate and pursue robust and inclusive growth, the twin policies need to be rebalanced, reprioritized, and interconnected in a mutually reinforcing manner to empower the private sector to play a bigger role. As a mid-sized open economy, Korea requires global market competitiveness on the supply side to create decent jobs by buoying entrepreneurship and innovation. Structural reforms in the labor market combined with deregulations necessary for the advent of disruptive 4th-industrial-revolution technologies must be expedited. Furthermore, a new business ecosystem in which win-win collaborations between globally-oriented conglomerates and small businesses must be encouraged to replace a zero-sum business culture.

Key Words: South Korea, Moon administration, income inequality, structural reform, business ecosystem

Introduction

The Republic of Korea's (hereafter Korea) economy is at a critical crossroads. Like many countries since the 2008 global economic crisis (GEC), Korea continues to exhibit its own "new normal" economic symptoms. Slower growth, rising youth unemployment, and worsening income inequality have been accompanied by a rapidly falling potential growth rate. Against this backdrop, the Moon Jae-in administration, inaugurated in May 2017, has initiated unique economic policies, commonly referred to as J-nomics. The goal of these policies is to shift the Korean economy from a development model that has long revolved around large companies and an export-oriented strategy to a new paradigm that can generate more equitable growth and jobs.

There are two main pillars of J-nomics. The first and flagship policy, instrumental to Moon's election, is what is often referred to as "income-led growth" through wage hikes and increased social expenditures for low- and middle-income individuals to mitigate worsening income polarization. Boosting household income is intended to trigger domestic consumption and lead to more investment, production, and finally jobs. The second pillar, which entered the picture about six months after Moon took office, focuses on innovative growth to spur startups and small and medium-sized enterprises (SMEs) by initiating or strengthening government support measures in preparation for a 4th industrial revolution. In line with these two pillars, the Moon government also stressed "fair economic surroundings" toward a level playing field between big and small businesses.

However, early signs of J-nomics outcomes raise some challenging questions. Chiefly, to what extent are the two policies effective and complementary, or perhaps contradictory, in achieving job creation and equitable growth? In some crucial ways, the twin

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policies appear to be struggling to conform with each other based on early signs of economic performance, especially job creation. However, their combined goals of inclusive and equitable growth while boosting corporate and SME competitiveness rightly identifies the main challenges for the Korean economy.

This paper attempts to shed light on the successes and shortcomings of these two-pronged economic policies and argues for a rebalancing of priorities. It also suggests how a virtuous business ecosystem, one that goes beyond fiscal and monetary tools, can lead to the mutual growth of big and small businesses, as partly practiced by the Korea Commission for Corporate Partnership.²

The first section introduces Korea's economic performance after the GEC, with special reference to income polarization, prolonged unemployment, and, more importantly, declining potential growth rates. The next sections outline the key policy instruments of the income-led and innovative growth policies and their early outcomes. How these policies need to be rebalanced based on these outcomes is then discussed. Before concluding, the paper emphasizes how a new business ecosystem centered around a fair and collaborative framework between corporations and SMEs can further inclusive growth.

The Korean Economy since the Global Financial Crisis

In the past half century, Korea has emerged from being one of the poorest agrarian societies in the world to an industrialized economy that joined the OECD in 1996. Korea's rapid industrialization and export-led development are often cited as an example of "compressed and equitable growth" in the developing world. Then came the 1997-98 Asian Financial Crisis (AFC) and the GEC. Both crises hit Korea hard, leading it to remain in a slow-growth trap.

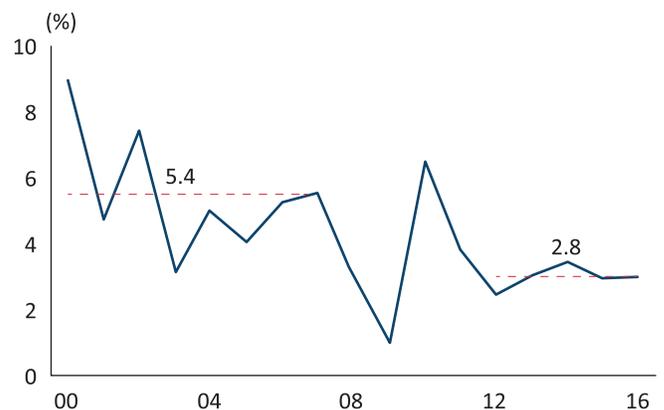
When the AFC erupted, Korea had no choice but to seek financial help from the International Monetary Fund (IMF), drawing \$54 billion, the largest-ever sum of standby credit for a single country at the time. In return, the IMF demanded that Korea carry out comprehensive banking, corporate, labor, and public

enterprise reforms.³ A decade later, the GEC hit Korea hard and quickly resulted in new "normal symptoms" of slow growth, low employment, and rising income and social inequalities. Figure 1 shows that the average growth rate of Korea's real GDP was 5.4 percent per year from 2000 to 2007, but declined sharply, by almost half, to 2.8 percent on average from 2009 to 2016.

Prior to the AFC, the Gini coefficient for urban working households reached about 0.307 in 1980 and gradually declined to 0.281 in 1995, setting global standard for desirable income equity amid high growth.⁴ But the unprecedented shock in 1998, engendering negative 5.5 percent growth, quickly resulted in massive unemployment and subsequently led to income polarization due to the restructuring and downsizing of many companies. Korea's slow growth and low employment since the AFC has caused an upsurge in the Gini coefficient, reflecting worsening income inequality (Figure 2), and income polarization (Figure 3).

Korea's rising inequality has also been driven by a rapid increase

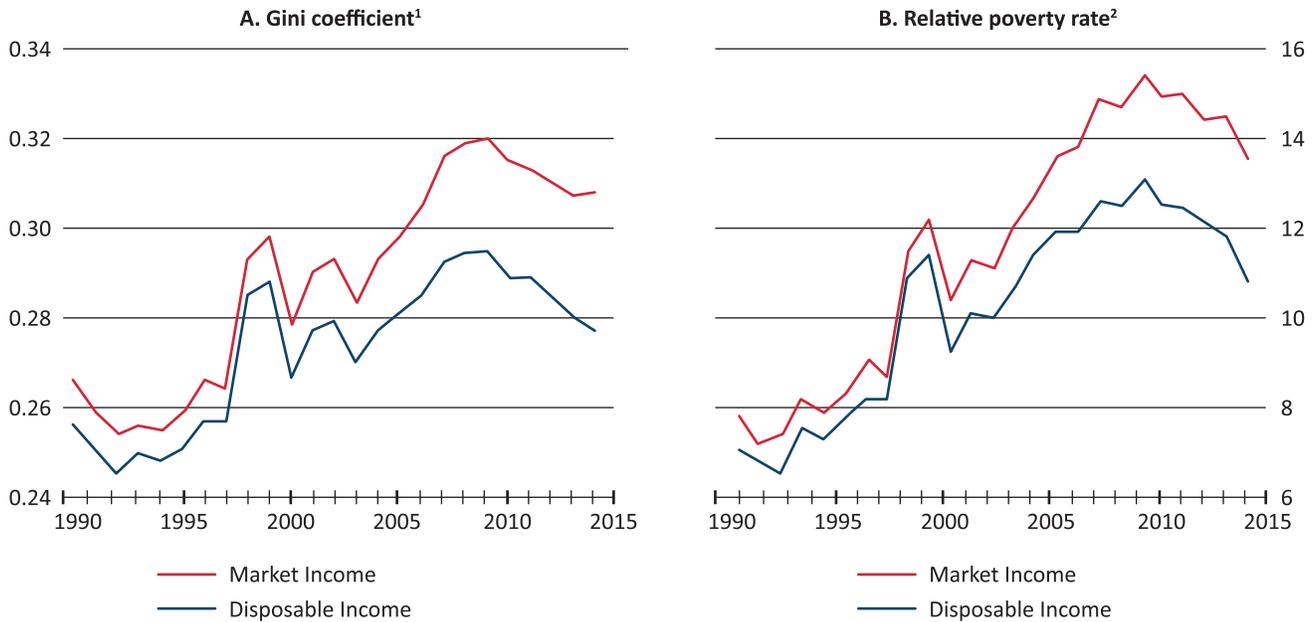
Figure 1. Annual Growth Trend of Korean Real GDP



Source: Bank of Korea, Kim Downan, J.H. Lee, & E.K. Lee, "Estimation of Potential Growth Rate of Korea," *Monthly Survey Report*, August 2017 (in Korean): 16.

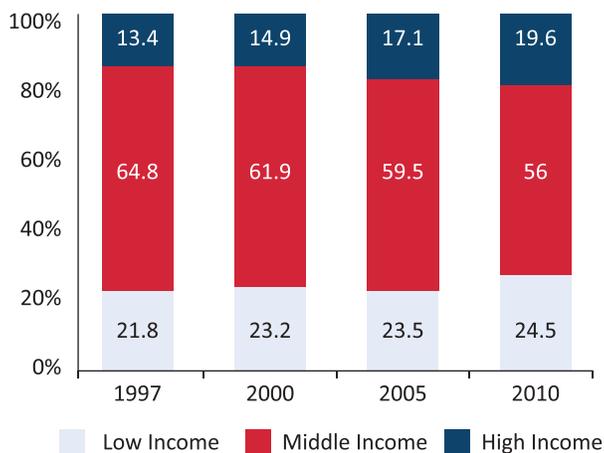


Figure 2. Income Inequality and Relative Poverty in Korea



¹The Gini coefficient can range from 0 (perfect equality) to 1 (perfect inequality).
²“Relative poverty rate” is defined as the percentage of the population with income less than half of the national median.
 Source: OECD Economic Surveys: Korea Overview, May 2016, 125.

Figure 3. Shrinking Middle Income in Korea

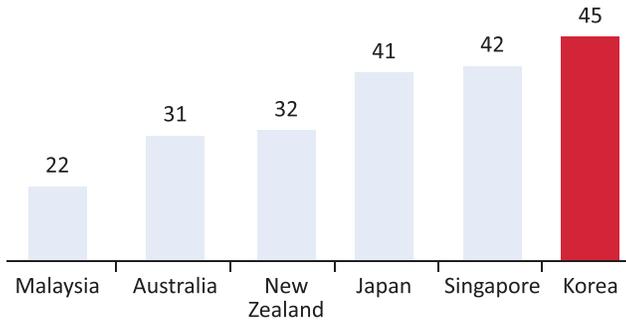


Note: The “Middle Income” bracket is defined as the range of plus and minus 50% of the median income level.
 Source: KOSIS DB, Korea Statistics

in the income share of the top decile, consistent with global trends. A recent IMF study shows that over the last two decades the income share of the top decile increased in most Asian countries, among which Korea was the highest with the top 10 percent earning 45 percent of the national income as shown in Figure 4, up from 29 percent in 1990.⁵

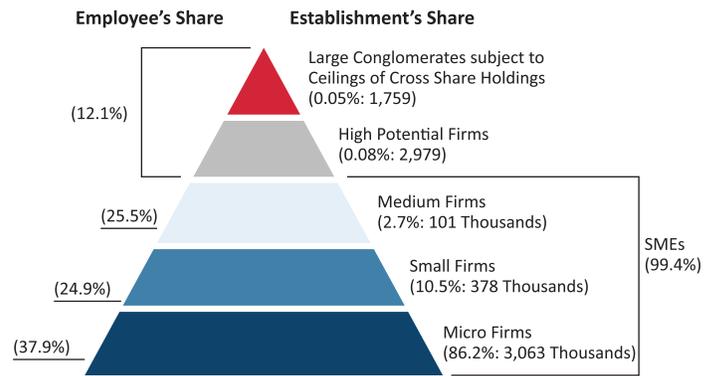
Key structural factors of the Korean economy are also exacerbating current global trends of rising income inequality, particularly an increasing gap between large conglomerates (LCs) and SMEs. Korea’s rapid industrial growth was led by the intentional promotion of LCs⁶, better known as *chaebols*, to compete in the world market. Korea’s dominant industrial strategy during the high growth era was for LCs to take a latecomers’ advantage and maximize economies of scale as well as economies of scope in the global market. As a result, Korea’s SMEs have become domestic-oriented, less technologically competent, and less profitable relative to LCs, causing an acute dichotomy between LCs and SMEs and consequently greater income inequality. Korea’s SMEs are referred to as “998833,”

Figure 4. Top 10 Percent of Income Earners as a Share of Total Income in Selected Asian Countries in 2013 or Latest Available Year



Source: IMF, Sonali Jain-Chandra et al (2016), 12.

Figure 5. Multi-layered SMEs in Pyramid Structure Relative to LCs in Korea



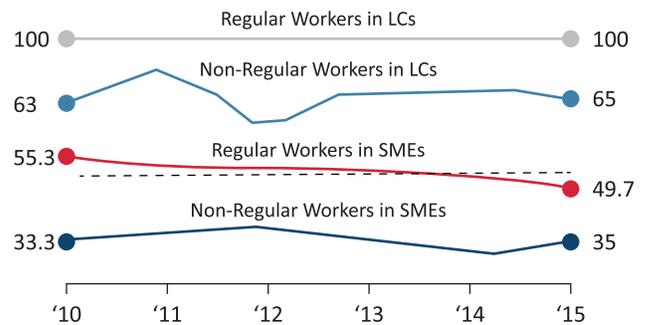
Source: National Survey of Business Establishments (2014), KOSIS Database and Korea Federation of Small and Medium Enterprises.

meaning that they account for 99 percent of Korea’s total business establishments, provide 88 percent of the country’s total jobs but are only a third as productive as LCs. Korea’s SMEs have increasingly suffered from lower salaries and are dominated by non-regular workers.

Korea’s SMEs maintain an acute multilayered pyramid structure in terms of business establishments, as shown in Figure 5, ranging from self-employed and family-based micro-businesses to medium-sized firms and near large enterprises that are called “potentially high enterprises.” Although Korea’s SMEs are fragmented and technologically limited, they provide a major portion of total employment.

Korea faces great challenges due to triple dualities that have become gradually and deeply embedded in the labor market, between services and manufacturing, and between SMEs and LCs since the early 1960s. These dualities are key causes of inequality and inefficiency. In the labor market, there is a significant divide between regular and non-regular workers such as fixed-term, part-time, and dispatched workers. Non-regular workers constitute over 20 percent of total employment compared to an average of 11 percent in OECD economies.⁷ Non-regular workers on average earn 66.3 percent of a regular worker’s wage even though their skills are matched. They are also less likely to enjoy social benefits or on-the-job training. The labor market divide is further aggravated by the dichotomy between large and small firms (Figure 6).

Figure 6. Wage Disparity between LCs and SMEs (%)



Source: Ministry of Employment and Labor



Another duality is the productivity differential between manufacturing and services. Korea’s service sector is largely in fragmented, domestic-based, and technologically outdated SMEs. Typical service sectors include food and beverage, lodging, retail, and construction sub-tier companies. As a result, the productivity of this sector has been far lower than that of the export-oriented manufacturing sector.

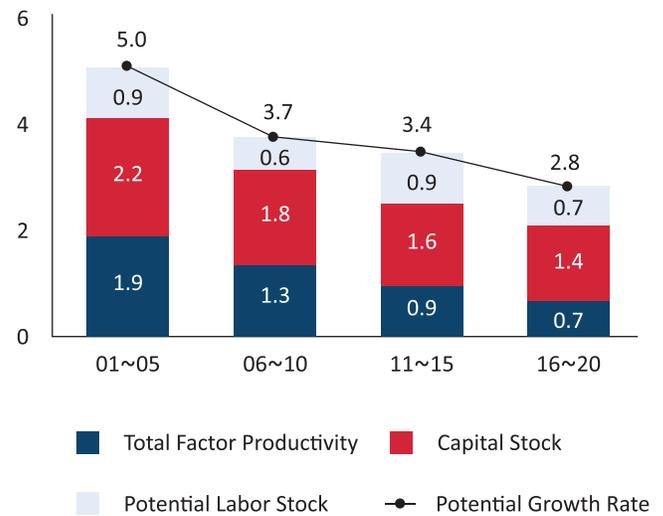
These dualities have contributed significantly to income inequality,⁸ which IMF research has shown matters for growth as well. Specifically, if the income share of the top 20 percent increases, then GDP growth actually declines over the medium term, suggesting that the benefits of growth do not trickle down. In contrast, an increase in the income share of the bottom 20 percent is associated with higher GDP growth.⁹

On top of the serious challenges Korea faces due to the triple dualities, one of the most alarming signs for Korea’s sustainable growth lies in the rapidly declining potential growth rate. The Bank of Korea estimates for Korea’s potential growth rate have continuously declined from 4.8 to 5.2 percent for 2001-2005 to 3.7 to 3.9 percent for 2006-2010, and then to 3.0 to 3.4 percent for 2011-2015 (Table 1). Of even greater concern is that Korea’s potential growth rate may continue to fall at a faster pace because of a rapidly aging population. Korea’s potential growth rate is projected to fall to 2.4 percent in the 2020s, according to the OECD. However, the Bank of Korea has attributed the falling potential growth rate largely to stagnant service sector efficiency and a decrease in overall productivity.

According to the growth accounting equation, the potential growth rate is determined by the sum of the growth rate of three factors: labor stock, capital stock, and total factor productivity.

Figure 7 shows that the three factors, except a few years of labor stock, have consistently declined in the past two decades. Most notable is the consistent and most drastic drop of total factor productivity. In general, total factor productivity is largely determined by R&D systems, rule of law, education system, etc. In this paper, it is suggested that a business ecosystem involving inter-firm relationships between big and small businesses should also be considered as a major factor influencing total factor productivity in Korea.

Figure 7. Factor Contributions to Declining Potential Growth Rate



Source: Bank of Korea, Kim Dowan, J.H. Lee, & E.K. Lee “Estimation of Potential Growth Rate of Korea,” *Monthly Survey Report*, August 2017 (in Korean), 24.

Table 1: Estimation of Potential Growth Rate (% per annum)

Method	2001~2005	2006~2010	2011~2015	2016~2020
Production Function Method	5.0	3.7	3.4	2.8
HP Filtering Method	5.2	3.9	3.0	2.9
Semi-Structural Method	4.8	3.8	3.1	2.8
Range by Different Method	4.8 ~ 5.2	3.7 ~ 3.9	3.0 ~ 3.4	2.8 ~ 2.9

Source: Bank of Korea, Kim Dowan, J.H. Lee, and E.K. Lee “Estimation of Potential Growth Rate of Korea,” *Monthly Survey Report*, August 2017 (in Korean), 24.



Key Features of Income-Led Growth

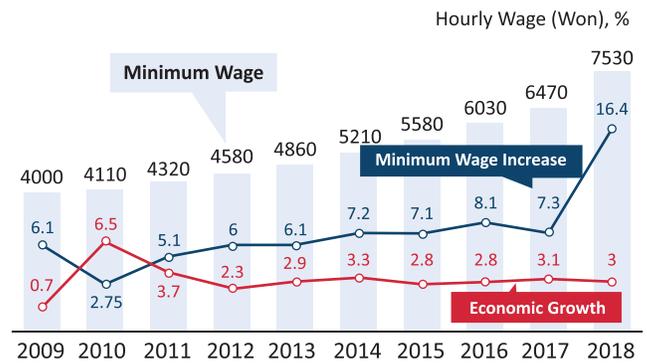
The potential for protracted sluggish global growth has triggered renewed thinking about equitable growth. The IMF, OECD, World Bank, World Economic Forum, Joseph Stiglitz, and ILO each have called for inclusive growth strategies.¹⁰ Unlike the other international organizations which emphasize equal opportunities, education and skill development, and social safety nets, the ILO has called for a demand-driven approach, namely a pro-labor and wage-led growth model, to exert a paradigm shift toward equitable growth.¹¹ This is a major deviation from neo-classical trickle-down wisdom focusing on supply side dynamism and investment-led growth and seems to be the inspiration of Korea’s income-led growth measures.

To promote income-led growth, the government has initiated a set of new economic policies to raise incomes for individuals in the middle- and low-income brackets through substantially raising minimum wages, income taxes for the higher-income bracket, and corporate income tax for big businesses. It is also converting irregular workers to regular workers, shortening work hours, hiring new public employees to help reduce unemployment, and lowering tax benefits on R&D investment, as briefly described in Table 2. These policies were intended to zero in on job creation, one of President Moon’s most important goals, as further emphasized by the creation of a presidential job creation committee at the start of his administration.

The Moon administration’s prioritization of income-led growth over innovative growth is clearly reflected by key policy measures

as shown in Table 2. The most significant departures from the previous government’s economic policy guidelines can be found in the areas of minimum wage, tax, labor, and welfare expenditure. Compared to 2017, the government increased the 2018 national budget by 7.1 percent to 429 trillion won (around \$400 billion). Categorically, income-led growth areas saw the largest increase, going up 12.9 percent to 146.2 trillion won (around \$135 billion) from 2017, whereas innovative growth had a zero percent rise to stand at 35.5 trillion won (around \$32 billion). It should be noted that the budget for job creation is almost the same as the R&D budget.¹²

Figure 8. Minimum Wage Trend, 2009-2018



Source: BOK, Ministry of Employment and Labor

Table 2: Key Policy Measures and Goals of Income-led Growth

Wage Policy	- Raising minimum wage by 16 percent to 7,530 won in 2018, aiming to reach 10,000 won by 2020
Tax Policy	- Raising Corporate Income Tax from 22 percent to 25 percent for large firms with 300 billion won and over in annual revenue. - Raising personal income tax from 40 percent to 42 for those who earn 500 million won or more, and from 38 percent to 40 for those earn 300 million won
Welfare Expenditure	- Tailor-made lifelong income support programs for low income individuals and seniors - Raising basic pension from 206,000 won per month to 250,000 won
Labor Policies	- Easy unionization of government employees below a certain rank - Lowering the maximum workweek to 52 hours from the current 68 hours starting in July 2018 at firms with 300 or more employees, with smaller firms expected to follow in the coming years - Conversion of non-regular workers to regular worker status - Hiring up to 810,000 public employees to ease youth unemployment
National Budget Allocation	- Income-led growth policies increased by 12.9 percent to 146.2 trillion won versus zero percent rise to 35.5 trillion won for innovative growth. Within the income-led growth budget, the 19.2 trillion won for job creation is almost equivalent to the R&D budget of 19.6 trillion won.

Source: Press Release on 2018 National Budget by the Ministry of Strategy and Finance on August 24, 2017.



Perhaps the most important measure towards income-led growth to date, the government raised the minimum wage by a record 16 percent, effective at the start of 2018, to 7,530 won (around \$7.06) to deliver on Moon’s campaign promise to raise the minimum wage to 10,000 won per hour by 2020.¹³ However, evidence in mid-April 2018 suggests that the quick and steep minimum wage hike produced unintended consequences: hiring cuts, business shutdowns, and job losses. Figure 8 shows that increases in the minimum wage have consistently been higher than the economic growth rate since 2011, and is exceptionally higher in 2018. As shown in Figure 9, Korea’s minimum wage, relative to the average full-time workers’ wage, ranks very high among high-income OECD economies.¹⁴

This year’s record rise in the minimum wage has burdened SMEs the most. Many retail businesses and contractors have been unable to cover the increased labor costs, taking on fewer people or even freezing new hires. Many retail store owners say that if wages increase at a similar rate in 2019 as planned by the government, they will have no choice but to close shop.

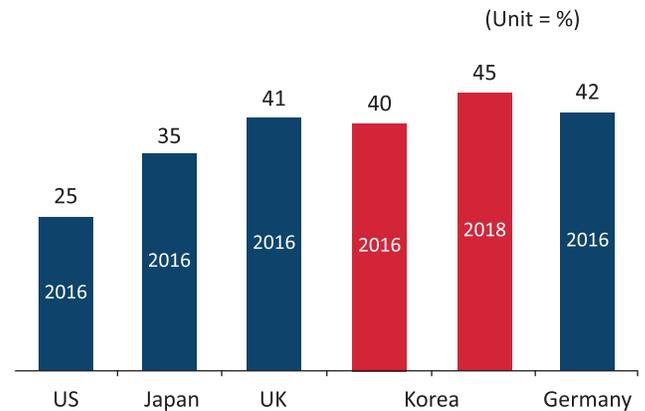
As a measure to induce young people to join SMEs and meet the government’s target of creating 220,000 new SME jobs by 2021, the government introduced an employment subsidy system amounting to 9 million won (around \$8,400) per year per employee for up to four years, thereby narrowing the average salary gap of 1.3 million won (around \$1,000) between LCs and SMEs. However, the subsidy program has not been enthusiastically welcomed by either employers or employees. The two main reasons for this are that the subsidy is short-lived and that it requires employers to cover half of their employees’ unemployment benefits, health insurance, national pension, and pay for all of their occupational health and safety insurance. The reality is that new employees at SMEs quit, on average, in less than three years.

As part of these policies, the Moon government has also stressed work-life balance. A new labor bill was passed to lower the maximum working hours to 52 hours per week from the current 68 hours starting in July 2018 at firms with 300 or more employees. Smaller firms are expected to follow in the coming years. Considering Korea’s average annual work hours clock in at 2,069—far higher than the OECD average of 1,764 hours in 2016—the intended reduction of working hours also aims to increase employment through job sharing.¹⁵

Key Features of Innovative Growth

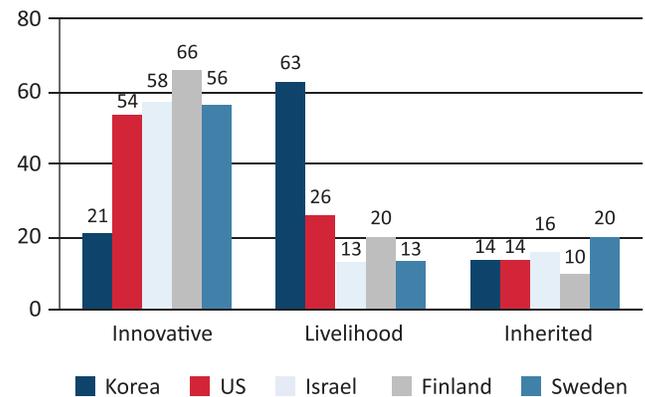
Innovative growth, the other main pillar of J-nomics, surfaced about six months after the Moon administration took office and aims to induce business startups for job creation. For this purpose, the government upgraded the Office of Small Business Administration to the Ministry of SMEs and Startups for the first time—a move that has long been demanded by SMEs.

Figure 9. Minimum Wage Relative to Average Wages of Full-Time Workers in Select OECD Economies



Source: IMF: Republic of Korea, Selected Issues: IMF Country Report No. 18/41, February 2018, 88.

Figure 10. Types of Start-ups in Selected Countries



Source: OECD Entrepreneurship at a Glance 2014

The government also created a new presidential Technology Innovation Committee to promote startups, including venture businesses and venture capital, and other innovative growth issues. By and large, innovative growth is a government-led scheme with a variety of fiscal support measures. As a result, it appears that far less attention is given to technological innovation across existing industries and SMEs compared to the overwhelming emphasis on new startups.

While income-led growth focuses on demand, innovative growth concentrates on supply through investment. For a future high-tech society, new business startups should encourage venture capital, which require broad deregulations of market entry barriers and institutional rigidities. In this regard, it is critical to increase labor market flexibility.

Korea now faces unprecedented technological challenges and opportunities from the 4th industrial revolution, led by artificial intelligence, the internet of things, big data, the cloud, etc. Inherent to the 4th industrial revolution is technological fusion and convergence, which is likely to alter the modern industrial landscape very quickly. New industries will emerge and some old industries will die. Ongoing technological change in this “second machine age” not only risks displacing some specific types of jobs but could lead to a decline in overall employment. This is a serious challenge for Korean firms, especially for labor intensive SMEs unable to accommodate emerging technologies. Unless Korea’s SMEs undergo digitalization, the existing technology divide between big high-tech firms and labor intensive SMEs will only deepen the duality between big and small businesses, worsening income inequality and employment prospects.

Figure 10 shows that Korea’s livelihood-type business startups accounted for 63 percent of all startups while innovative-type startups constituted only 21 percent of the total startups in 2014. However, high-tech economies like the United States, Israel, Finland, and Sweden show almost the opposite picture. In Korea, early retirees and semi-skilled people who fail to get decent jobs tend to start easy livelihood-type businesses, and are often self-employed, such as with traditional food restaurants, bakeries, fried chicken houses, and beverage franchises. However, a good number of them tend to shut down their shops within one to two years due to unprofitability and, more importantly, lack of experience.

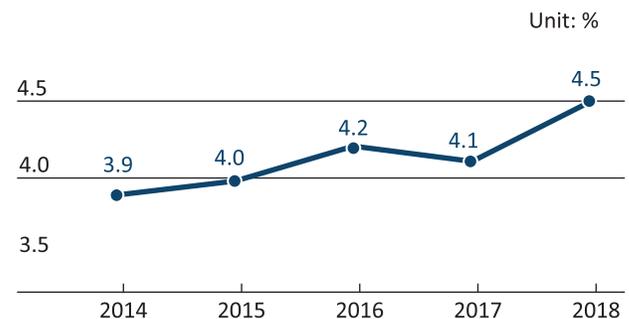
Assessing Moon’s Two-Pronged Agenda, Prescriptions for Rebalancing, and Needed Structural Reforms

Given high income inequality and unemployment, the Moon government is right to pursue inclusive growth, but the challenges posed by the 4th industrial revolution must not be overlooked if sustainable long-term growth is to be achieved. In this regard, from observing how income-led and innovative growth policies have been implemented, the Moon administration should seek a stronger balance and reprioritization of the two moving forward.

Unabated Unemployment and Minimum Wage Adjustment

Although it may still be premature to judge, the policy effectiveness of J-nomics after a year could be assessed primarily in terms of job creation, which the administration has singled out as its most important priority. However, thus far, J-nomics has not produced the expected job creation and resulting economic recovery. Some policy measures have even shown some negative consequences. According to a report by Statistics Korea, Korea’s unemployment rate for March 2018 stood at 4.5 percent, up 0.4 percentage points year-on-year and at a 17-year high for the month of March (Figure 11).

Figure 11. Trend of Unemployment Rate in March of Recent Years



Source: Statistics Korea



In March 2018, the number of those unemployed stood at 1.26 million, up 120,000, or 10.6 percent, from a year ago. The youth unemployment rate, those aged 15-29, reached 11.6 percent in March, up 0.3 percentage points from a year earlier, becoming one of the highest in the OECD. The service sector—including retail, wholesale, accommodations, and restaurants—experienced significant job losses. The number of people employed in these services alone dropped by 116,000 compared to a year before. A public survey conducted by the Chosun Ilbo and an opinion leaders survey by Korea Economic Daily indicates that the minimum wage increase could be a large contributor to the recent rise in unemployment and could have negatively affected incomes of low income and self-employed households.¹⁶ In response to deteriorating youth unemployment, the government proposed a rare supplementary budget worth 3.9 trillion won (around \$3.6 billion) in early 2018 which focused on finding jobs for unemployed young people.¹⁷

Despite the government emphasis on elevating low incomes, SMEs and micro businesses have been disproportionately affected by the minimum wage hike, shortened working hours, and hiring of regular employees. Big businesses also appear to be less enthusiastic about big investment commitments in the domestic market that the government is attempting to bring about with these policies. This is partly due to the corporate

tax hike and “wait and see attitude” toward how the *chaebol*-governance policies of the Fair Trade Commission may evolve.

However, *chaebols* are still investing, though are doing so overseas. In 2016, Korea’s outbound foreign direct investment (FDI) was \$38.8 billion, but jumped to \$43.4 billion in 2017.¹⁸ In the past 10 years, Korea’s accumulative FDI outflows have been three times the accumulative FDI inflows as shown in Table 3. Increasing wage costs at home, labor market rigidity, on-going cross-border supply chains, and rising protectionism abroad have been pushing more Korean companies off shore and to cheaper labor-cost countries, and income-led growth policies could be exacerbating these trends.

Another possible reason why these policies have struggled to produce the intended results thus far can be explained by economic theory. According to the conventional labor productivity theory, a wage increase needs to be aligned with labor productivity and economic growth in the medium and long term. Over the 2010-2016 period, wage costs steadily rose while labor productivity declined, as shown in Table 4. The abrupt and record minimum wage increase has made many firms reduce workers to avoid excessive labor costs relative to productivity. The validity of the ILO’S wage growth model might hold if the real wage rate of increase is lower than the economic growth rate and increases in labor productivity over a sustained period.

Table 3: Korea’s Inbound and Outbound FDI Flows

FDI	Year										Total
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	
Inbound (Arrival)	8,371	6,668	5,422	6,593	10,693	9,854	12,056	15,953	10,604	12,817	99,031
Outbound	20,085	20,784	25,341	29,292	29,095	30,649	28,187	29,786	38,780	43,445	295,444

Source: Ministry of Trade, Industry and Energy and Korea EXIM Bank

Table 4: Increase Rates of Labor Productivity and Wages in Korea in Recent Years (%)

Index	2010	2011	2012	2013	2014	2015	2016
Nominal Wage/ Hour Index	100	101.72	107.18	112.45	116.24	120.19	125.73
Labor Productivity Index	100	100.2	97.6	98.7	97.3	84.5	87.1

Note: Two indices are expressed in terms of 2010 as the base year. The labor productivity index excludes agricultural workers.

Source: Bank of Korea and Government Statistics

To address these issues, Korea should recalibrate the speed of increasing the minimum wage expected next year under the intended goal of reaching 10,000 won by 2020. As practiced in many OECD economies, the definition of the minimum wage needs to include overtime pay, bonuses, and employer-provided welfare benefits.¹⁹ The same logic could also be applied to define the concept of “ordinary wage.”

A More Market-based Innovative Growth Policy with a Greater Focus on Existing Industries

Korea’s innovative growth model should expand its coverage to existing SMEs beyond startups. Further, the deregulation and policy coordination necessary for the proliferation of innovative startups has yet to be realized. As a result, some government-led policy tools, which have already been effective, need to be substantially readjusted.

Korea’s tech startups have been triggered mostly by government policy initiatives, including short-term government policy funding. After government funding runs out in three to four years, many startups suffer from a “death valley” due to a lack of continued financing from commercial banks and Korea’s barren venture capital environment.

In this regard, several directional changes are in order: First, a private-led venture capital market rather than government initiatives must be promoted through deregulation to boost the entrepreneurial environment. Second, an open innovation platform needs to be created so that large technology firms and small venture firms can interact with each other. Third, an in-house venture spinoff model within large technology-oriented firms needs to be promoted.²⁰ Fourth, the mergers and acquisitions market and venture capital must play a more active role.

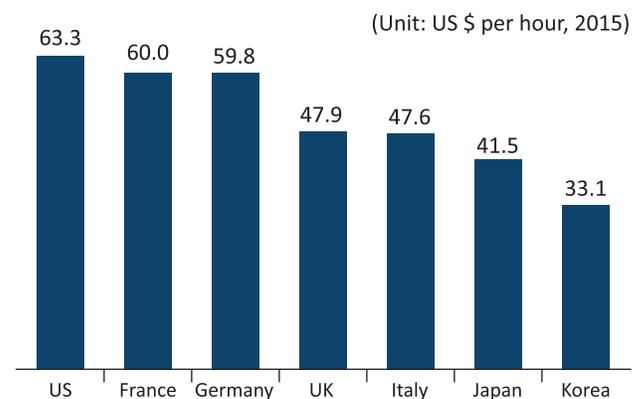
Many of Korea’s existing SMEs still have outdated technologies. According to the 2016 annual sample survey conducted by the Ministry of SMEs and Startups covering 124,165 SMEs, 25 percent of them have not yet installed a digital automation system while another 33 percent has just started to introduce a smart factory concept at a preliminary stage.²¹ As digitalization spreads, unskilled factory workers will lose their jobs to machines, but the number of people qualified to work with these machines remains insufficient. Therefore, innovative growth should address skills training and digital manpower development for SMEs.

To create more decent jobs, innovative growth policies should also pay greater attention to the service sector and existing industries through internalizing the notion of innovation. Segregating existing and new industries cannot wholly address the problem of job elimination caused by automation and digitalization. In the new industrial age, traditional industries must become more productive through the application of new technologies. Consequently, Korea should benchmark Germany’s “Industry 4.0 movement,” in which existing industries underwent digitalization. The government needs to undertake a digitalization of even micro-firms so that they can engage in business to consumer and business to business exports as a major activity for their business.

Increasing Productivity and Enacting Structural Reforms

In line with the objectives of the Moon administration, structural reforms are vital to mitigate inefficiencies stemming from the triple dualities in the labor market, product market, and businesses. Structural reforms are particularly necessary for labor productivity, which remains near the bottom among OECD economies. The average value added per hour per Korean worker was \$33.10, far below the OECD average of \$47.10 (Figure 12). According to data from the Korea Productivity Center, Korea’s labor productivity grew at an annual average of 0.38 percent from 2009 to 2016 while the annual increase in real wage averaged 1.66 percent. As long as wage hikes outpace increases in labor productivity, Korea’s competitiveness will dwindle.

Figure 12. Korea’s GDP per Worker Compared with Major OECD Economies



Source: OECD (2018) GDP per Hour Worked(indicator).
 Doi:10.1787/1439e590-en (Accessed on 11 May 2018)



Korea’s productivity gap between SMEs versus LCs and manufacturing versus services is much bigger than other OECD countries, as was shown in Figure 10. The relative labor productivity of small firms to large firms in Korea is also far lower compared to the OECD average (Figure 13). The low productivity of SMEs as well as the service sector in Korea are among the most crucial policy challenges. To enhance low SME productivity, Korea’s innovative growth model should focus more on SME globalization and take advantage of rapidly changing global value chains in collaboration with Korea’s large export-oriented firms and their global networks.²²

The government-planned increase in public-sector jobs will draw college graduates to take exams for government posts at the expense of the private sector, which will continue to struggle to find employees who can work with new technologies. Against a backdrop of labor scarcity amid high unemployment, labor supply and manpower development must be realigned. The ongoing 4th industrial revolution requires labor mobility across industries and working styles as special tasks and functions are required.

As a part of its pro-labor policies, the government has strengthened restrictions on the dismissal of regular workers and working hours. The government has also instructed public entities to convert temporary workers to permanent ones. With the adoption of robust unemployment insurance, the government should also push for more flexibility for regular workers and working hours to meet the varying needs of individuals and move away from the strictly seniority-based wage system to adapt to a rapidly changing digital economic landscape. More fiscal resources need to be diverted for training, professional schools, and life-long learning systems, especially regarding digitization for job seekers and the self-employed in marginal services rather than direct subsidies to uncompetitive firms.

Thus, labor market flexibility is regarded as crucial for increasing labor productivity and fostering inclusive growth. The government must accelerate labor reforms that allow for more flexibility and pass bills which revitalize Korean businesses. In the absence of a productivity increase, a set of pro-labor policies, including the steep wage hike, will also exacerbate the current trend of Korean firms moving production abroad, reducing jobs at home.

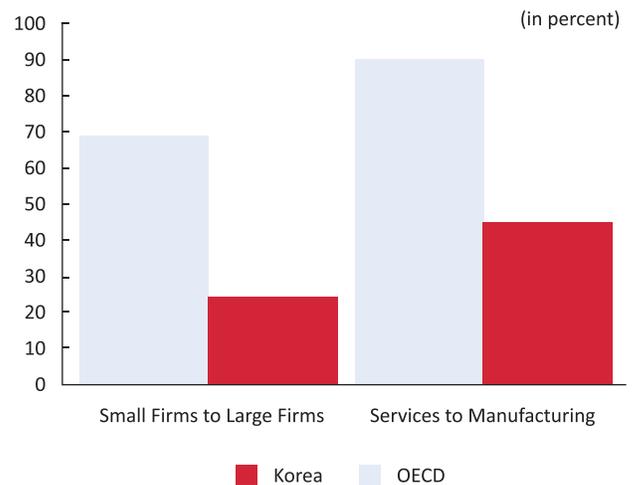
Creation of a New Business Ecosystem

Beyond macro and monetary policy, Korea has introduced an institutional mechanism to encourage the concept of a new business ecosystem, with the notion of “creating shared value” as elaborated by Porter and Kramer,²³ and Moor²⁴. The essence of a business ecosystem is summarized as:

“An economic community supported by a foundation of interacting organizations and individuals - the organisms of the business world...Over time, they coevolve their capabilities and roles,... Companies need to become proactive in developing mutually beneficial (“symbiotic”) relationships with customers, suppliers, and even competitors...”²⁵

In Japan, Inamori Kazuo, Chairman of Kyocera, has emphasized the concept of a symbiotic business ecosystem to develop beneficial relationships with suppliers and customers beyond corporate social responsibility. Kyocera’s managerial excellence has been benchmarked globally. At Kyocera, Inamori has implemented his “amoeba management” system, emphasizing symbiotic and ethical management.²⁶

Figure 13. Relative Labor Productivity of LCs versus SMEs and Services versus Manufacturing in Korea Compared to OECD Average



Source: IMF: Republic of Korea; Selected Issues, Country Report No. 18/41, February 2018, 53.

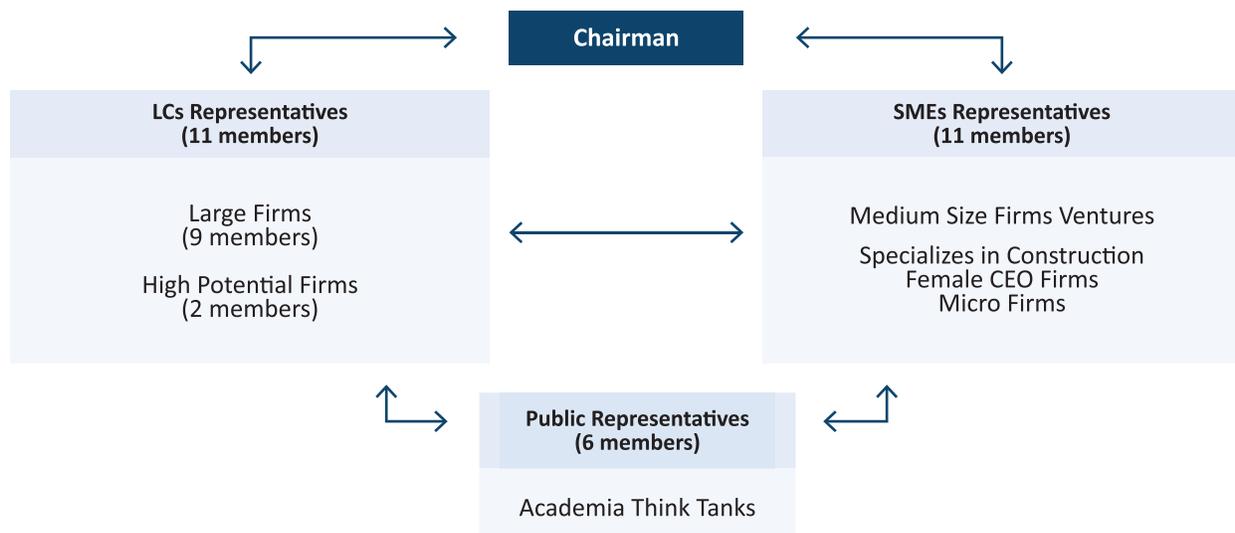


Figure 6 pointed out that factors responsible for increasing total factor productivity normally include R&D capacity, education systems, rule of law, etc. On top of these factors, an additional factor, which involves the concept of a business ecosystem emphasizing win-win collaboration among firms on a level playing field, must be considered. During the high growth period, LCs and SMEs both played a zero-sum game where the winner took all. In contrast to globally emerging LCs in terms of technology and competitiveness, Korea's SMEs have become depressed and shallow, though signs of small but competitive ventures can be seen. Under these circumstances, if Korea could combine the relative strengths of its LCs and SMEs in a win-win framework, it would have another robust source of equitable economic growth. Korea's big firms are technologically competent and have overseas networks, which when shared with sub-tier innovative SMEs generates greater flexibility and new ideas.

Korea's prominent *chaebols* are now into their third or fourth generation of management. As a result, the number of implicit and explicit sub-tier companies belonging to LCs keeps bulging, reaching around 1,600. In recent years, some *chaebols'* subsidiary companies, including new ones, have sought quick profits by taking advantage of business opportunities in traditional domestic markets dominated by SMEs. At present, Korea's micro and small businesses number around 7 million, constituting Korea's grassroots economic base.

To enhance SME competitiveness and their complementary linkages with LCs, Korea established the Korea Commission for Corporate Partnership (KCCP) in December 2010, which aims to encourage synergistic partnership between LCs and SMEs.²⁷ The SME representatives in the Commission include micro-businesses, medium-size companies, venture associations, female business associations, and sub-tier construction companies (Figure 14). Based on the mutual growth law, the Commission carries out two broad functions with a view to encourage voluntary win-win programs between big and small firms such as joint R&D, joint overseas market exploration, a systematic purchase fair for SME products, and mutual prompt payments for SME deliveries. The first major function is to designate SME business boundary lines²⁸ which discourage big businesses and their sub-tier SMEs from expanding further into a product market. The second is the annual mutual growth index for LCs to evaluate to what extent they have worked to collaborate with SMEs. The commission's decisions are made based on private consensus-based voluntarism to ensure transactions between LCs and SMEs are on equal footing. The KCCP's private business dialogue mechanism also helps to remove information asymmetry between LCs and SMEs.

Figure 14. Organization of the KCCP as of January 2018



Source: KCCP White Paper on Mutual Growth in 2016 (in Korean)



Conclusion

The twin policy guidelines of J-nomics—with their different degrees of emphasis in terms of new legal enactments, budget allocation, and ancillary supportive policy measures that greatly favor income-led growth—tend to downplay the role of private sector entrepreneurship and initiatives. The 2018 budget and key policy measures clearly indicate that income-led growth is greatly prioritized over innovative growth. While income-led growth policies are attempting to make much needed changes for a “trickle up effect” and income equity by raising wages, policies promoting higher labor productivity must also be pursued to achieve equitable and sustainable growth.

Korea is a mid-sized open economy in which international competitiveness should be continuously addressed. Consequently, capacity building and the competitiveness of LCs as well as SMEs must be more systematically pursued from the supply-side. The Moon administration’s innovative growth policies approach growth from the supply-side but concentrate primarily on business startups. These policies should be expanded to consider how to induce existing industries to converge with the 4th industrial revolution. Thus, innovative growth requires broad deregulations to remove deeply rooted labor market rigidity and institutional barriers for new businesses aligned with disruptive digital technologies to develop in a business-friendly environment.

This year, Korea is likely to join the high-income economy group, with a per capita GNI of US\$ 30,000, in which consumers look for newer, high-quality products. Evidence in Korea as well as other high-income economies suggests that we are living in a modern version of Say’s law, which claims that “a new

sophisticated product supply creates its own demand.” As a corollary, consistent and continued emphasis on innovation in the supply-side through encouraging vibrant entrepreneurship, and building technological absorption capacity is critical to create decent jobs and sustainable growth.

The two-pronged directional guidelines need to be better reprioritized, interconnected, and reconciled with each other to generate overall economic efficiency and positive distributional impacts. Beyond the government’s macro and micro policies for robust and inclusive growth, a virtuous business ecosystem needs to be promoted to enable big and small companies to play out a mutually reinforcing positive sum game instead of the zero sum relationship that prevailed during the high-growth era.

Amid the ongoing global economic recovery, Korea should take advantage of the growing world economy through rebalancing the overly domestic demand-orientated first year of the Moon administration with supply-side-led open competition. Entering its second year, the Moon administration is highly recommended to carry out structural reforms to raise the potential growth rate and mitigate unemployment through boosting productivity while ensuring that the gains from growth are shared widely for equitable and sustainable growth. At a time of prolonged economic recession and rising economic and social inequality, Korea’s policymakers, need to pay attention to Giacomo Corneo, who said: “Markets can encourage economic efficiency and frugality, and they can bring about valuable innovation and coherence within complex economies. They are therefore extremely helpful in solving the cooperation and allocation problem that economic systems face.”²⁹



Endnotes

- ¹ The author would like to express his gratitude to Chang Young and Jung Hyosun for their help to collect data for graphical expositions and editorial assistance.
- ² The Korea Commission for Corporate Partnership (KCCP) was established in December 2010 to encourage voluntary win-win collaborations between LCs and SMEs at a level playing field. For the history and organizational structure, see the KCCP's White Paper of Mutual Growth (2015) here: <http://www.winwingrowth.or.kr/> (in Korean).
- ³ For details of Korea's four sector reforms under the IMF program, see Ahn Choong Yong, "Financial and Corporate Restructuring in South Korea: Accomplishments and Unfinished Agenda," *The Japanese Economic Review* 62, no. 4 (2001): 452-470
- ⁴ For details on income distribution and polarization, see Ahn Choong Yong and Kyttack Hong, "Korean Economy in Transition: Toward an Advanced Economy," in *Korea-India: Deepening Partnership for the 21st Century*, eds. Parthasarathi Shome and Ahn Choong Yong, (Korea Institute for International Economic Policy, 2012), 71-102. Korea used to be a representative economy, which had achieved growth and equity simultaneously, see *East Asian Miracle: Economic Growth and Public Policy*, World Bank, (New York: Oxford University Press, 1993).
- ⁵ For further details, see Sonali Jane-Chandra, Tidiane Kinda, Kalpana Kochhar, Shi Piao, and Johanna Schauer, "Sharing the Growth Dividend: Analysis of Inequality in Asia," IMF Working Paper 16/48, March 2016, 11-12.
- ⁶ Typical policy tools provided to *chaebols* include cross-shareholding schemes among *chaebol* subsidiaries and such incentives for export activities as automatic bank loans to exporters with concessional interest rates and tariff exemptions for imported intermediate goods for export purposes.
- ⁷ OECD Economic Surveys: Korea Overview, May 2016, 42.
- ⁸ Ibid. For description of rising inequalities and income and societal divide, see Ahn Choong Yong, "Rising Inequities in South Korea and the Search for a New Business Ecosystem," *Global Asia* 11, no. 2 (Summer, 2016): 28-35.
- ⁹ For details, see Era Dabla-Norris, Kalpana Kochhar, Nujin Suphahiphath, Frantisek Ricka, Evridiki Tsounta, "Causes and Consequences of Income Inequality: A Global Perspective," IMF Staff Discussion Note 15/13, (June, 2015), 4-9.
- ¹⁰ Inclusive growth models advocated by international organizations and Joseph Stiglitz might be viewed in a neo-Keynesianism framework, but they vary in policy emphasis and priority ordering. For example, Joseph Stiglitz lays out a comprehensive agenda to create a more dynamic economy and fairer and more equal society. See Joseph Stiglitz, *The Price of Inequality: How Today's Divided Society Endangers our Future*, (New York: W.W. Norton, 2016.). Many policy prescriptions for inclusive growth call for equal access to opportunities, human resource development, and strengthening social safety nets. Some argue that it is possible, and indeed, essential, to be pro-labor and pro-business to advocate a strengthening of both social inclusion and the efficiency of the market. For this see Richard Samans et al., *The Inclusive Growth and Development Report 2015*, World Economic Forum, September 2015, Executive Summary, viii.
- ¹¹ Marc Lavoie and Engelbert Stockhammer, "Wage-led Growth: Concept, Theories and Policies," in *Wage-led Growth: an Equitable Strategy for Economic Recovery*, *Advances in Labor Studies*, eds. Marc Lavoie and Englebert Stockhammer, International Labor Office, (2013), 13-39.
- ¹² For details of 2018 national budget, see "Press Release on 2018 National Budget, Ministry of Strategy and Finance," August 28, 2017. For supplementary information, link to http://blog.naver.com/donga_pr_bot/221088469481
- ¹³ For the minimum wage for 2018, see Public Notification on August 4th, 2017 No. 2017-42, Ministry of Employment and Labor, <http://www.moel.go.kr>
- ¹⁴ IMF Country Report No. 18/41, February 2018, 88-95.
- ¹⁵ OECD Employment and Labour Market Statistics: Average Annual Hours Actually Worked, <https://www.oecd-ilibrary.org?employmnet/data/jhours-worked/average-annual-hours> (accessed on May 5, 2018).
- ¹⁶ For the public survey results on one year's J-nomics with a finding that 54 percent of the self-employed experienced a reduction of disposable income," Chosun Ilbo (www.chosun.com) on May 4th, 2018 pA3 and also see an opinion leaders survey result by the Korea Economic Daily (www.hankyung.com) to report that 69 percent called for a revision of income-led growth on May 6, 2018 pA and see the front page headline coverage including comments by experts by Joongang Ilbo, April 14, 2018, www.joongang.co.kr
- ¹⁷ "Government Draws Up Supplementary Budget to Support Young Adult Employment and Local Economies" Ministry of Strategy and Finance Press Release, April 6, 2018.
- ¹⁸ Korea used to rely on foreign loans for development financing but switched to a pro-active FDI inducement policy by switching from a positive list to negative list system in 1984. The Ministry of Trade, Industry, and Energy handles the inbound FDI while the Korea EXIM bank manages outbound FDI flows.
- ¹⁹ Another issue related to wage definition is the scope coverage of ordinary wages, which has a great impact on hiring, layoffs, and manpower development policy.
- ²⁰ For example, Samsung Electronics has established an in-house spinoff venture model, called Samsung Creation lab, in which new employees are given a chance to commercialize their creative ideas at the Samsung Creation Lab after two or three years of original company assignment at the creation labs with free-wheeling work styles. Successful ventures are allowed to spinoff and get listed on the KOSDAQ market.
- ²¹ The Ministry of SMEs and Startups, Home Page, www.mss.go.kr and link to http://211.253.148.167:8083/statHtml/statHtml.do?orgId=142&tblId=DT_D40009&dbUser=nsisupdb
- ²² For details, see Jaehan Cho and Stacey Frederick et. al, "A Study of Korean Manufacturing Competitiveness and Industrial Upgrading in Global Value Chains," Korea Institute for Industrial Economics and Trade and Duke Global Value Chains Center, (December 2017).
- ²³ For discussions of "creating shared value," see Michael E. Porter and Mark R. Kramer, "Strategy and Society: The Link Between Competitive Advantage and Corporate Social Responsibility," *Harvard Business Review*, (December, 2006): 78-92; and, Michael E. Porter and Mark R. Kramer, "Creating Shared Value," *Harvard Business Review*, (January-February, 2011): 62-77.
- ²⁴ James F. Moore, *The Death of Competition: Leadership and Strategy in the Age of Business Ecosystem*, (New York: Harper Business, 1996).
- ²⁵ Ibid, 3.



- ²⁶ For details, see Robin Cooper, "Case Study: Kyocera Corp.: The Amoeba Management System," *Harvard Business Review*, (1994). Inamori Kazuo's managerial principles are based on symbiosis in intra and inter- company relations vis-a-vis society as a whole. In Korea, a number of LCs and high potential large firms have been carrying on their own activities as related to corporate social responsibility (CSR) and creating shared value. In particular, SK group has adopted a managerial principle to help "social enterprises" stand on their own feet. For this see 2018 KAIST-SK Social Entrepreneurial Management Program at <http://sksecneter.kaist.ac.kr/>
- ²⁷ The author served as the chairman of the KCCP from August, 2014 to January, 2018. For details about KCCP's history, organization, missions, major achievements, see the White Paper of Win-Win Growth (in Korean) in Korea published by the KCCP, 2015; and, Ahn Choong Yong, "Mutual Growth: Contents and Challenges in Transition of Korea Toward an Advanced Economy," *Asia Finance Forum* 3, no. 1 (Autumn, 2018): 29-42 (in Korean).
- ²⁸ SME proper businesses are those traditionally dominated by micro firms and SMEs. For example, they include businesses that sell rice cakes, sausage makers, and auto repair shops. They number about 100 items and are effective a maximum of six years.
- ²⁹ Giacomo Comeo, *Is Capitalism Obsolete?* (Cambridge, MA: Harvard University Press, 2017), 128-151.

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