

# A framework for growth and social cohesion in Korea



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Better Policies

# **A Framework for Growth and Social Cohesion in Korea**

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## Preface

The world economy is emerging from the most severe crisis of our lifetimes, but many countries are still dealing with a legacy of large deficits, high accumulated debt, high unemployment, especially among the youth, and increased poverty. Restoring growth is a priority, but growth alone will not solve all our problems.

The OECD has been working with governments and other organisations worldwide to get our economies moving again and to shape the post-crisis world economy, making it stronger, cleaner and fairer.

This implies for instance achieving higher growth with stronger job creation, while simultaneously addressing issues of equity and inter-generational solidarity. Any effective strategy requires major re-thinking about how to reduce the gap between the rich and the poor and how to equip workers with the adequate skills for today's fast changing labour market. This also requires bringing opportunities to all, including women, immigrants, minorities and youth.

This report was prepared to help Korea identify and address main social policy challenges. It suggests specific policy options, based on the practices and reforms that have worked well in other countries. It proposes a strategy to “go social”, accompanied by action plans in each of the following seven areas: I) Employment; II) Income Distribution and Poverty; III) Gender Equity and Fertility: Reconciling Work and Family Life; IV) Social Protection: Public Pensions, Long-term Care and Health Care; V) Improving Equity in Education; VI) Entrepreneurship, SME Promotion and Micro-credit Schemes; and VII) Tax Policies to Finance Rising Social Spending.

Korea aims to become a flourishing green economy. Indeed, Korea is already a leading light on policies to spearhead green growth. In realising the promise of this green, “low carbon”, growth model, Korea is building upon solid foundations; a hard working, well educated and inventive population and a business environment that encourages innovation, trade and integration in a globalised world economy.

This path would be made more sustainable if increased attention were paid to the social agenda, to strengthen cohesion and reduce inequalities.

The OECD is proud to be able to contribute to the policy debate in Korea on how best to achieve these objectives.



**Angel Gurría**  
**Secretary-General**

## Why Is Achieving Social Cohesion Such an Urgent Priority for Korea?

Korea is confronting a serious challenge. It has to improve income equality in the context of a severe demographic transition. Such a transition, from one of the youngest populations in the OECD at present to the second oldest by 2050, may boost the need for public spending and slow economic growth.

Sustained rapid growth during the first decade of the 21st century has been accompanied by a marked rise in income inequality. Underlying social problems were further exacerbated by the 2008 global economic and financial crisis.

As Korea becomes increasingly integrated in a globalised economy, it faces many of the same forces that have led to rising inequality in other OECD countries. Yet, Korea stands out for several reasons. First, its level of social spending is among the lowest in the OECD area. Second, the impact of its tax and transfer systems on income distribution and poverty is among the weakest. Third, Korea's dualistic labour market is highly segmented between regular and non-regular workers, leading to wide inequality in wage income.

In this context and as the pace of population ageing is accelerating, it is important to act quickly in a wide range of areas:

- Policies to sustain Korea's growth potential in the face of falling labour inputs;
- Measures that improve both growth and equality;
- Carefully-targeted increases in social spending to reduce inequality and poverty;
- Financing higher social spending, with priority given to a reform of tax and social security that minimises the negative impact on output growth.

This Chapter puts social priorities in context. As background, Annex 1 briefly reviews Korea's outstanding development pattern.

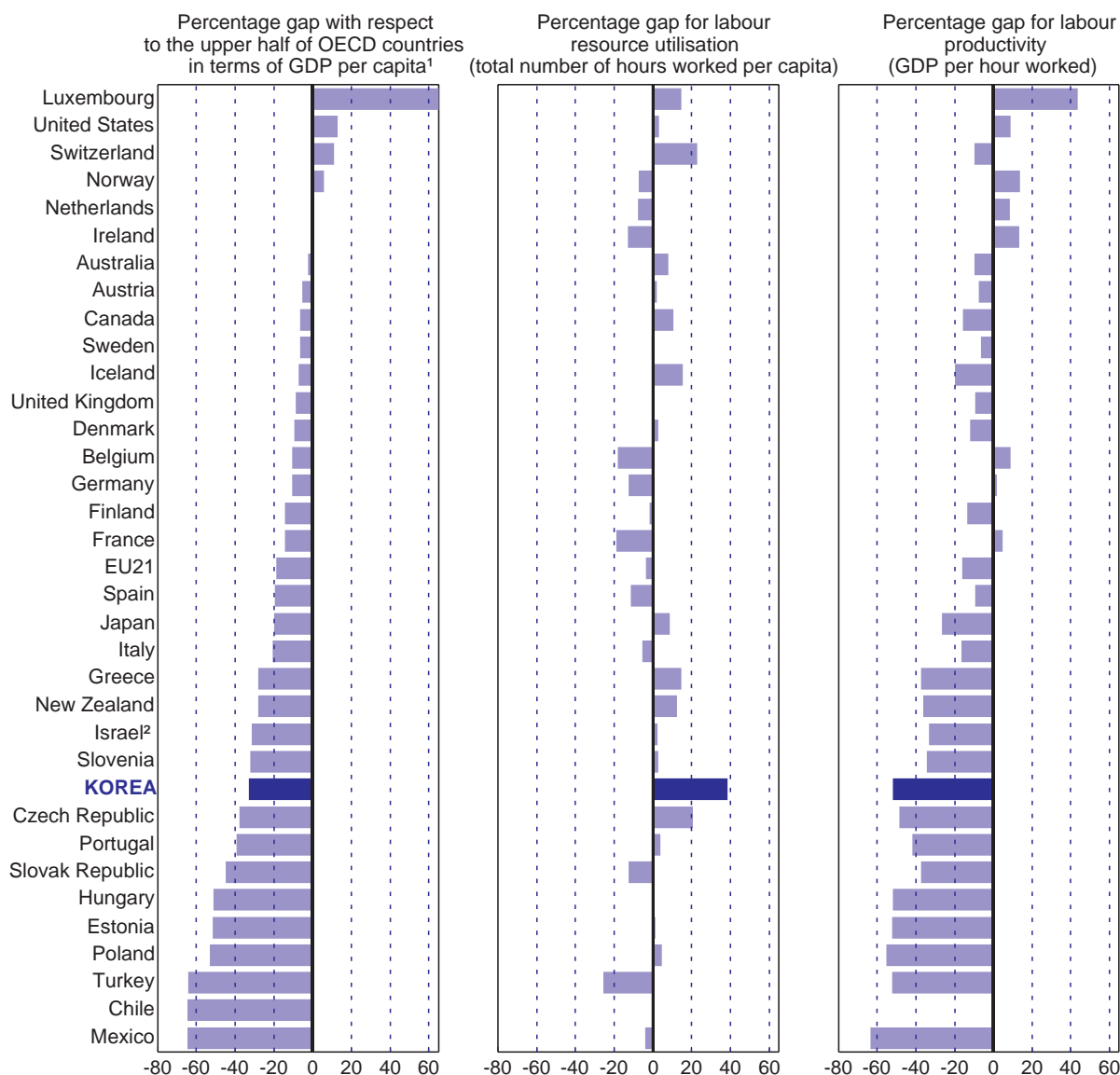
### **First, sustainable growth is essential for achieving social cohesion...**

Output growth is essential to promote social cohesion. It serves to create the jobs and generate the public revenues necessary to fund social welfare spending and insurance programmes. Indeed, increasing social spending from its current level of 7.5% in Korea toward the OECD average of 20% would certainly be more difficult in a stagnant economy, as it would seriously impact private-sector spending.

Yet pursuing output growth needs good policies. To set out the framework for such policies, it is useful to start with a review of the links between economic growth and the separate contributions of productivity growth and labour utilisation to GDP growth.

Output in Korea is sustained by large inputs of labour (Chart 1, middle column), reflecting exceptionally long working hours. Indeed, working time per capita was almost 40% above the top half of OECD countries in 2009. With the working-age population projected to begin falling in 2018 and measures to reduce working hours towards the OECD average, Korea's potential growth rate is projected to fall from 4.1% in the 2010s to 2.8% in the 2020s and 1.7% in the 2030s, according to the Korea Development Institute.

**Chart 1. Explaining differences in income in 2009**



1. Using 2009 PPP exchange rates.

2. The data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Source: OECD (2011), *Going for Growth*, 2011.



In contrast to labour inputs, labour productivity per hour worked is 55% below the average of the top half of OECD countries (Chart 1, right-hand column), explaining the large per capita income gap between Korea and the high-income countries. The key to sustaining growth in Korea, therefore, is to increase labour productivity. Given that productivity is relatively high in the manufacturing sector, the priority is the service sector, which accounts for two-thirds of employment. Indeed, labour productivity in Korea's service sector is only about one-half of that in its manufacturing sector and 40% of the US service sector.

Faster labour productivity growth in services requires strengthening competition through regulatory reform. Despite progress during the past decade, around a third of business lines in the service sector remain subject to entry barriers. In addition, competition policy should be further strengthened by increasing financial penalties to increase the deterrent effect and scaling back the number of exemptions from the competition law, including for SMEs. Greater openness to the world economy is another priority to boost productivity, particularly in services. The stock of foreign direct investment (FDI) as a share of GDP in Korea is the second lowest in the OECD area and the share in services is the third lowest. Consequently, foreign affiliates accounted for only 8% of service-sector turnover and 4% of employment in 2004, well below the OECD averages of 19% and 10%, respectively. Strengthening international competition requires reducing barriers to FDI, including foreign ownership ceilings in key services, and liberalising product market regulations. In addition, it is important to foster a foreign investment-friendly climate by enhancing the transparency of tax and regulatory policies and reforming the labour market (2008 *OECD Economic Survey of Korea*).

Setting Korea on a path of sustainable growth over the long-term also depends crucially on how it responds to the challenge of climate change. In 2008, President Lee Myung-bak proclaimed "Low Carbon/Green Growth" as the vision to guide Korea's development during the next 50 years and in 2009 he introduced the National Strategy for Green Growth to mitigate climate change and create new engines for economic growth (2010 *OECD Economic Survey of Korea*). In 2009, Korea voluntarily set a goal of cutting its greenhouse gas emissions by 30% relative to a "business as usual" baseline by 2020, which implies a 4% reduction relative to 2005. Meeting this target will be challenging, as emissions almost doubled between 1990 and 2005, making Korea one of the fastest-growing sources of emissions in the OECD area. Moreover, Korea has one of the highest levels of energy intensity in the OECD area, reflecting its concentration in energy-intensive industries. Thus far, Korea has relied primarily on voluntary commitments by firms to reduce emissions. Achieving the 2020 target in a cost-effective manner requires improving the policy framework by introducing market-based instruments to reduce emissions. Market instruments, notably emissions trading systems and carbon taxes, are efficient as they equalise abatement costs across all emitters and, over the long run, provide incentives to develop new technologies that lower abatement costs.

### **...but "go social" policies are at least equally important**

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While structural reforms are indispensable to achieve sustainable growth, Korea also has important social challenges to address. Growth is important but growth alone will not solve all problems. In order to make the Korean economy more equitable and cohesive, the government needs to give priority to the implementation of well-targeted employment and social policies. This is the fundamental "go social" challenge that lies ahead of Korean policymakers.



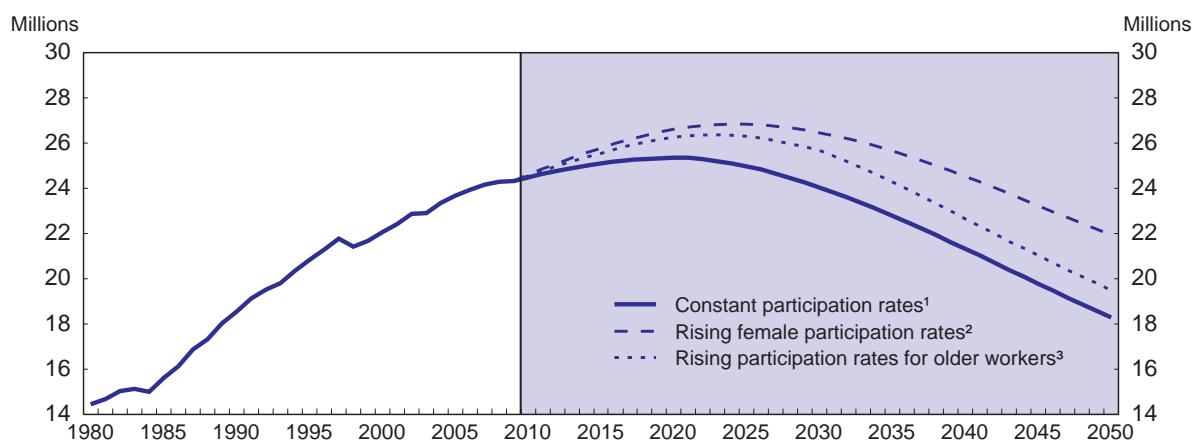
In several areas discussed in this report, such as employment and education, reforms would both sustain output growth and reduce inequality. In the labour market, the sharp increase in the share of non-regular workers, to more than one-third of employees, has negative consequences for both growth and equity. Such dualism is largely explained by the rising share of temporary workers, from 17% of employees in 2001 to 26% in August 2008, almost double the OECD average.

Not surprisingly, temporary workers receive less firm-based training than permanent workers, thus slowing human capital formation and productivity growth. Lower wage costs encourage firms to hire non-regular workers, who earn only about half as much as regular workers, with productivity differences explaining only part of the gap. The cost advantage is magnified by the low coverage of non-regular workers by the social insurance system. Firms also hire non-regular workers to achieve greater employment flexibility, given the employment protection for regular workers.

Dualism creates equity concerns as a significant portion of the labour force works in precarious jobs at relatively low wages and receives less protection from social insurance. Reducing dualism requires weakening the incentives that encourage firms to hire non-regular workers. One priority is to liberalise employment protection for regular workers so that firms can achieve the necessary flexibility without depending as much on non-regular workers. A second priority is to increase the coverage of non-regular workers by the social safety net, thus improving equity and narrowing the gap in labour costs. In addition, measures to ensure adequate training opportunities for non-regular workers and to prevent discrimination against them are also necessary.

Rapid population ageing makes it important to make better use of women and older workers (Chart 2). Raising the relatively low participation rate of women requires reforms to increase the availability of childcare, encouraging family-friendly policies, breaking dualism and promoting the take-up of paid parental leave. As for older workers, firms should not be able to impose mandatory retirement income below the age of 60, thus promoting greater labour income for the elderly, who face the highest rate of poverty among OECD countries.

**Chart 2. Long-term projections of Korea's labour force**



1. The participation rates for men and women are assumed to remain at their current levels for each age group.
2. Female participation rates are assumed to reach current male rates in each age group by 2050.
3. The participation rates are assumed to 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 Secretariat calculations based on population projections by the Korea National Statistical Office.

Education, ranging from early childhood education and care (ECEC) to university, is also a priority. ECEC is crucial for improving the educational development of children; empirical work has established that fundamental cognitive and non-cognitive abilities are created well before the age of five. Given that ECEC provides an important foundation for subsequent learning, high-quality programmes enhance later school achievement, resulting in very high rates of return from pre-primary education. In addition, ECEC also contributes to reducing social inequality as children from disadvantaged families receive much less cognitive and emotional stimulation.

Another key equity concern is the important role of *hagwon* -- private institutes for after-school instruction, which increase inequality in educational results and place a heavy burden on families. While reforms to reduce reliance on *hagwon* are called for, it is important to increase the accessibility of low-income households to after-school learning. At the tertiary level, tuition fees are the third highest in the OECD area. It is important to ensure that public loans are available to qualified students. Making loan repayment contingent on income after graduation would also encourage students from low-income households to invest in education.

## Increasing social spending

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As Korea became an industrialised and urbanised society, part of the responsibility for social welfare shifted gradually from families and firms to the government, which introduced social insurance programmes for medical care (1977), pensions (1988), employment (1995) and long-term care (2008). Nevertheless, social spending -- at 7.5% of GDP -- remains well below the OECD average of 20%, reflecting Korea's relatively young population, the limited coverage of health and long-term care insurance and the immaturity of the pension system. As these special factors evolve in coming years, social spending in Korea is likely to converge toward the OECD average. Indeed, social spending in Korea grew at an annual rate of 14% between 2000 and 2007, the fastest in the OECD area. It is crucial, though, to ensure efficiency in social spending.

In addition, Korea's tax and transfer systems have the smallest impact on inequality of any country in the OECD area. Well-targeted tax and benefit programmes are needed to mitigate increasing inequality trends. One priority is the Earned Income Tax Credit (EITC), an in-work tax credit that is used in a number of OECD countries that was introduced in 2008. In 2009, 3.6% of households received the EITC, with total payments of 0.1% of total government spending. The impact of an EITC in terms of increasing total labour supply and decreasing unemployment is greater in countries with a wide earnings distribution, low tax rates on labour and low benefits for the non-employed, indicating that it should be an effective instrument in Korea.

## How to finance rising social spending?

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Increases in social spending have sharply pushed up tax burdens in many OECD countries, weakening work incentives and slowing growth. A low tax burden promotes economic growth by enhancing entrepreneurship and incentives for foreign direct investment and education. The overall "tax wedge" on labour income, including social security contributions, was only 20% in Korea in 2009, the third lowest among OECD countries.

The most efficient way to boost revenue to finance rising government spending is through consumption taxes, which impose fewer distortions than direct taxes (2008 *OECD Economic Survey of Korea*). Korea has considerable scope to hike its value-added tax (VAT) rate of 10%, which is well below the OECD average of 18%, and to broaden its base. Other relatively non-distortionary taxes include environmental taxes, which address negative externalities of climate change and pollution, and property taxes. Taxes on property are also more favourable for growth than other taxes as they have less impact on decisions to supply labour, produce, invest and innovate. At present, Korea's tax on property-holding is relatively low compared to other OECD countries. Shifting the emphasis from direct to indirect taxation tends to have some adverse impact on income distribution. But given the efficiency gains of relying more on indirect taxes, any negative impact on equality should be offset by well-targeted policies.

As for direct taxes on personal and corporate income, the objective should be to broaden bases and keep rates low. For personal income taxes, this requires increasing the compliance of self-employed workers. The tax authorities need to enhance transparency about the income of the self-employed, as only 40% is captured by the tax system at present. This would also promote compliance with social security contributions, which are also based on income.

## OECD policy recommendations to promote economic growth and social cohesion

### **Employment**

- Promote employment for women through policies to increase the availability and quality of part-time work and improving access to high-quality childcare.
- Implement co-ordinated packages of demand- and supply-side measures to boost employment of youth and older workers. Prohibit companies from setting the mandatory retirement age below 60 and consider abolishing mandatory retirement.
- Increase the flexibility of the wage and working-time systems for regular workers so as to promote better work-life balance and generate more and better jobs.
- Reinforce non-discrimination policy so as to curb the unfair treatment of non-regular workers and ensure that they have adequate training opportunities.
- Ensure that non-regular workers are covered by the social insurance system, so as to narrow the cost advantage of hiring such workers. Relax employment protection for regular workers so that firms can achieve their desired level of employment flexibility without relying so heavily on non-regular workers.
- Remove incentives for informal employment by reinforcing labour inspection, while decreasing compliance costs for employers. Reform the welfare and tax system to increase the economic returns to working in the formal labour market.

### **Income Distribution and Poverty**

- Make greater efforts to tackle poverty by increasing the level of benefits and targeting them on the most needy.
- Relax the eligibility conditions for receiving assistance under the Basic Livelihood Security System.
- Reduce the tax burden on the lowest quintile, which is paying relatively more taxes than in many other OECD countries.
- Address the issue of high private education expenses, which has negative implications for equality and for fertility.

### **Gender Equity and Fertility: Reconciling Work and Family Life**

- Gradually increase government expenditure on childcare to fill existing gaps in coverage, thereby promoting female labour force participation and raising the fertility rate. Extend support for the most vulnerable families through, for example, “Dream start” programme.
- Encourage companies to adopt more family-friendly policies to facilitate work and family responsibilities.
- Break down labour market dualism and promote performance-based pay to make employment more attractive to women.
- Promote the take-up of paid parental leave.
- Ensure that the design of government spending schemes do not negatively affect the work incentives of parents.

### **Social Protection: Public Pensions, Long-term Care and Health Care**

- Reducing old-age poverty should be the priority of all short- to medium-term pension reforms.
- Accelerate the increase in the pension eligibility age from 60 to 65 to help ensure the financial sustainability of the National Pension Scheme.

- Encourage the development of the company pension system based on defined contributions, in part by eliminating the favourable tax treatment of the retirement allowance.
- Limit the increase in long-term care (LTC) spending by shifting it from hospitals to LTC facilities or home-based care.
- Contain the burden of LTC spending on the working-age population by increasing the share financed by retirees.
- Reform the payment schemes for health care by moving away from fee-for-service and improve quality control systems to get better value for investment.
- Avoid cost-containment efforts that might further increase the already high out-of-pocket spending by patients, thereby undermining universal access.

### **Improving Equity in Education**

- Move towards a common framework for high-quality, early childhood education and childcare services and lower the costs for households so that all children can participate, regardless of their family's financial resources.
- Continue efforts on multiple fronts to minimise the negative social impact of pressures on students and their families to succeed in the competitive university entrance exam, thereby reducing the dependence on *hagwon*.
- Develop policies to make the advantages of *hagwon* more widely available, notably to students from low-income families.
- Make vocational schools more attractive by increasing their quality and relevance for the labour market *inter alia* by engaging industry in the design of programmes and incorporating a significant element of workplace training. Expand the Meister School approach.
- Expand and redesign financial support for tertiary students, providing public loans with repayment contingent on income after graduation, together with income-tested grants.

### **Entrepreneurship, SME Promotion and Micro-credit Schemes**

- Continue to reduce regulatory and administrative burdens on start-ups, notably by streamlining the administrative procedures to start a business.
- Build up entrepreneurship education in universities and higher education institutions.
- Upgrade training in SMEs, supporting in-company projects and apprenticeship schemes.
- Recognise the role of social entrepreneurship in responding to social needs and strengthening social cohesion, tailoring support schemes to the different typologies of social enterprises.
- Reduce the level of public guarantees for lending to SMEs and address the distortions created in the financial markets and in the SME financial structure.
- Phase out excessive public support for SMEs, which were introduced during the recent crisis, and promote restructuring based on market incentives.

### **How to Finance Rising Social Spending? Reforming the Korean Tax System**

- Broaden the personal income tax base, in part by increasing the compliance of self-employed workers by enhancing transparency about their income, while keeping tax rates low.
- Limit increases in the tax wedge on labour to encourage employment, saving, capital investment, working hours, entrepreneurship, FDI and education.
- Keep the corporate tax rate low to promote investment in fixed capital.



- Make the value-added tax the main source of additional government revenue by increasing the rate from its relatively low level of 10%, while maintaining a unified rate and further broadening the base.
- Increase environmental taxes as part of the Green Growth Strategy.
- Boost property holding taxes, which would also address concerns about rising real estate prices.
- Address equity concerns related to rising indirect taxes through well-targeted social programmes and expanding the earned income tax credit.
- Enhance the compliance and coverage of non-regular workers and employees at small firms with the tax and social insurance systems.



# Employment

## **The Korean labour market bounced back quickly from the global economic crisis**

The quick recovery of the Korean economy in the wake of the 2008-09 global economic crisis was reflected in the comparative resilience of its employment performance. Korea's harmonised unemployment rate fell to 3.4% in the fourth quarter of 2010, down from a peak of 4.8% in January 2010, and close to the pre-crisis level of 3.1% in December 2007. In contrast, the OECD average unemployment rate in the fourth quarter of 2010 was 8.5%, down only slightly from its peak at 8.8% and still 2.7 percentage points above its pre-crisis level of 5.8%. The differing labour market outcomes reflect the fact that output in Korea had risen to 6% above its pre-crisis level by the end of 2010, in contrast to the OECD area as a whole, where it was still below the pre-crisis level. Notwithstanding the impressive resilience of the Korean labour market over the past several years, several structural weaknesses persist which need to be addressed.

### **Main OECD Policy Recommendations on Employment are summarised below:**

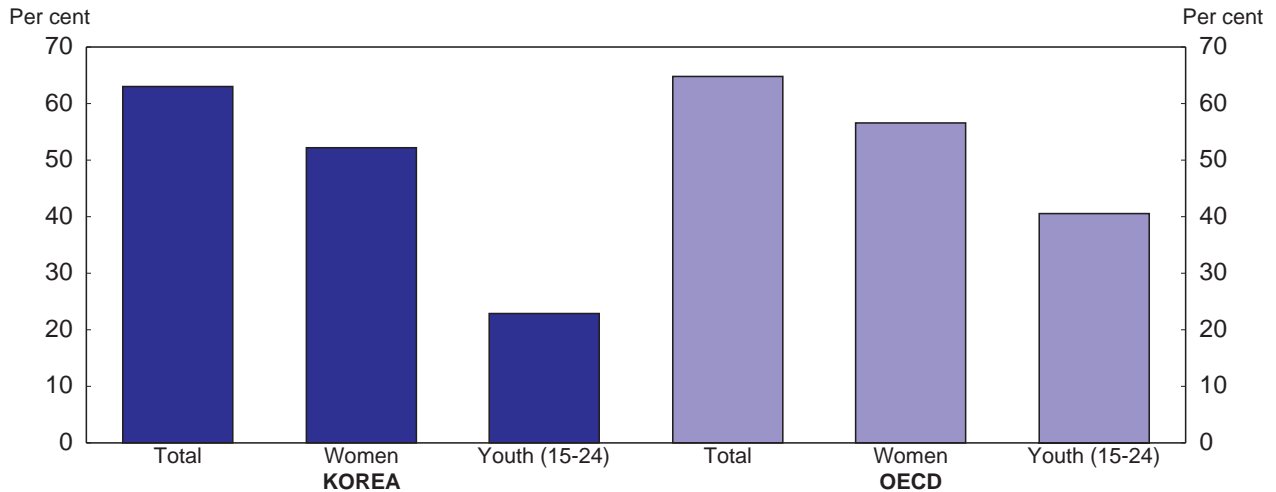
- Promote employment for women through policies to increase the availability and quality of part-time work and improving access to high-quality childcare.
- Implement co-ordinated packages of demand- and supply-side measures to boost employment of youth and older workers. Prohibit companies from setting the mandatory retirement age below 60 and consider abolishing mandatory retirement.
- Increase the flexibility of the wage and working-time systems for regular workers so as to promote better work-life balance and generate more and better jobs.
- Reinforce non-discrimination policy so as to curb the unfair treatment of non-regular workers and ensure that they have adequate training opportunities.
- Ensure that non-regular workers are covered by the social insurance system, so as to narrow the cost advantage of hiring such workers. Relax employment protection for regular workers so that firms can achieve their desired level of employment flexibility without relying so heavily on non-regular workers.
- Remove incentives for informal employment by reinforcing labour inspection, while decreasing compliance costs for employers. Reform the welfare and tax system to increase the economic returns to working in the formal labour market.

## **Promote employment among under-represented groups**

The employment rate for the 15-to-64-age group has been stagnant for more than ten years at around 63%. This is somewhat below the OECD average due to particularly low employment for youth and women (Chart 3). The persistence of a relatively low employment rate is especially worrisome, given that Korea faces the most rapid population ageing in the OECD area, reflecting its birth rate of 1.2, the lowest in the OECD area. By 2050, Korea's elderly dependency ratio is projected to be the second highest in the OECD area.

**Chart 3. Employment rates in Korea compared to the OECD average**

Employment divided by total population, in per cent in 2009 <sup>1</sup>

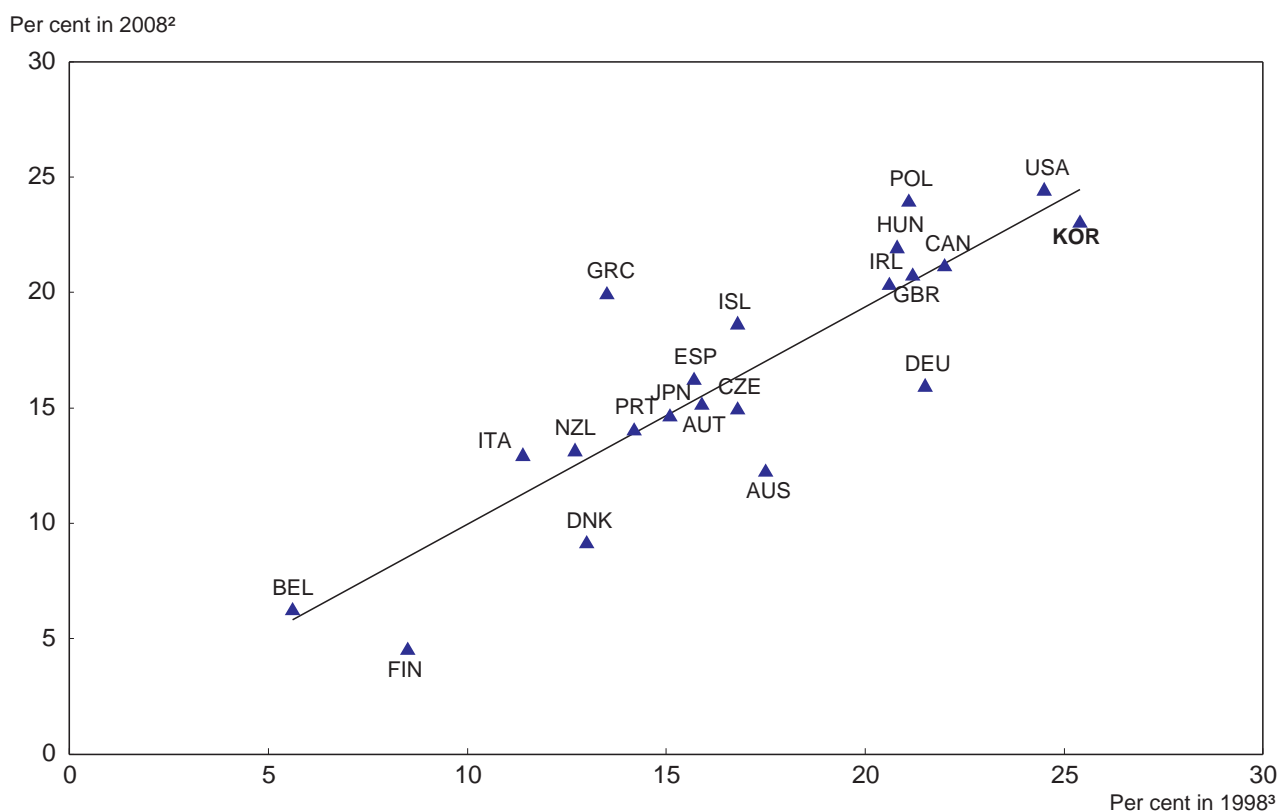


1. The total is for persons aged 15-64. Data for the OECD refer to a weighted average of OECD member countries' figures.

Source: OECD (2010), *Employment Outlook, Statistical Annex*.

A second structural weakness in the Korean labour market is the severe and growing inequality, which is closely associated with the rising share of non-standard forms of work that generally involve lower pay and worse working conditions than standard jobs. The share of non-regular workers – defined as temporary, part-time and atypical (such as workers dispatched by temporary agencies) employees – increased from 31% of employment in 2001 to 36% in 2007, before falling to 33% in 2010, as firms dismissed non-regular workers to reduce employment in the wake of the crisis. Labour market inequality is reflected in the high and rising incidence of low-paid employment in Korea (Chart 4). Addressing the double challenge to generate more and better jobs has become a national policy priority, and features in the President's recent initiative to promote a "fair society."

**Chart 4. Evolution of the incidence of low-paid work since 1998 <sup>1</sup>**



1. Percentage of full-time wage-earners earning less than two thirds of the median wage of full-time wage-earners.

2. Data refer to 2007 (instead of 2008) for Belgium.

3. Instead of 1998, data refer to 1997 for Ireland, 2001 for Finland, 2004 for Belgium, Greece, Italy, Portugal, Spain and 2005 for Poland.

Source: OECD (2010), *Employment Outlook, Statistical Annex*.

## Youth employment

The employment rate for the 15-to-24-age group was 22.9% in 2009, much lower than the OECD average of 40.6%. One factor that explains the low youth employment rate is the high rate of graduation from upper secondary school (93% compared to the OECD average of 80%) and the rapid expansion of tertiary education, where enrolments have quadrupled over the past two decades. In 2010, 82% of high school graduates advanced to university compared to the OECD average of 56%. However, the so-called “NEETs”, who are neither in employment nor in education or training, is a concern. The combination of the heightened aspirations of youth with tertiary degrees, in terms of the types of jobs they consider acceptable, and a severely segmented labour market between regular and non-regular workers appears to have deterred many highly-educated youth from the job market. Skill and knowledge mismatches further discourage youth participation in the labour market.

## Working time

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Average annual hours worked by employees were 2 256 in Korea in 2009, the longest in the OECD area. One factor is the low take-up rate for annual leave, at less than 60%. By contrast, labour productivity per hour worked in Korea is less than half of that in the top half of OECD countries (Chart 1). It is possible that very long hours adversely affect productivity levels. In any case, the expectation that regular workers put in very long hours represents a barrier to raising employment rates, particularly for mothers of young children.

## Labour market participation of older workers

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Promoting labour market participation of older workers is also key to avoid the possible negative impact of population ageing on the Korean labour market. Both the labour force participation rate for the 55-to-64-age group, at 62.7%, and their employment rate, at 60.9% in 2010, are higher than the OECD average. However, Korean workers are typically required to retire from their main career jobs at or before the age of 55. A majority of firms still set their mandatory retirement age below the age of 60 recommended by the law. Indeed, average employment tenure peaks in the 45-to-49-age group, compared to the 55-to-64-age group in most other OECD countries. As a result, many older workers in Korea are engaged in low productivity and low-paid jobs, including self-employment in the agriculture and service sectors. This is clearly reflected in the decline of average monthly labour income from 2.3 million KRW for the 40-to-49-age group to 2.1 million KRW for the 50-to-59-age group and only 1.5 million KRW for the 60-to-69-age group. One reason employers enforce early retirement is the prevalence of seniority-based wages, which eventually surpass the productivity of many middle-aged and older workers who lack the skills required to cope with rapidly changing industry needs. This forces such workers to move into lower-productivity employment.

## Discrimination against non-regular workers

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Korean firms hire non-regular workers primarily to reduce labour costs and expand employment flexibility. Despite the introduction of a regulation in 2007 to prevent unjustified discrimination against non-regular workers doing the same job as their regular counterparts, a recent survey shows that the average wage of non-regular workers is 45% below that of regular workers, while their productivity is only 22% lower. One factor is shorter tenure; the average tenure of non-regular workers is only two years compared to 6.5 years for regular workers. Labour costs are further reduced by the fact that non-regular workers are less covered by social insurance schemes. In 2010, 38% of non-regular workers were covered by the National Pension Scheme, 41% by the Employment Insurance Scheme and 42% by the National Health Insurance.

In addition, the temporary contracts of most non-regular workers enhance employment flexibility, which is a priority for firms in an increasingly competitive global economy. Temporary employment accounts for 21.3% of total employment in Korea, the fourth highest incidence in the OECD area. Consequently, non-regular jobs offer little job security. The higher turnover rate of non-regular workers also reduces their opportunities to receive firm-provided training. Such training is an important determinant of career advancement in Korea, as public spending on vocational training as a share of GDP is one of the lowest in the OECD. While the growing role of non-regulars lowers labour costs and enhances employment

flexibility, the differential treatment of non-regular workers raises serious concerns about equity and growth. Similar concerns arise for in-house outsourced workers (*i.e.* employees of sub-contracting firms who work at the purchasing firm), who are not covered by the non-discrimination provision and other laws protecting other non-regular workers.

## **Large share of informal employment**

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About 25% of the workforce in Korea remains unregistered for social security. Informal employment is often associated with tax evasion, unfair competition and inefficient production methods. Older workers, the less-educated and social benefit recipients are particularly likely to be in informal employment. The current benefit system may contribute to the prevalence of informal work, as many benefits are withdrawn as soon as a household's income (*i.e.* the sum of benefits and earnings) exceeds a threshold tied to the minimum cost of living. While informal employment may provide a buffer for some people with few labour market options, it tends to leave workers with little protection against old age, unemployment or work accidents. It also results in reduced tax and social security revenues, making it more difficult for the government to provide necessary public services.

## **OECD key messages**

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### ***Raising the employment rate***

Raising the low participation rate of women, particularly those with higher education, would be the most effective way to increase total employment. A number of policies are necessary to remove barriers to female employment. The government's initiative to support flexible forms of work, especially permanent part-time jobs, seems appropriate to encourage women to remain in the labour force after childbirth. Given that part-time work is considered to be non-regular work, the government should combine this initiative with additional measures to improve working conditions for non-regular workers. It could also be useful for the government to attempt to alter negative perceptions of non-regular work. A possible model for broadening current initiatives to encourage the expansion of part-time work for women is the Dutch experience of combining legislative action (*e.g.* fair treatment in wage and social insurance, assuring the possibility of moving between full- and part-time jobs without undermining long-term career prospects, etc). In addition, increasing the supply of quality child-care and encouraging family-friendly workplaces would make part-time work more attractive. Experience in other OECD countries also suggests that these latter policies would also help to raise the very low fertility rate in Korea.

A key measure to raise the low employment rate of youth is to make the education and training systems more responsive to labour market needs. Tackling demand-side obstacles to hiring, notably by easing employment protection legislation and promoting the creation and expansion of strong SMEs, would also be a way to promote youth employment. For older workers, a flexible wage system (*e.g.* performance-based payment) and a well-functioning public employment service, including jobs training, would encourage continued, high-productivity employment for workers aged 45 or more. In addition, prohibiting firms from setting mandatory retirement age below 60 would promote the continued employment of older workers. Given that firms accept seniority-based wages on the condition that they can force older workers



to leave, abolishing mandatory retirement altogether would weaken the link between tenure and wages, thus encouraging women to enter the work force. In addition, it would promote continued employment past the age of 60.

### ***Reducing labour market duality and informal employment***

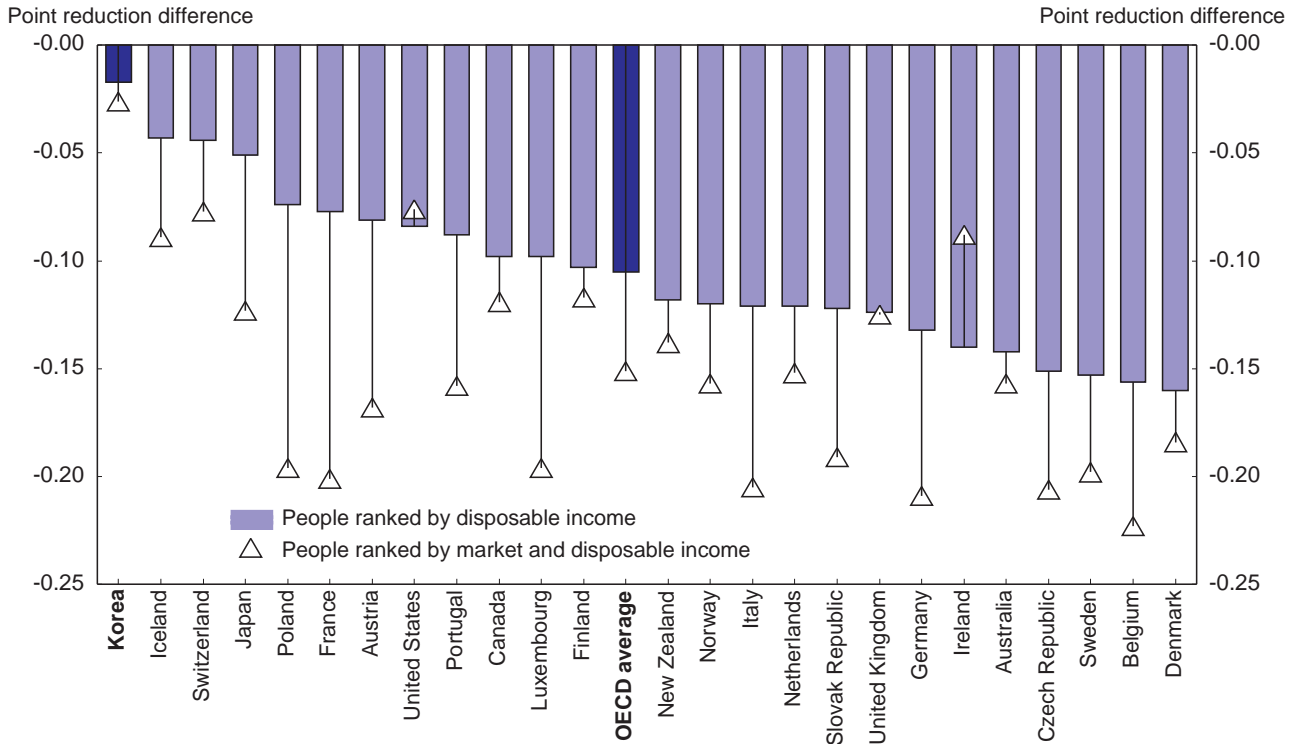
The key to reducing labour market duality is to enforce non-discriminatory treatment of non-regular workers, especially as concerns pay and access to training, although as noted above, this is difficult in practice. Measures to make outsourced employees' working conditions more comparable to those for regular employees would also help to address the duality problem. It is also important to address unfair trade between large corporations and SMEs, in part by stricter enforcement of the law requiring fair treatment of sub-contractors, which aims at protecting SMEs, by the Korea Fair Trade Commission. In addressing unfair trade between large corporations and SMEs, corporate social responsibility needs to be stressed as well. In addition, non-regular workers need to be more effectively covered by the social insurance system. This would narrow the gap in labour costs between regular and non-regular workers, while also directly improving equity insofar as non-coverage is one of the reasons the Korean tax-transfer system does little in comparison with other OECD countries to reduce income inequality (Chart 5). Incorporating more non-regular workers into the Employment Insurance System would also increase their training opportunities and enhance their employability and their chances to move into better jobs. Finally, relaxing employment protection for regular workers would reduce the incentive for firms to hire non-regular workers as a means to enhance employment flexibility.

One effective way to discourage informal employment would be to reinforce labour inspection activities, including by improving co-operation between labour, social security and tax inspectorates. The decision to unify the collection of social security contributions under the National Health Insurance is an important step forward. Allowing the authorities to compare the wage bill an employer declares when calculating corporate or entrepreneurial taxable income with the wage bill on which social insurance contributions have been paid would promote compliance. This needs to be accompanied by measures to lessen the compliance burden both for employers and workers. For example, the tax and benefit system should be reformed so as to encourage registered employment while at the same time making Korean society more equal.



**Chart 5. Differences in inequality before and after taxes and transfers in OECD countries**

Point reduction difference in concentration (Gini) coefficients, <sup>1</sup> mid-2000s



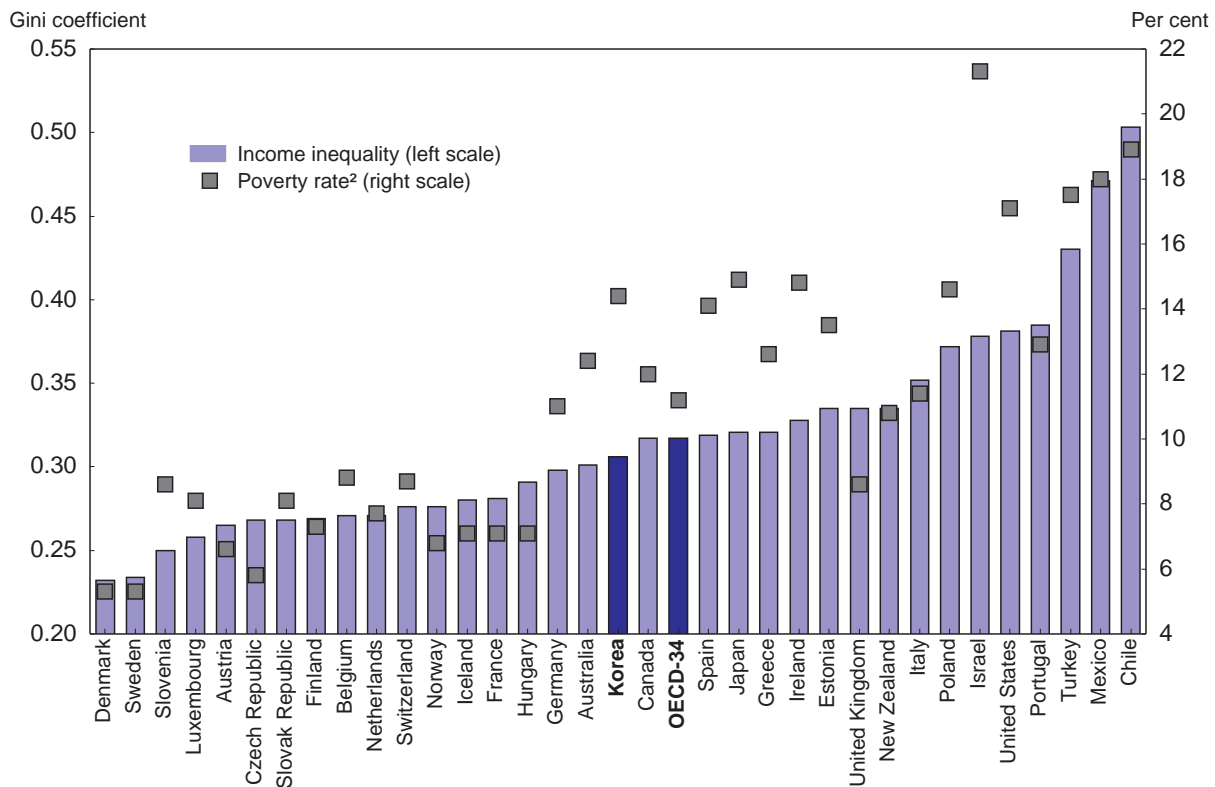
1. Countries are ranked, from left to right, in increasing order of the percentage point reduction in the concentration coefficient achieved by household taxes and public cash transfers, based on people ranked by their household disposable income. Bars are computed based on grouped data for average market and disposable income, by deciles of people ranked by their household disposable income. Diamonds are computed based on individual data, with people ranked by market income (for the Gini coefficient of market income) and ranked by disposable income (for the Gini coefficient of disposable income).

Source: OECD (2008), *Growing Unequal? Income Distribution and Poverty in OECD Countries*.

# Income Distribution and Poverty

Income inequality in Korea is just below the OECD average, with an income concentration (Gini) coefficient of 0.306 compared to 0.315 for the OECD (Chart 6). However, the ratio of the top income decile to the bottom is 4.7, the 24th highest in the OECD area and well above the OECD average of 4.2. Moreover, Korea's relative poverty rate – measured as the share of people who live on less than half median income – was 14.4% in 2006, the ninth highest in the OECD.

**Chart 6. Levels of income inequality and poverty <sup>1</sup>**



1. Data refer to the most recent possible year in the mid-2000s (2006 for Korea).

2. Poverty rates are defined as the share of individuals with equivalised disposable income less than 50% of the median for the entire population. Countries are ranked, from left to right, in increasing order of poverty rates. The income concept used is that of household disposable income adjusted for household size.

Source: OECD income distribution questionnaire, [www.oecd.org/els/social/inequality](http://www.oecd.org/els/social/inequality).

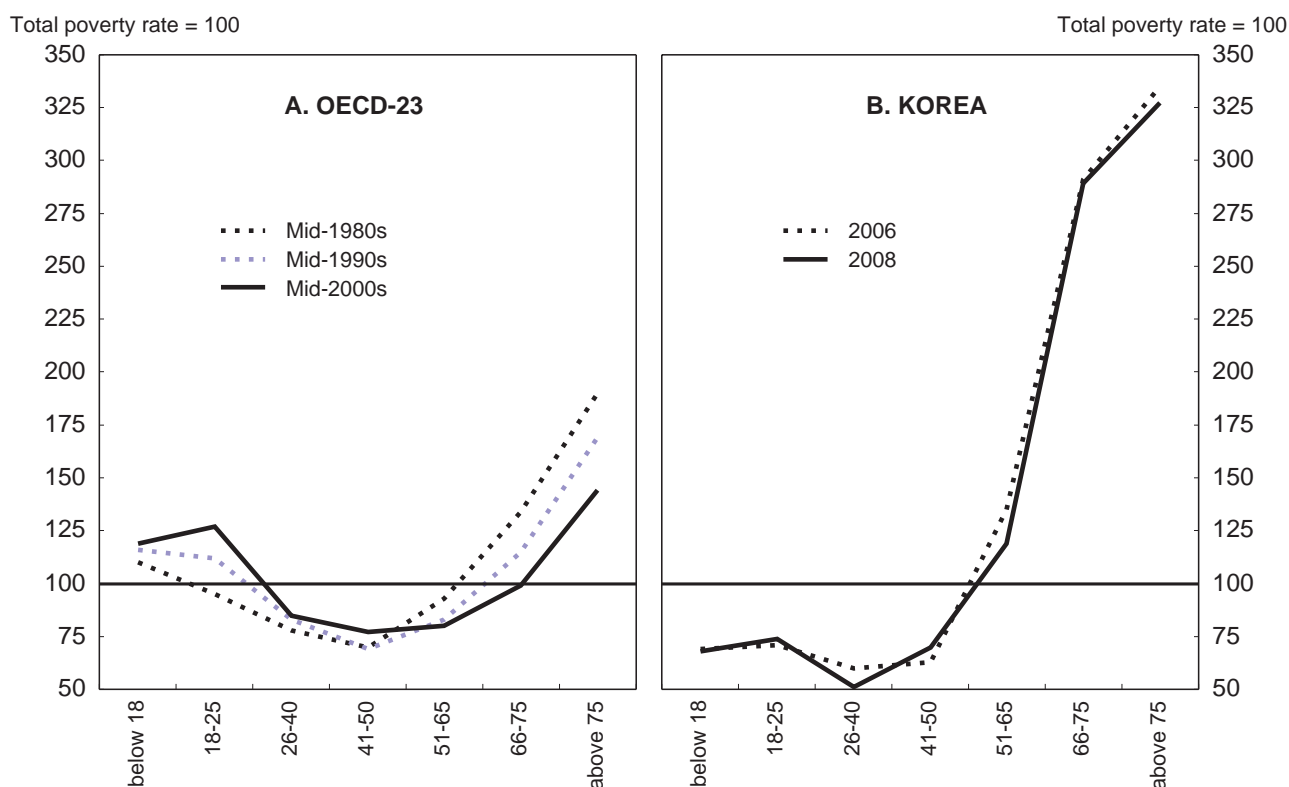
## Main OECD Policy Recommendations on Income Distribution and Poverty are summarised below:

- Make greater efforts to tackle poverty by increasing the level of benefits and targeting them on the most needy.
- Relax the eligibility conditions for receiving assistance under the Basic Livelihood Security System.
- Reduce the tax burden on the lowest quintile, which is paying relatively more taxes than in many other OECD countries.
- Address the issue of high private education expenses, which has negative implications for equality and for fertility.

## High poverty, especially among the elderly

Korea stands out as one of the few OECD countries in which older people are much more likely than the rest of the population to be poor: almost one out of two older people lives in a poor household. The poverty risk of people aged 66 to 74 was three times higher than that of the population at large in the mid-2000s, and that of people aged 75 and over, 3.3 times (Chart 7). In contrast, data for 23 other OECD countries showed that for people aged 66 to 74, the poverty risk is the same or less than the national average and that it is only 1.5 times higher for people aged 75 and over. In fact, most OECD countries have seen a considerable reduction in old-age poverty over recent decades.

**Chart 7. Risk of relative poverty by age of individuals**



Note: Relative poverty risk is the age-specific poverty rate divided by the poverty rate for the entire population times 100. The poverty threshold is set at 50% of median income of the entire population. OECD-23 is the average poverty rates across all OECD countries except Australia, Belgium, Chile, Estonia, Iceland, Israel, Korea, Poland, the Slovak Republic, Slovenia and Switzerland. Data based on cash income.

Source: Computations from OECD income distribution questionnaire, [www.oecd.org/els/social/inequality](http://www.oecd.org/els/social/inequality).

Old-age poverty, however, is largely a legacy from the past. As the pension system was introduced only in 1988, most pensioners are still entitled to only very low benefits. For the population as a whole, paid work is more important as a way of avoiding poverty in Korea than it is in other countries. The poverty rate is only 4% if there are two or more workers in a household and 11% if there is at least one worker, which corresponds to the OECD average. However, if there is no worker in a household, the poverty rate is 55%, far above the OECD average. Among older people, the poverty rate increases to 70% when there is no income from work, the highest level recorded in the OECD. Overall, the poverty rate among the elderly is 45%, well above the OECD average of 13%. The maturing of the National Pension Scheme in the years ahead should help to gradually reduce poverty.

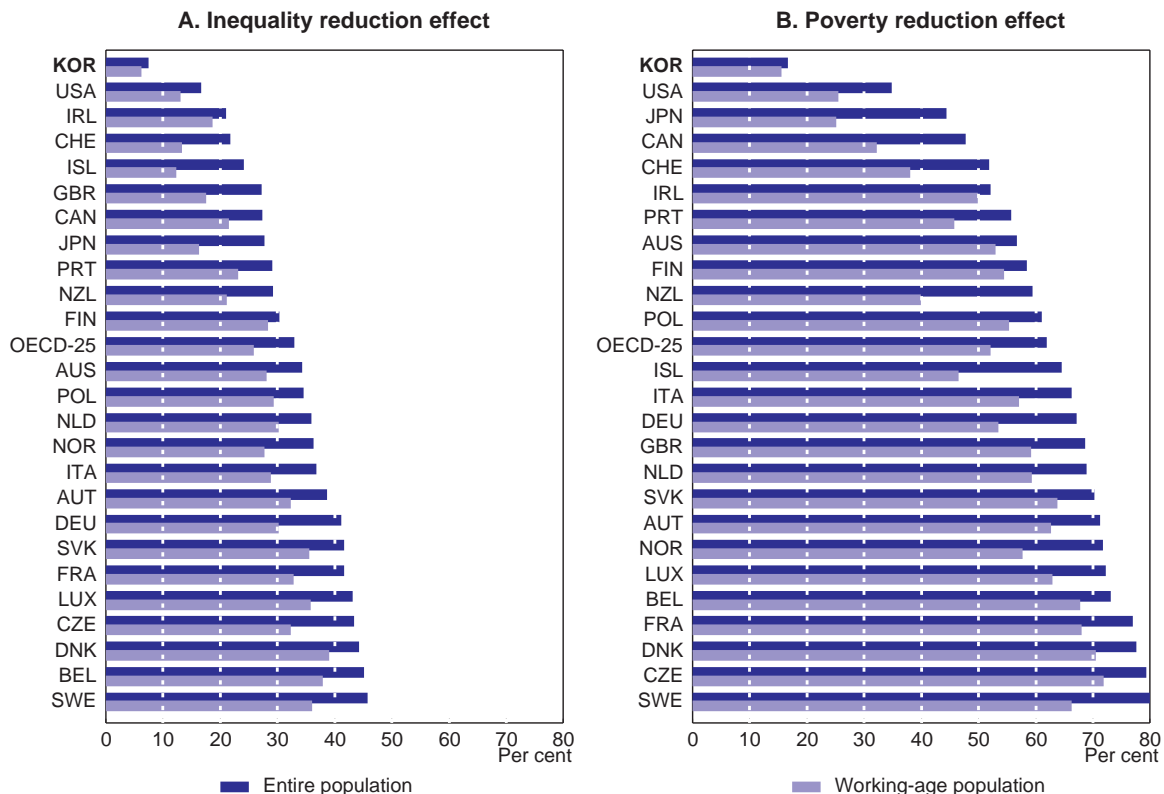
## A small and inefficient redistribution system

The main reason for the high poverty rates of non-working Koreans is the insufficient and ineffective tax/benefit system. On average, Korean households receive just 4% of their income from the government in the form of cash benefits and pay not more than 8% of their income in taxes and social contributions. These are by far the lowest levels in the OECD. In a typical OECD country, cash benefits constitute some 22% of income and taxes paid some 29%.

The low spending on benefits reflects the strict eligibility requirements for the Basic Livelihood Security System, Korea's main social welfare programme. Indeed, eligibility depends on income, assets and the possibility of assistance from family members. Consequently, the Basic Livelihood Security System covers only 3% of the population, well below the 15% in relative poverty.

At the same time, neither benefits nor taxes are particularly targeted in Korea, unlike in most countries with low benefit and tax shares (such as Australia and New Zealand). Indeed, only a quarter of total cash benefits go to the poorest 20% of the population, which is no higher than the OECD average. Moreover, about 5% of taxes are paid by the same poorest 20%, which is higher than the OECD average of 4%. Taking both features together – low levels of social spending and taxation and limited targeting – Korea's tax/benefit system is the least effective among OECD countries in reducing inequality and poverty (Chart 8). However, the introduction of an earned income tax credit in 2008 was a major step forward and should help better target the tax/benefit system on low-income households.

**Chart 8. Korea's tax/benefit system is not effective in reducing inequality and poverty <sup>1</sup>**



1. Data refer to a year in the mid-2000s (2006 for Korea).

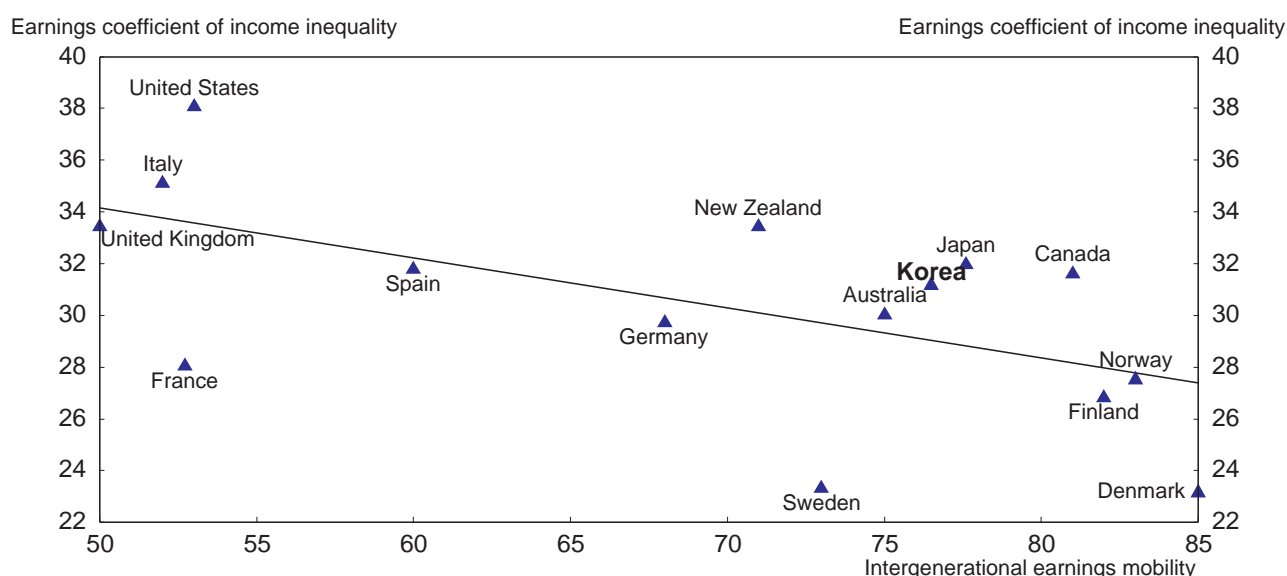
Source: OECD income distribution questionnaire, [www.oecd.org/els/social/inequality](http://www.oecd.org/els/social/inequality).

## High intergenerational earnings mobility

Korea has witnessed rapid economic growth along with a substantial increase of both the quality of education and educational attainment in a context of relatively low income inequality. This has favoured investment in human capital by the poor, thereby increasing income mobility across generations. Also, the overall shift in the composition of employment from the primary sector to white-collar jobs in manufacturing and services has promoted upward mobility across generations.

These trends are confirmed by recent studies, which for example suggest that mobility in Korea is relatively high compared to other OECD countries. Estimates of the strength of the relation between the earnings of fathers and their sons are similar to those observed in Japan and Australia and come close to those observed in Canada, Sweden, and Finland, which are among the most mobile societies (Chart 9). However, the degree of mobility between generations might change in the future in Korea because the fathers lived during a period of much more rapid economic growth than their children.

Chart 9. Intergenerational earnings mobility



Source: OECD (2008), *Growing Unequal? Income Distribution and Poverty in OECD Countries* and Anna d'Addio, "Social Mobility in OECD countries: Evidence and Policy Implications" (2011, forthcoming), [www.oecd.org/els/social/inequality/GU](http://www.oecd.org/els/social/inequality/GU).

## OECD key messages

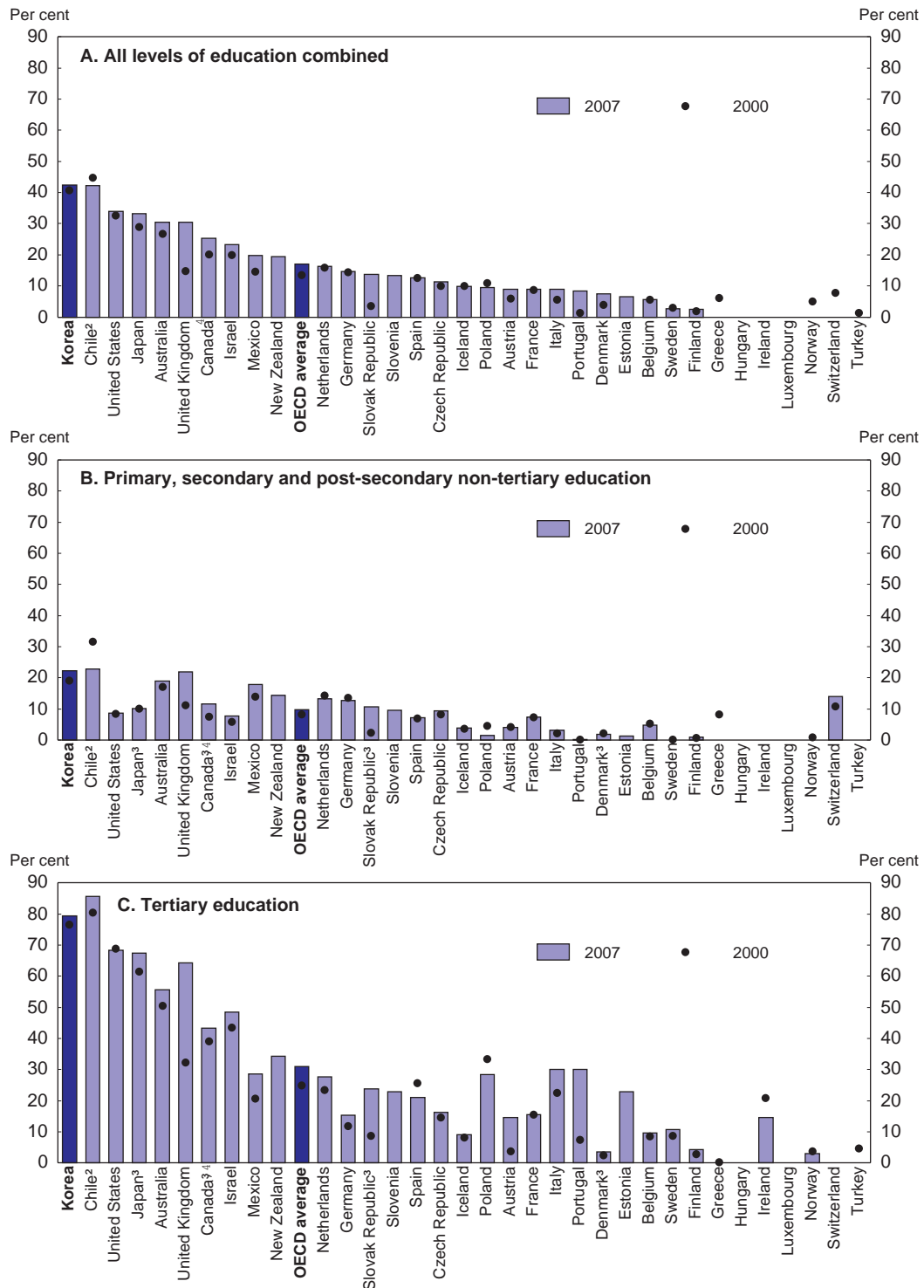
Taxes and public benefits have helped to reduce inequality and poverty substantially in welfare states. Compared with other OECD countries, Korea's tax/benefit system has been neither large enough to compensate for income deficiency, nor efficient enough to alleviate the poverty problem of those who are most in need (Chart 8). Developing its social protection schemes, such as public pensions and long-term care services, will allow Korea to address the problem of old-age poverty in effective and systematic ways (see the chapter on Social Protection Policies). The tax system should be carefully reviewed, to better focus on the inequality/poverty problem and to increase the amount of public cash transfers.

Korea has one of the highest rates of potential growth in the OECD area at present. It is important to implement structural reforms to maintain the potential growth rate as high as possible, thereby generating well-paying jobs and maintaining Korea's high rate of intergenerational earnings mobility. Moreover, Korea should ensure the availability of quality education at a reasonable price, which for decades has been the foundation of its social mobility. In this regard, the high level of private expenses on education is a warning sign (Chart 10).



**Chart 10. Share of private expenditure on educational institutions (2000, 2007) <sup>1</sup>**

As a per cent of total expenditure



1. Countries are ranked in descending order of the share of private expenditure on educational institutions in 2007 for all levels of education.  
 2. Year of reference 2008 instead of 2007.  
 3. Some levels of education are included with others. Refer to "x" code in Table B1.1a for details.  
 4. Year of reference 2006 instead of 2007.

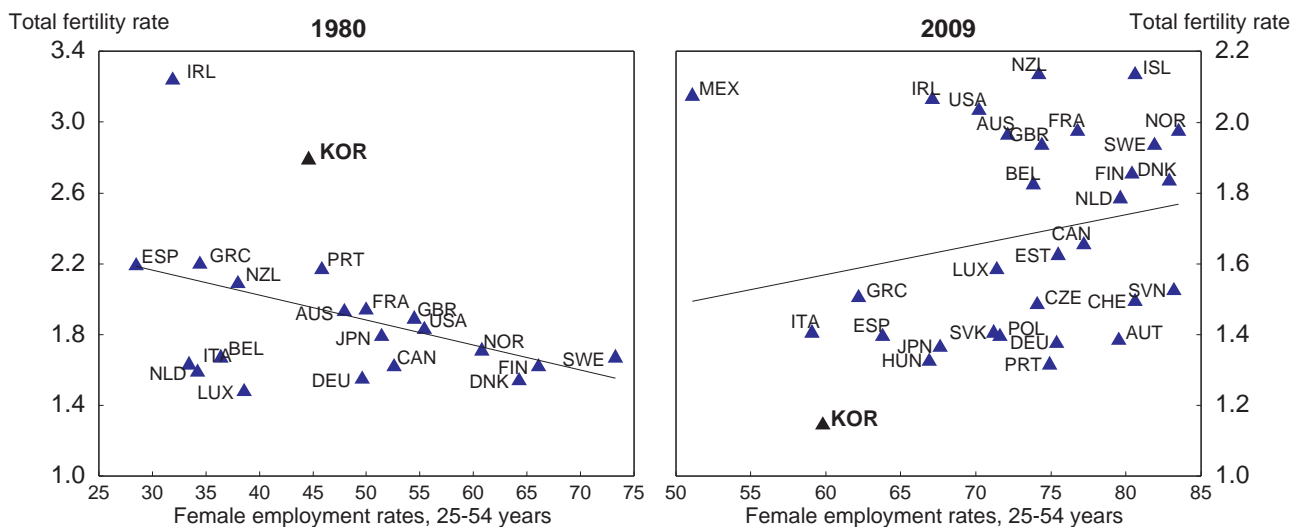
Source: OECD (2010), *Education at a Glance 2010* (<http://dx.doi.org/10.1787/888932310320>).

# Gender Equity and Fertility: Reconciling Work and Family Life

Although Korean women are well-educated, their role in the labour force is relatively small. As of 2008, 32% of women (aged 25 to 64) in Korea had a tertiary education, slightly above the OECD average of 29%. While the female employment rate (age 25-54) has increased steadily over the years, it was still low at 60% in 2009 (Chart 11), 11 percentage points below the OECD average and well below the prime-age male employment rate (86%). Only 61% of Korean women who have completed tertiary education are in the workforce, only 4 percentage points higher than for those with an upper secondary degree. For the OECD area, the rate for women with tertiary education is 82%, more than 11 percentage points higher, reflecting the higher opportunity cost of not working for women with higher education. The gender wage gap – the largest in the OECD area at 38% -- may discourage women from entering the labour force. Moreover, one-third of women hold temporary work contracts, and only 8% have supervisory responsibilities.

Low female labour force participation is accompanied by a low fertility rate, reflecting the difficulty of matching work and family commitments. Indeed, the fertility rate has fallen from almost three in 1980 to about 1.2 children per women in 2007, the lowest in the world. Recent work by the Hyundai Research Institute shows that Korean parents have on average 0.76 children less than they would like to.

**Chart 11. Female employment rates and total fertility rates <sup>1</sup>**



1. Note the different scales on the horizontal axis of the two panels.

Source: OECD Family Database, SF2.1 [www.oecd.org/els/social/family/database](http://www.oecd.org/els/social/family/database).

Korea is thus confronted with the dual challenge of promoting women's labour force participation while boosting fertility rates. The government's second plan (2011-15) to respond to an ageing population and a low fertility rate includes promoting family-friendly workplaces and parental leaves, shorter work hours for parents and expanded public financial support for childcare and education. In the OECD area,

motherhood and female employment appear more compatible now than they were in 1980 (Chart 11). Comprehensive and well-coordinated policies for reconciling work and family life have turned out to be successful in sustaining birth rates and female employment rates, especially in Nordic countries.

**Main OECD Policy Recommendations on Gender Equity and Fertility are summarised below:**

- Gradually increase government expenditure on childcare to fill existing gaps in coverage, thereby promoting female labour force participation and raising the fertility rate. Extend support for the most vulnerable families through, for example, “Dream start” programme.
- Encourage companies to adopt more family-friendly policies to facilitate work and family responsibilities.
- Break down labour market dualism and promote performance-based pay to make employment more attractive to women.
- Promote the take-up of paid parental leave.
- Ensure that the design of government spending schemes do not negatively affect the work incentives of parents.

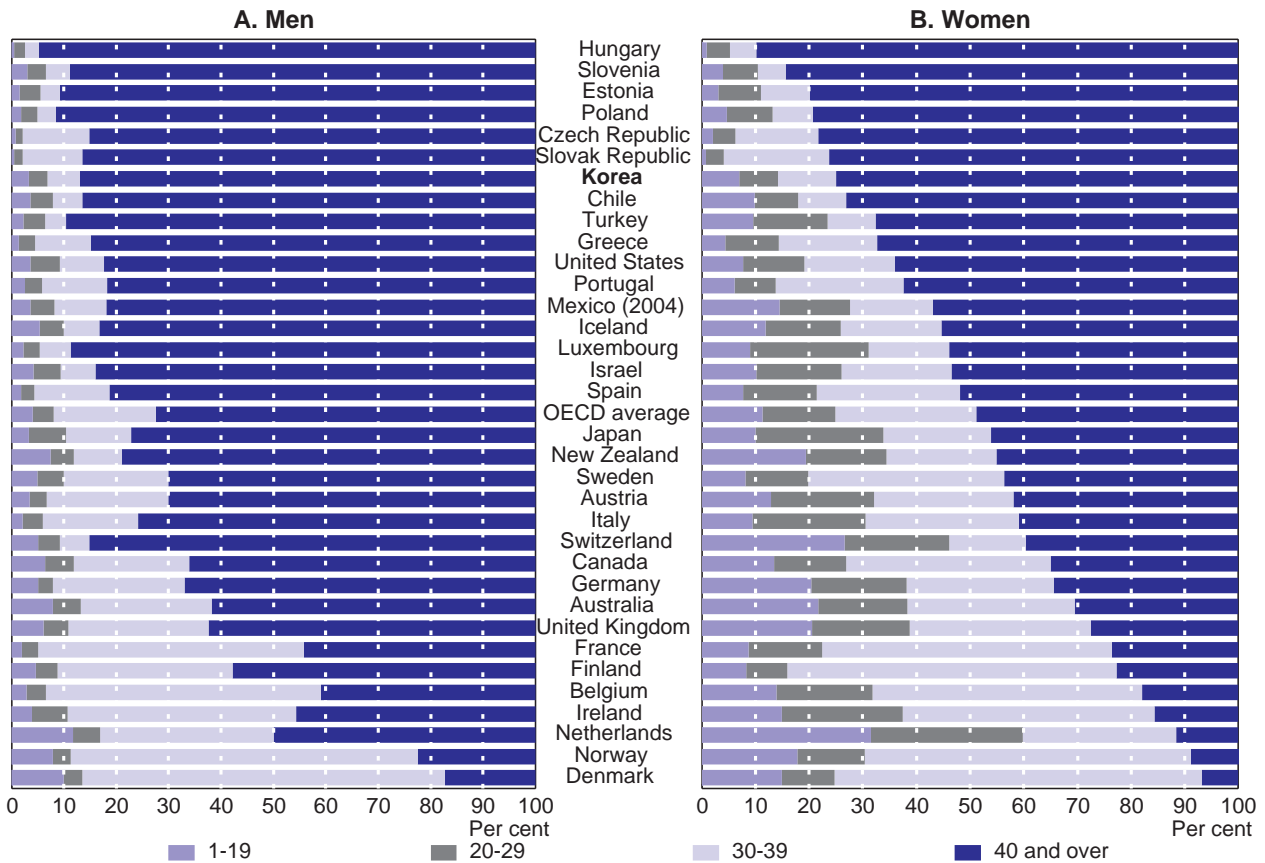
## **Workplace culture**

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Korea’s traditional labour market system based on long-term employment and seniority-based wages make it costly to take a leave of absence from work. Anyone who temporarily drops out of the labour force for whatever reason, including caring for young children, will pay a price in terms of forgone earnings. This leaves Korean workers, particularly women, with a difficult choice. The longer the time spent caring for children, the more challenges they face when re-entering the labour market. If they leave the labour force to care for young children for a significant period, they often cannot return to regular employment. The alternative is low-paid non-regular employment. Mothers who can afford it tend to stay at home rather than return to the labour force in a job that does not fulfil their potential. Therefore, women who wish to pursue a career often decide to remain in regular employment and have no children. Breaking down labour market dualism and making the remuneration system more performance-based would provide greater incentives for female workers to go back to work.

In addition, regular workers (especially white-collar ones) are often expected to sacrifice for their firms as a signal of their commitment, resulting in long working hours, often including unpaid overtime and using less leave than they are entitled to. While annual working hours have fallen from more than 2 500 hours in 2000 to around 2 074, they remain the highest in the OECD area and well above the average of 1 736 hours. Indeed, about 87% of men and 75% of women work more than 40 hours per week (Chart 12). Moreover, long commuting hours in urban areas and (especially for men) a culture of socialising after work result in long working days and force parents to find childcare services for up to 9 to 10 hours per day. Indeed, the average length of childcare services for a household with a working mother is 8 hours and 38 minutes per day. In addition to securing affordable and reliable childcare and out-of-school-hours (OSH) care, family-friendly solutions, such as flexible working hours and part-time employment opportunities, should become more widespread. It is also important to achieve the tripartite Economic and Social Development Commission’s target of cutting annual work hours to less than 1 900 by 2020.

Chart 12. Share of workers by distribution of usual weekly hours of work, by gender in 2007 <sup>1</sup>

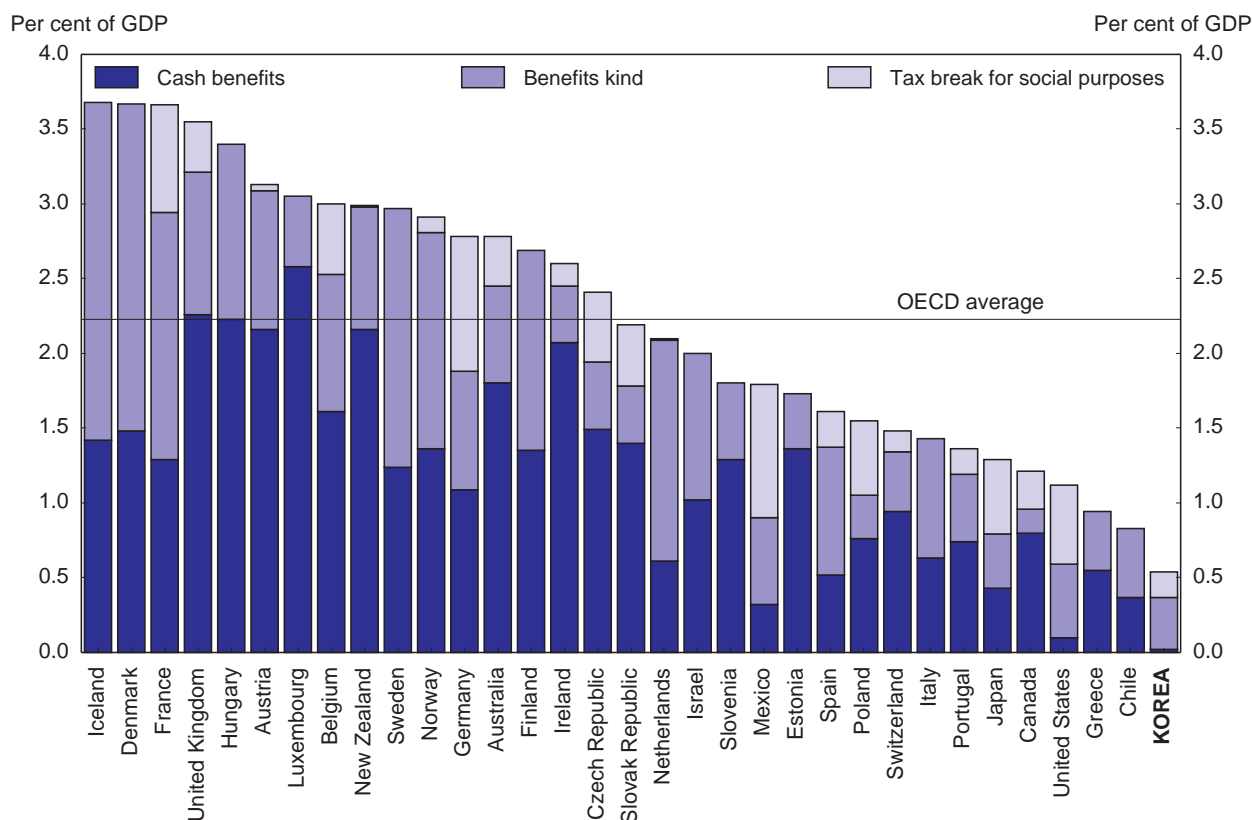


1. Countries are ranked in decreasing order of the share of female workers working 40 or more hours per week. Unweighted average.  
Source: OECD Employment database, 2010, [www.oecd.org/els/employment/database](http://www.oecd.org/els/employment/database).

## Public support for families

The biggest source of public support for families with children has been public spending on primary and secondary education, which in Korea amounted to 3.1% of GDP in 2007, close to the OECD average of 3.3% (OECD, *Education at a Glance*, 2010). However, private spending, at 0.8% of GDP, is more than double the OECD average, and this does not include large outlays for after-school instruction in private institutes known as *hagwon*. The burden of educational expenses on families appears to be one factor explaining the low fertility rate. Indeed, a 2009 government survey of women between the ages of 20 and 44 found that education costs were the most important reason for not having more (or any) children. In 2007, public spending on family benefits (including child allowances, paid parental leave, fiscal support and family services including child and OSH care) amounted to 2.2% of GDP on average in the OECD area (Chart 13). Public spending on family benefits in Korea was by far the lowest in OECD. Even the amount of public support to education may not be sufficient, given that Korean parents are bearing more than 20% of the expenses on primary and secondary education, while parents in other OECD countries paid just 9.7% in 2007.

Chart 13. Public spending on family benefits in cash, services and tax measures, 2007 <sup>1</sup>



1. Public support included here only concerns support that is exclusively for families (e.g. child payments, paid leave and childcare support, etc.). Spending recorded in other social policy areas such as health and housing support also benefits families, but not exclusively, and is not included here. Data on tax breaks for families is not available for Greece, Italy, Estonia, Slovenia, Finland, Luxembourg, Hungary, Denmark and Iceland.

Source: OECD Social Expenditure Database (SOCX), [www.oecd.org/els/social/expenditure](http://www.oecd.org/els/social/expenditure).

## OECD key messages

Spending large sums is no guarantee for good work/family outcomes, and not all OECD countries are prepared to accept the high public spending levels observed in the Nordic countries, where taxes represent close to half of GDP. Hence, in many countries there are gaps in policy support at some point in the child's life, for example, when parental leave ends before childcare support is available, when children go to school but only for part of the day, or when parents go back to work but find that their hours are so inflexible that they cannot cope when children are sick. Smart and careful policy formation/coordination will be crucial in order to get the best possible outcome out of limited resources, and additional investment in childcare support is inevitable to help more families match work and care commitments. In 2011, Korea reformed its parental leave system to provide 40% of the basic wage, up to a limit of 1 million won, over a one-year period. Making the payment more generous would increase the share of parents using this leave. In 2011, the government expanded the eligibility for public financial support for childcare and education up to age five from the bottom 50% to the bottom 70% of households based on income. This change will boost the government's budget for childcare and education from 1.7 trillion won in 2007 to 4.7 trillion won (0.4% of GDP) in 2011. This financial support will be extended to all five-year-olds beginning in 2012. In addition, Korea should further develop its



childcare system to help parents with the cost of young children and reinforce its “Dream start family services programme” to ensure that public programmes reach more vulnerable families most in need of support.

The gender gap in employment and earnings reflects a huge waste of investment in human capital, especially as Korean women, particularly the younger age cohorts, are among the best educated in the OECD. In order to promote future economic growth and address fertility concerns, as well as individual well-being, the Korean society as a whole, and the business community in particular, should review their policies and attitudes to maximise the use of women’s competencies. Most of all, workplace cultures have to change and give all workers a fair chance to fulfil their individual aspirations and provide for their children. Firms should facilitate the return to work by female workers with children through flexible working-time arrangements and part-time employment opportunities. Labour market dualism, which traps many women in low-paid non-regular jobs, should be reduced. The remuneration system should be reformed into an essentially performance-based system to provide greater incentives for women to work.

OECD governments are spending more money to help families reconcile work and family life than before. Korea has been no exception, and considering the still very low level of public expenditure on family benefits, a further significant increase is needed over the medium term. Equally important, though, is how the funds are spent. Policies should be better integrated to cope with the gaps in the current support system. For example, targeting benefits at low-income families may involve risks that public support is withdrawn too rapidly when their earnings increase, thereby discouraging parents from entering work or increasing working hours. In order to maintain Korea’s strong work incentives, it is important to keep effective tax rates on paid work low and tax/benefit systems should be designed so that they give both parents equally strong financial incentives to work. In this regard, the recent reform of childcare leave that replaced the prior lumpsum benefit scheme with a pro rata one, set at 40% of the employee’s basic wage, is certainly a step in the right direction.



## International Practices for Promoting Female Labour Market Participation and Boosting Fertility Rates

A number of OECD countries have achieved higher than average rates of fertility and female employment as a result of good parental-leave arrangements and childcare policies.

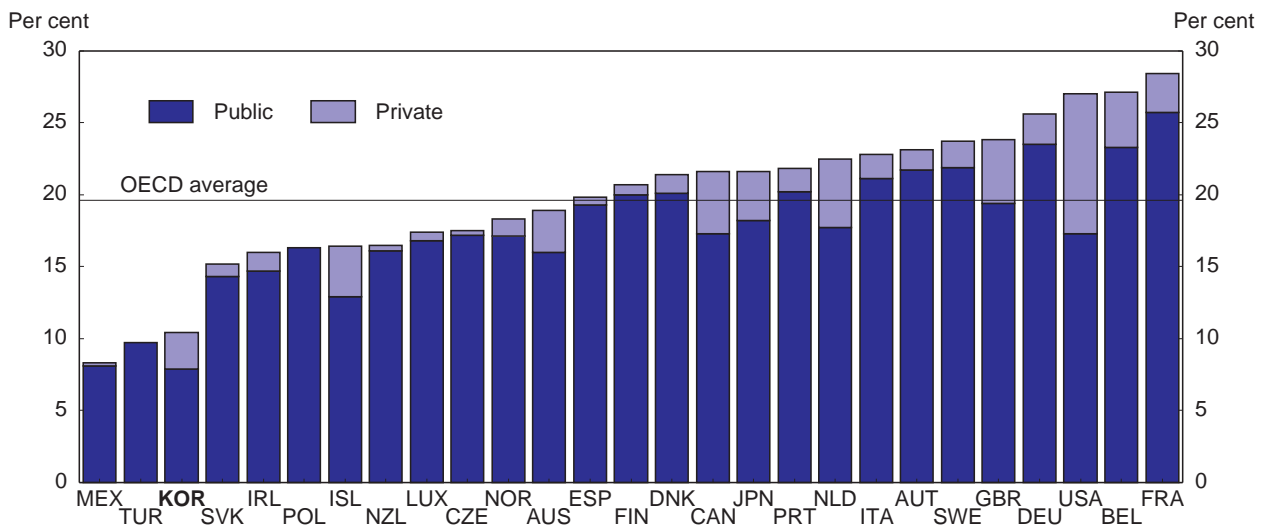
- **Promoting shared parental leave reduces barriers to female employment and fertility.** Shared leave encourages men to participate more in caring activities and reduces the length of leave taken by women relative to men. In *Sweden* and *Iceland* parental leave policies have been adapted to encourage shared rights and responsibilities in parenting. Overall, across the OECD, there tends to be fewer working women in countries with longer parental leaves.
- **Ensuring quality in childcare settings.** If parents are confident about the quality of childcare services, they are more likely to take them up, and return to work when their children are young. A number of countries take steps to promote high-quality childcare. *Australia*, *France*, the *United Kingdom* have strict licensing and regulatory systems, and *Denmark*, *Norway* and *Sweden* have integrated systems of education and care, facilitating standard setting and monitoring. To meet the demand for childcare services, *Canada*, the *Netherlands*, and the *United Kingdom* rely on closely-supervised private provision, as does *Australia*, where voucher payments for private provision are linked to quality standards.
- **Providing for the care of older children.** Out-of-school-hours (OSH) care supports families by providing a variety of centre-based activities for school-aged children whilst their parents are at work. In *Denmark*, *Sweden*, *Hungary* and *Australia* 50-70% of 6 to 11 year olds benefit from OSH care. In *Denmark* and *Sweden* low-cost OSH care is frequently provided in school facilities, including during school holidays.
- **Encouraging family-friendly workplaces.** Workplaces that are mindful of their employees parenting responsibilities can facilitate the work-family balance, and in doing so promote women's work and reduce the barriers to family formation. Family-friendly workplaces are encouraged in the Nordic countries, *Australia*, *Japan*, *New Zealand*, the *Netherlands*, and the *United Kingdom* using policies such as flexible working hours, part-time options for mothers returning to work, and incentives to provide workplace care facilities for the children of employees.
- **Building consensus on the value of family-friendly policies.** Promoting the importance of family-friendly policies is central to their take-up by families, the business community and broader society. In *Finland*, prior to childbirth, every pregnant woman receives an information pack on the rights they will get once the child is born. Closer involvement of employers is also possible, as in *France*, where an "observatory" is used to disseminate information on best practices regarding the work-life balance for businesses (<http://www.parenthood-observatory.com>).

For supporting evidence and further reading see: OECD (2011), *Doing Better for Families*.

# Social Protection: Public Pensions, Long-term Care and Health Care

Effective social policy protects individuals and helps them overcome poverty, inequality, discrimination or other adversities, thereby enabling them to lead fulfilling lives. Governments in OECD countries spent around 20% of GDP on average on social protection in 2007, compared to only 7.5% in Korea (Chart 14). Accounting for the effect of the tax system and private social expenditures (both mandatory and voluntary), total social expenditure in Korea amounts to 10.4% of GDP, still far below the OECD average, reflecting the fact that Korea's social policy framework was developed fairly recently and is still evolving.

**Chart 14. Public and private social expenditure in percentage of GDP in 2007 <sup>1</sup>**



1. After accounting for the impact of the tax system. Private spending includes mandatory and voluntary payments.  
Source: OECD Social Expenditure Database (SOCX), [www.oecd.org/els/social/expenditure](http://www.oecd.org/els/social/expenditure).

Another reason for low social spending is that Korea has one of the youngest populations in the OECD area, thus limiting the pressure for elderly-related spending for public pensions, long-term care and health care. Korea has six persons in the 20-to-64 age group per person of retirement age (65 and over), making it the fourth-youngest OECD country after Turkey, Mexico and Chile (Chart 15). However, Korea faces the most rapid population ageing in the OECD. The old-age support ratio is projected to decline steeply to 1.5 in 2050, making Korea (together with Italy) the second-oldest country after Japan. The rapid demographic shift reflects increasing life expectancy and a fall in the fertility rate since 1970. By 2010, it was only 1.2 births per woman, the lowest in the world.

### Main OECD Policy Recommendations on Social Protection are summarised below:

- Reducing old-age poverty should be the priority of all short- to medium-term pension reforms.
- Accelerate the increase in the pension eligibility age from 60 to 65 to help ensure the financial sustainability of the National Pension Scheme.

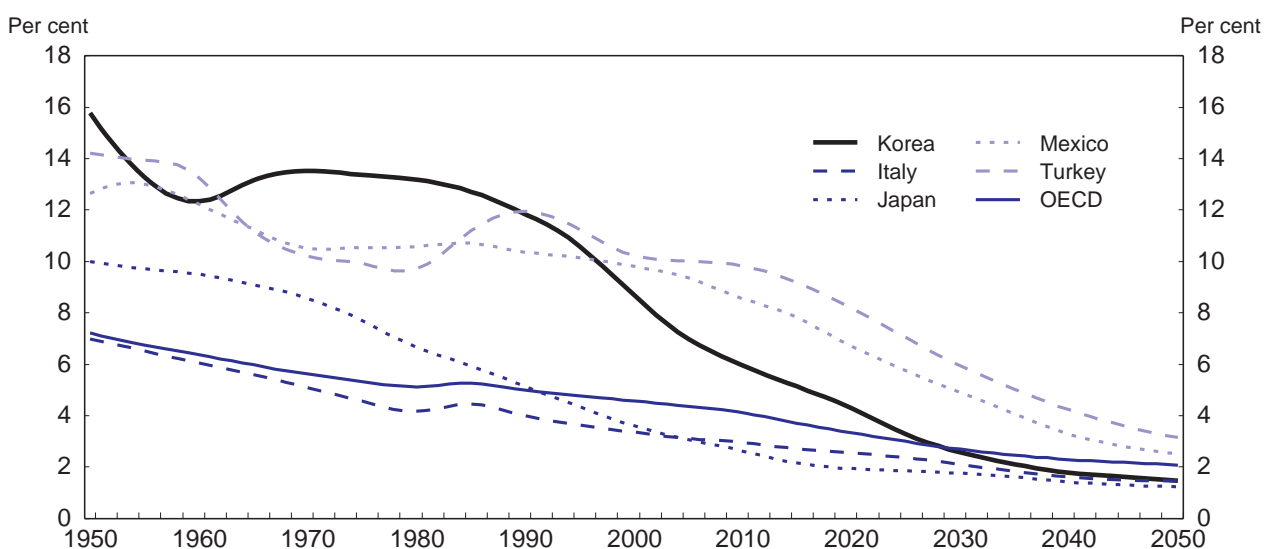
- Encourage the development of the company pension system based on defined contributions, in part by eliminating the favourable tax treatment of the retirement allowance.
- Limit the increase in long-term care (LTC) spending by shifting it from hospitals to LTC facilities or home-based care.
- Contain the burden of LTC spending on the working-age population by increasing the share financed by retirees.
- Reform the payment schemes for health care by moving away from fee-for-service and improve quality control systems to get better value for investment.
- Avoid cost-containment efforts that might further increase the already high out-of-pocket spending by patients, thereby undermining universal access.

## Public pensions

Public spending on old-age benefits in Korea was 1.7% of GDP in 2007, just a quarter of the OECD average. As the National Pension Scheme (NPS) was introduced in 1988, most pensioners still receive partial pensions. In 2005, more than 45% of Koreans aged over 65 were in relative poverty with incomes below one-half of median household income, the highest proportion among OECD countries. The Basic Old-age Pension System, introduced in 2008, provides assistance to elderly people who meet the income and asset criteria. Around 70% of the elderly currently receive the benefit, which for a couple can reach 10% of the average wage, a relatively low level compared to similar programmes in other OECD countries.

**Chart 15. Old-age support ratio**

Number of people between the ages of 20 and 64 per person of pension age (over 65) in selected countries



Source: OECD (2011), *Pensions at a Glance*, OECD Publishing, Paris ([www.oecd.org/els/social/pensions/PAG](http://www.oecd.org/els/social/pensions/PAG)); United Nations, *World Population Prospects - 2008 Revision*.

About one-third of the working-age population does not contribute to the NPS, even though it is mandatory. Moreover, the lack of transparency about the income of the self-employed (almost one-third of the labour force) and non-regular workers (about one-third of employees) limit contributions and the eventual financial support for the elderly during retirement. The mandatory “retirement allowance”, which requires firms to pay departing employees at least one month of income per year of work, is another potential source of retirement income. However, many workers use this allowance, which is actually a severance payment, each time they change jobs, rather than saving it for retirement.

## Long-term care

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Formal long-term care (LTC) services are not well developed in Korea, reflecting the traditional pattern of elderly people living with their children. According to data from the Korean Longitudinal Study of Ageing (KLoSA), 60% of the population aged between 50 and 64 years report being a family caregiver. However, the availability of family-based care has fallen as the share of the elderly living with their children declined from more than 80% in 1981 to 29% by 2008 and the female labour force participation rate increased.

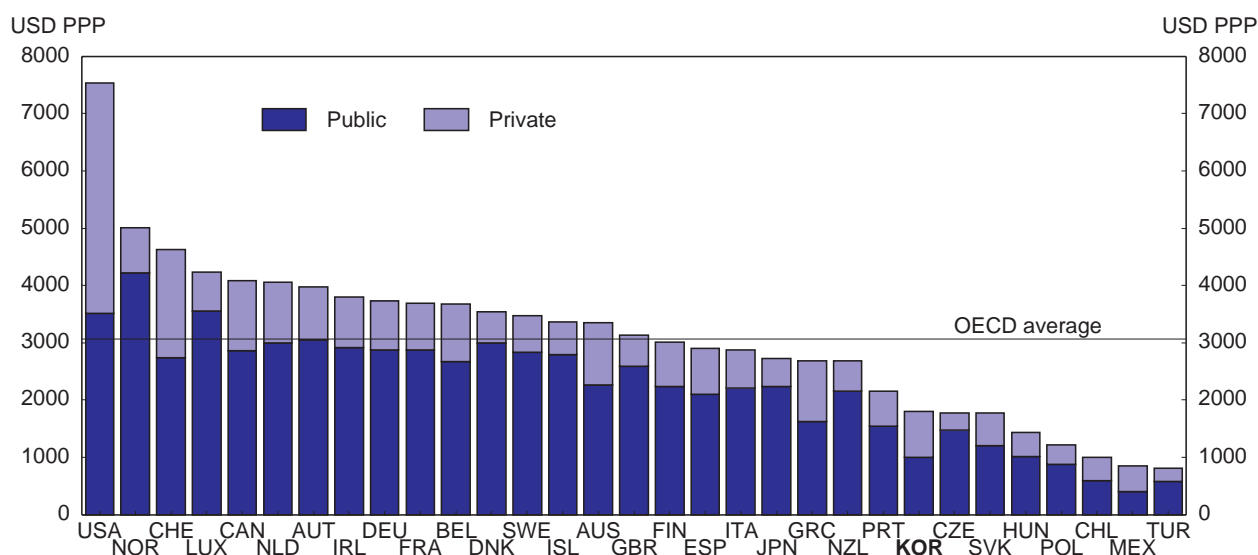
The implementation of the Long Term Care Insurance (LTCI) system for the elderly in 2008 sparked the growth of home-care providers and of beds in LTC institutions. The LTCI is the cornerstone of Korea’s policy response to the needs of its rapidly ageing population. It was designed as a universal yet low-cost social insurance system, with strict functional eligibility criteria, particularly for care in LTC institutions, covering a rather narrow “breadth” of services. The recent implementation of the LTCI and its low-cost design help to explain why total spending on LTC, at 0.3% of GDP in 2008, is only one-fifth of the OECD average. In addition, the long average stay in hospitals – which was 10.6 days in 2007 compared to the OECD average of 6.6 days -- suggests that much of this care is provided in the health-care sector. Such an approach is inefficient and increases the cost of health care.

## Health care

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Korea still ranks among the countries with the lowest spending on health care, at 6.5% of GDP in 2008, well below the 9.0% OECD average. Health spending per capita, at around \$ 1 800, was less than 60% of the OECD average (Chart 16). However, the rate of growth in health spending has been almost twice the OECD average since universal coverage for a core set of health services under the National Health Insurance (NHI) was achieved in 1989, driven primarily by a rapid rise in public health spending. The share of public spending on health in Korea steadily increased from 36% in 1995 to 55% in 2008 thanks to an expansion in the breadth of services covered, a reduction in cost-sharing and the introduction of ceilings on catastrophic health spending. Nevertheless, the public sector’s share of health spending remains well below the OECD average of 73%.

**Chart 16. Health expenditure per capita**  
Public and private expenditure in 2008 or latest year



Source: OECD (2010) *OECD Health Data 2010: Statistics and Indicators*, [www.oecd.org/health/healthdata](http://www.oecd.org/health/healthdata).

## OECD key messages

Although the overall social protection system is maturing, the level of protection in Korea is still one of the lowest in the OECD area. Rapid population ageing will boost the demand for social protection, while reducing Korea's potential growth rate. Korea will face the difficult challenge of finding the optimal balance between protection and sustainability. "Value for money" should always be the criterion for raising the level of protection.

To strengthen the long-term financial sustainability of the NPS, the very gradual increase in the pension age from 60 to 65 between 2013 and 2033 should be accelerated. Once the pension age has reached 65, it should be increased in line with changes in life expectancy. Achieving financial sustainability of the NPS is crucial, but any further cuts in benefits, beyond the large reductions planned, should envisage protecting low earners so as to prevent old-age poverty persisting into the long term. Poverty among the elderly should be reduced by increasing the benefits paid by the Basic Old-age Pension System until most retirees have spent a full career under the new pension scheme. It is also essential to increase the share of the population that contributes to the NPS so as to ensure adequate retirement income for the elderly. The unification of the collection of social insurance, which had been divided between health, long-term care, pensions, employment and workplace injuries, under the NHI in January 2011 should be used to improve compliance. In addition, it is important to accelerate the development of the company pension system launched in 2005 to replace the retirement allowance. The adoption of the new system has been hindered by the fact that management and workers must agree on a defined benefit or defined contribution system and by the favourable tax treatment granted to retirement allowances.



In the case of LTC, supply and demand for care is expected to develop rapidly, making it a challenge to control costs. Healthy-ageing policies to delay the onset of disability, more emphasis on community and home-care services, and better control over provider payments may all help contain the cost of LTC services. In the long run, as the increasing number of elderly people account for a rising share of national income, requiring them to contribute more to the LTCI would limit the financing burden on the working-age population.

Korea also faces the challenge of further expanding the coverage of the NHI, while keeping costs under control. Indeed, the government plans to spend 3.1 trillion won (0.3% of GDP) over the period 2009-13 to expand coverage. According to an OECD projection, health and long-term care spending combined in Korea will be the highest among OECD countries in 2050. The government has been pursuing reforms in the payment system by, for example, expanding the DRG payment system. Despite reforms, the NHI is still prone to cost growth, with relatively weak mechanisms to regulate quality and prevent unnecessary care. These factors make it a priority to further improve efficiency to ensure that health spending increases lead to more and better services.



# Improving Equity in Education

Although Korea places high value on education, is a strong performer in PISA and achieves high rates of university graduation, youth unemployment is trending upwards and a growing number of young graduates do not find jobs that match their level of qualifications. Furthermore, intense competition in education places heavy financial burdens on families, with significant consequences for equity, social inclusion and the fertility rate.

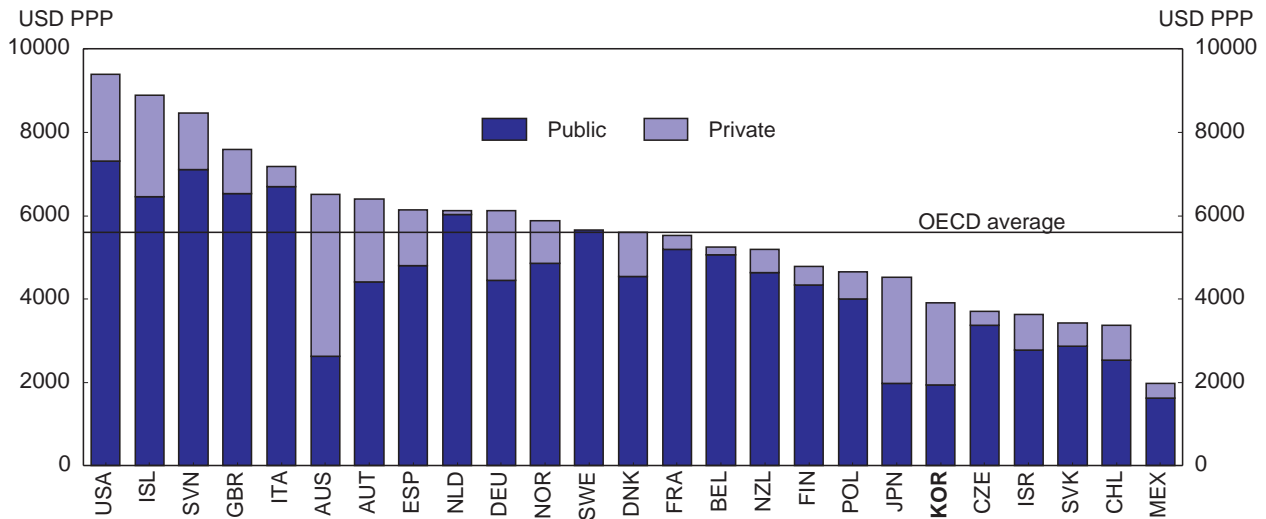
## **Main OECD Policy Recommendations on Improving Equity in Education are summarised below:**

- Move towards a common framework for high-quality, early childhood education and childcare services and lower the costs for households so that all children can participate, regardless of their family's financial resources.
- Continue efforts on multiple fronts to minimise the negative social impact of pressures on students and their families to succeed in the competitive university entrance exam, thereby reducing the dependence on *hagwon*.
- Develop policies to make the advantages of *hagwon* more widely available, notably to students from low-income families.
- Make vocational schools more attractive by increasing their quality and relevance for the labour market *inter alia* by engaging industry in the design of programmes and incorporating a significant element of workplace training. Expand the Meister School approach.
- Expand and redesign financial support for tertiary students, providing public loans with repayment contingent on income after graduation, together with income-tested grants.

## **Social disparities emerge early and are exacerbated by intense competition for university**

Extensive international evidence indicates that high-quality early childhood education provides strong economic and social benefits, especially for disadvantaged children. In Korea, 80% of children between the ages of three and five are enrolled in either childcare or kindergarten. However, the level of spending on pre-primary education is exceptionally low; in 2007 it was 30% below the OECD average in absolute terms (Chart 17). The private sector accounts for around one-half of the spending compared to an average of 20% in OECD countries. Consequently, public spending on pre-primary education is the lowest in the OECD area, Moreover, it is relatively low compared to spending at other levels of education; total outlays per student in kindergarten were only 38% of that in primary and secondary schools, well below the OECD average of 64%.

Chart 17. Spending per student on pre-primary education is low in Korea <sup>1</sup>

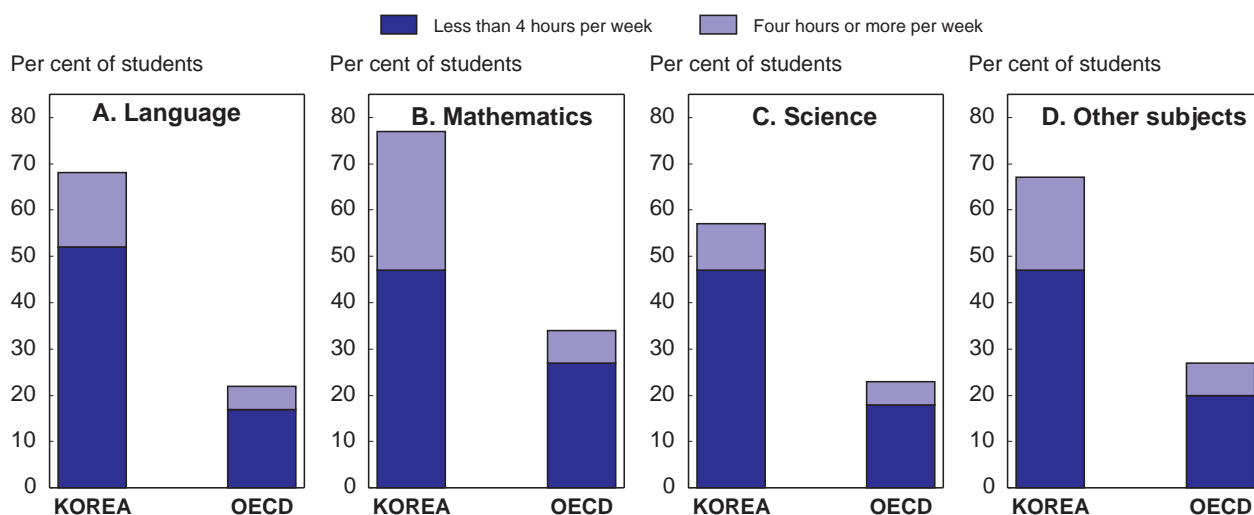


1. Annual spending based on full-time equivalent students in 2007. Public spending does not include tax expenditures.  
Source: OECD (2010), *OECD Education at a Glance 2010*.

Although students' performance in PISA is excellent, there are concerns about social inclusion. Students in small towns typically lag behind their counterparts in urban settings and much of the variation between schools is explained by socio-economic background. Social disparities are reinforced by private tutoring in institutions known as *hagwon*, which are intended to help students gain admission to prestigious universities. A government survey found that 77% of students in primary and secondary schools go to private tutoring for an average of about 10 hours a week. The share of students attending after-school lessons in the language of instruction is the highest in the OECD at three times the average (Chart 18). The proportion in Korea is highest for math and second highest for science and other subjects. Parents shoulder a high financial burden for *hagwon*; households with a child attending *hagwon* pay an average of about 8% of monthly income, with the total cost amounting to 2.2% of GDP in 2007. Private tutoring adds to the high level of private spending on education, which is a factor that negatively affects fertility. According to a recent survey of parents, the burden of education costs is the major factor for having fewer children than their desired number.

**Chart 18. The percentage of 15 year old students attending after-school lessons is exceptionally high**

By hours per week in 2009

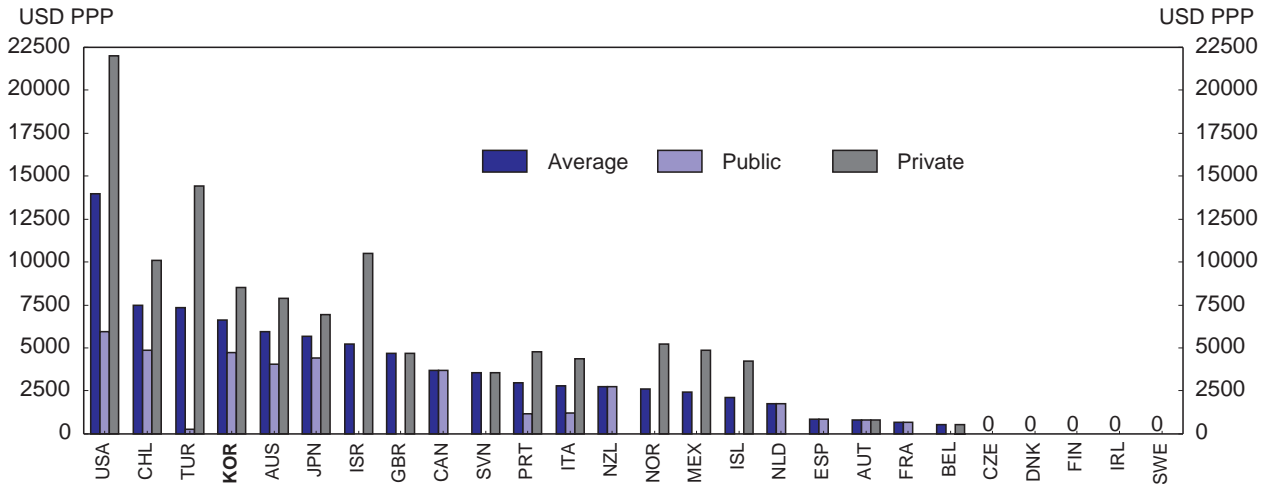


Source: OECD (2010), *PISA 2009 Results: What Students Know and Can Do, Volume I*.

Preparing for the competitive university entrance examination (CSAT) involves high stress and also comes at the expense of fostering creativity, originality and work-readiness skills. Less academically-able students are typically channelled into professional high schools, which are intended to provide attractive vocational education and training. However, these schools often see themselves as having a largely academic orientation, and two-thirds of their students go on to tertiary education. The academic programme is less intensive than in general schools while workplace and practical training is weak, limiting their capacity to prepare students effectively for either tertiary education or for jobs.

The public sector's share of spending on tertiary education in Korea declined between 2000 and 2007 at 21%, and is now one of the lowest in the OECD area and well below the average of 69%. Consequently, tuition fees paid by households finance most of tertiary education, although households can claim a tax credit on tuition fees paid. Tuition fees were the third highest in the OECD area, reflecting high fees at both public and private universities (Chart 19). Even so, government scholarships and grants to students (4.4% of public spending on education) and student loans (5.7%) are well below the OECD averages of 11.4% and 8.8%, respectively.

Chart 19. International comparison of university tuition fees <sup>1</sup>



1. Full-time students at tertiary type A institutions in 2006-07. Tuition fees are not adjusted for fee waivers granted by institutions nor for tax treatment of tuition fees.

Source: OECD (2010), *OECD Education at a Glance 2010*, OECD, Paris.

## OECD key messages

The government is developing a basic curriculum for all children in order to assure the quality of early childhood education. In addition, it recently decided to increase the subsidies for education and childcare for five-year-olds from 177 thousand won (\$163) per month at present to 300 thousand won by 2016. Eligibility for the grants, which was expanded from the bottom 50% to the bottom 70% of households based on income in 2011, will be expanded to all five-year-olds in 2012. Korea should go further by bringing together the regulatory oversight and funding into a consistent structure for children under age five to make it easier to tackle financial barriers that lower-income parents face. New Zealand's recent move to 20 hours of free early childhood education for three and four-year-olds and income-tested subsidies for additional hours for working parents shows how a range of providers can operate within a common approach for curriculum, regulation and funding.

Korea is trying some useful strategies to address the disparities amplified by the CSAT, which are not easy to overcome. One approach is to encourage universities to diversify admissions criteria and place less weight on CSAT results. This may help reduce the intense exam pressure and dependence on *hagwon*, but experience of other countries where competition is fierce suggests that families would reallocate their spending according to the revised admissions criteria. A complementary approach used in several countries is to encourage or oblige the most prestigious universities to provide special entry routes for able disadvantaged students often together with mentoring programmes. Given that *hagwon* would continue to play an important role despite these reforms, a third approach, already developed in Korea, is to provide additional tutoring and study support through after-school programmes, along with financial assistance for poorer families.

Improving alternative pathways to the labour market by strengthening the Vocational Education and Training (VET) system would also play a part in reducing the importance of the CSAT and offering better opportunities for disadvantaged youth. Professional high schools need to provide their students with

skills that are relevant to the labour market and will lead them to jobs or to post-secondary technical programmes. Engaging industry actively in the design of programmes and incorporating a significant element of workplace training are two important areas where Korea could improve VET. The new Korean Meister Schools embody these features and this approach could be extended and expanded.

It is important to expand and redesign the financial support extended to tertiary students, as the levels of student loans are limited, despite high tuition payments in Korea. A well-designed student loan system with repayment contingent on income after graduation, complemented with income-tested grants, would also help to facilitate access to tertiary education for students from low-income households. Providing means-tested grants to tertiary students instead of tax credits for tuition fees would also be a more equitable way of providing public support to households.

## International Practices for Improving Equity in Education

Countries typically take a multi-faceted approach to addressing equity in education, although the challenges they face vary as does the relationship between general policy approaches that also promote a more equitable system and tailored or targeted measures to address particular equity concerns.

- **Reducing the cost of early childhood education and care.** A wide range of countries, including *France*, *Belgium* and *New Zealand*, provide free early childhood education for children from age 3 onwards for at least 20 hours per week. These countries also provide income-adjusted subsidies to cover additional hours and for younger children to attend quality early childhood education and care. *Denmark*, *Finland* and *Norway* take a universal approach to providing early childhood education and care at low cost. *Sweden* sets a ceiling on the cost of early childhood education and care as a share of household income (3% for first child, 2% for second child and 1% for third child).
- **Providing consistent high quality education for all children through harmonised curriculum.** Most countries have either adopted or are developing integrated or harmonised curricula focused on clear early learning objectives that apply for all children, even if they are in different settings such as kindergarten or day-care. *New Zealand* has an early childhood education curriculum framework for children from birth to age 6. *Sweden* is currently implementing a new curriculum framework for all children below school age to promote early learning goals. The *United States* administration is promoting an early learning strategy for all children from birth to third grade.
- **Raising the performance of Vocational Education and Training programmes.** Countries such as *Denmark*, *Germany* and *Switzerland* have VET programmes that combine employer engagement, workplace and classroom learning designed to provide vocational students with skills that lead to good labour market outcomes. Maintaining core academic standards in vocational programmes has been tackled in the *United States*, *Belgium (Flanders)* and *Germany* through initiatives that integrate basic skills with vocational content and are adapted to the more practical learning style of most vocational students.
- **Facilitating access to tertiary education.** Countries such as *Australia*, *Canada*, *Chile*, *China*, *Iceland*, *New Zealand* and the *United Kingdom* provide income-contingent student loans, while almost all OECD countries offer some means-tested grants. Some institutions are developing special programmes and initiatives to promote more equitable access. For example, in *France*, the prestigious Institut des Etudes Politiques (SciencesPo) operates a partnership with high schools in disadvantaged areas that has significantly improved the intake of very able students who would otherwise not have applied due to lack of self-confidence and material constraints.

For supporting evidence and reading see:

- *Starting Strong II* (OECD, 2006), [www.oecd.org/edu/earlychildhood](http://www.oecd.org/edu/earlychildhood)
- *Learning for Jobs* (OECD, 2010), [www.oecd.org/education/vet](http://www.oecd.org/education/vet)
- *Tertiary Education for the Knowledge Society* (OECD, 2008) [www.oecd.org/edu/tertiary/review](http://www.oecd.org/edu/tertiary/review)



# Entrepreneurship, SME Promotion and Micro-credit Schemes

Small and medium-size enterprises (SMEs) account for 99.9% of industrial firms in Korea and 87.7% of industrial employment. SMEs in this sector are defined as enterprises with less than 300 employees and less than \$8 million in capital (\$3 million in mining and construction). As pointed out in a recent study by the Korea Development Institute (KDI), the large export-oriented enterprises subcontract intermediate and assembling production to SMEs characterised by relatively low wages and out-dated technologies. In the service sector, where SMEs are particularly important, productivity per employee was only 45.2% of that at large enterprises in 2005 (Table 1).

**Table 1. 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
<b>Service sector</b>	<b>32.6</b>	<b>29.4</b>	<b>65.1</b>	<b>45.2</b>	<b>91.1</b>

Source: 2008 OECD Economic Survey of Korea.

Rapid changes in the global environment, including worldwide outsourcing by large enterprises, the emergence of strong competitors with low-cost advantages, shortening product life cycles and fierce competition brought on by market liberalisation, have created a very challenging environment for SMEs. The performance of the SME sector has consistently lagged that of larger companies, with lower profits and higher debt-to-asset ratios (Table 2). In addition, SMEs invest less in R&D and spend a larger share of revenues on salaries. The deterioration in SMEs' profitability has occurred in the context of extensive and expanding public support to SMEs. Credit guarantees for SMEs have risen from 2% of GDP in 1995 to 7% in 2009. It is therefore urgent for Korea to reconsider its SME policies, in particular their effectiveness in strengthening the competitiveness of small firms and supporting innovative entrepreneurs.

### Main OECD Policy Recommendations on Entrepreneurship, SME Promotion and Micro-credit Schemes are summarised below:

- Continue to reduce regulatory and administrative burdens on start-ups, notably by streamlining the administrative procedures to start a business.
- Build up entrepreneurship education in universities and higher education institutions.
- Upgrade training in SMEs, supporting in-company projects and apprenticeship schemes.
- Recognise the role of social entrepreneurship in responding to social needs and strengthening social cohesion, tailoring support schemes to the different typologies of social enterprises.
- Reduce the level of public guarantees for lending to SMEs and address the distortions created in the financial markets and in the SME financial structure.
- Phase out excessive public support for SMEs, which were introduced during the recent crisis, and promote restructuring based on market incentives.

## Policy challenges

**Entrepreneurship and SME innovation.** Korea has undertaken intensive regulatory reform since the 1997 crisis to improve the business environment and foster the creation of new business ventures, particularly innovation-oriented firms. The streamlining of regulations governing business activities, such as entry barriers (licensing and registration) and price controls, has reduced the administrative burdens on start-ups to close to the OECD average by 2008 (Chart 20). Moreover, in the World Bank's worldwide rankings on the ease of starting a business, Korea's rank improved from 126th in 2008 to 60th in 2010.

**Table 2. Comparison of large corporations and SMEs**

Per cent

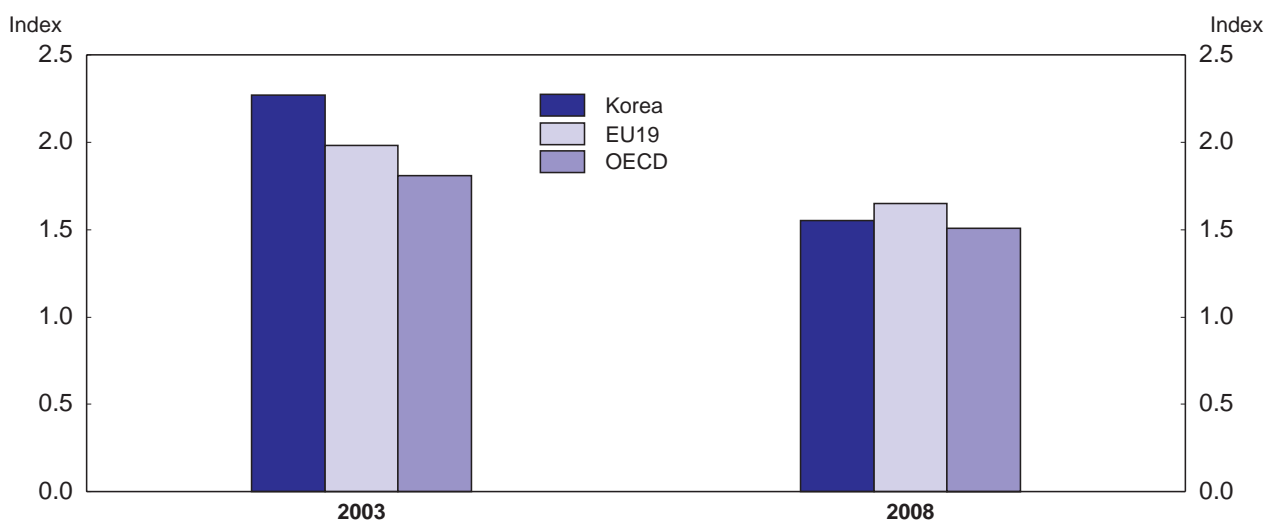
		1997	1999	2001	2003	2005	2006	2007
Operating profits/sales	Large firms	9.7	7.4	6.0	8.2	7.2	6.0	6.7
	SMEs	5.0	5.2	4.5	4.6	4.4	4.3	4.5
Wage bill/sales	Large firms	--	8.7	8.4	8.9	8.3	8.3	8.2
	SMEs	--	11.7	12.9	12.7	12.6	12.5	12.5
Borrowing-to-asset ratio	Large firms	56.5	44.5	42.0	25.9	19.1	18.1	18.0
	SMEs	46.8	37.8	34.6	33.5	30.8	30.9	32.0
Average borrowing rate <sup>1</sup>	Large firms	10.3	11.9	9.9	7.0	5.8	6.1	6.1
	SMEs	11.8	10.2	8.1	6.6	6.2	6.5	6.7
R&D/sales	Large firms	--	1.8	1.5	2.0	2.1	2.3	2.2
	SMEs	--	0.5	1.0	0.8	1.0	1.1	1.1

1. Interest expenses divided by total borrowings.

Source: 2008 OECD Economic Survey of Korea.

The SME innovation gap has been gaining attention in Korea's policy agenda, as SMEs significantly underperform large firms in all types of innovation (product, process and non-technological innovations) and are significantly less engaged in collaborating on innovation activities. The Small and Medium Business Administration (SMBA) operates numerous schemes to support SME innovation and encourage spin-offs from universities and research centres. In addition, under the Korea Small Business Innovation Research scheme, government ministries and government-financed institutions have been encouraged to allocate part of their R&D support budget to small firms. In 2008, approximately \$870 million (about 3% of the government's \$26.6 billion of outlays on R&D spending) was awarded through this system. The SMBA also operates the SMEs' Technology Innovation Programme, which allows SMEs to recover up to 75% of the cost of developing new products or enhancing product quality. Furthermore, the Korea Technology Finance Corporation (KOTEC) provides SMEs with credit guarantees based on technology value appraisal and certification, which facilitates their access to loans and guarantees by other institutions, as well as investment by venture capital companies and broader business support. Higher education institutions are increasingly providing entrepreneurship education, but in this regard, Korea still underperforms most OECD economies, as less than 15% of the population aged 18-64 has training in starting a business.

**Chart 20. Administrative burdens on start-ups**



Source: OECD, *Going for Growth*, 2010.

**Social entrepreneurship.** Social entrepreneurship can be an important driver of social innovation and deliver services that improve the quality of life of individuals and communities. Social enterprises (co-operatives, including credit unions, associations, non-profit organisations engaged in service provision and/or the creation of jobs and enterprises, and civic movements) have been developing in Korea in recent years. The Social Enterprise Promotion Act (2007) defined them as hybrid companies that focus both on profits and social aims. Emerging co-operative sectors (such as ethical foods) are providing essential goods and services, while community credit co-operatives supply much-needed financial services. However, the potential of social enterprises to contribute to economic growth in Korea is currently not sufficiently recognised, as the main focus tends to be on their capacity to address social exclusion issues related to unemployment and the provision of social services to disadvantaged groups. In 2010, there were 353 social enterprises, employing around 11 000 people (0.1% of dependent employment), of which 6 000 were disadvantaged. The need to increase their economic contribution is

reflected in the 2007 Act, which emphasises that social enterprises should generate market revenues and create permanent jobs. However, this is a challenging goal as these enterprises have to both train disadvantaged workers and develop markets for their services. In addition, the current short-term subsidy provided by the government may be insufficient to create sustainable jobs for those hired under this programme.

**SMEs' and entrepreneurs' access to finance.** Since the late 1970s, the Korean government has been very active in easing the access of SMEs and entrepreneurs to finance. According to a recent KDI study, the Small Business Corporation (SBC) has supplied loans to SMEs at interest rates below market rates since 1979. The SME credit guarantee scheme, which covered 85% of a loan made by a financial institution, was made more generous during the 2008-09 crisis. The coverage ratio was raised to 95%, and in some sectors, to 100%, and direct government loans were provided, essentially to bail out financially-distressed SMEs. In addition, banks were instructed to automatically roll over their loans to SMEs. These policies contributed to the banks' lax lending behaviour vis-à-vis SMEs, resulting in a negative interest rate spread with respect to loans to large firms, despite the banks' own liquidity shortages and the build-up in non-performing SME loans. While expanded financial support to SMEs has prevented some bankruptcies and helped to sustain employment in the wake of the 2008 crisis, it has also exacerbated moral hazard problems by increasing the reliance of SMEs and banks on public assistance.

## OECD key messages

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**Enhance entrepreneurship training and close the SME innovation gap.** Korea has launched numerous schemes to promote start-ups and created several institutions which target technology transfer and SME innovation. However, further efforts are needed to build entrepreneurial awareness and integrate entrepreneurial training in school and university curricula, as well as to upgrade training functions in SMEs.

**Provide more consistent support to social entrepreneurship to respond to social needs.** Social entrepreneurship is an increasingly important area of economic activity and supply of social services in Korea, as in most OECD economies. However, full recognition of its potential and a more coherent policy approach are required to increase its contribution to economic growth and social cohesion. Policy should distinguish, for instance, the specific needs and employment strategies of social enterprises providing job opportunities to the disabled from those offering training and transitional employment. Furthermore, social enterprise promotion should be more consistently linked to local and community development strategies.

**Make SME financing support schemes sustainable.** The recent massive increase in the amount and coverage of government loan guarantees raises serious doubts about their fiscal sustainability and their impact on SME performance. Furthermore, extensive financial support to SMEs has blunted competitive pressures, slowed reform and reduced the efficiency of resource allocation. While SMEs' and entrepreneurs' access to finance should remain a policy priority, it is essential to reform financing support schemes by: reducing distortions in pricing risks entailed by government intervention; lowering the fiscal burden; and achieving more balanced sharing of risks. The focus of government lending programmes should be shifted to financing new start-ups rather than supporting existing SMEs.

## International Practices for Strengthening Entrepreneurship Education in Universities and Higher Education

Universities, with their combination of knowledge, research and high-skilled human capital are unique places for ideas to emerge and be transformed into entrepreneurial ventures. The number of universities that mobilise their graduates for entrepreneurial careers is growing rapidly. Yet entrepreneurship education and the provision of “hands on support” are still new tasks for many universities. Successful implementation requires not only closer links between the “research” and “education” missions of a university, but also partnerships with entrepreneurship support providers and (global) sources of financing. There is a clear role for public policy to facilitate this process, fostering synergies between research and teaching and opening up universities towards their “third mission”:

- **Anchoring entrepreneurship support at top university management level.** In promoting entrepreneurship, universities themselves need to be entrepreneurial and innovative. Clear incentives and rewards are needed for professors, researchers and students to engage and to use more experimental teaching methods than the traditional textbooks and “talk and chalk” style lectures. In the *United States* and in *Malaysia*, recruitment and career development procedures for academic staff in many private and public universities nowadays take into account entrepreneurial attitudes and prior experience. Support for the design, implementation and dissemination of innovative and high quality pedagogical material and teaching methods is also provided in many countries. Within higher education institutions, top management level support for entrepreneurship is necessary to allow entrepreneurship activities to flourish, and this can be encouraged with appropriate public sector incentives.
- **Facilitating networking and exchange.** In-house communication by higher education institutions matters greatly to the effectiveness of the entrepreneurship support offered, as do networking and clear referral systems. Information needs to be easily accessible, especially for students. In *Germany*, where more than half of universities are engaged in entrepreneurship support, many have established dedicated centres that act as single-windows in offering information, training and access to networks. A new federal government programme (EXIST IV) awards universities that perform particularly well in this service area. Furthermore, inter-university collaboration can increase the diffusion and utilisation of innovative pedagogies and teaching materials. This is encouraged in *France* by the Observatory of Pedagogical Practices in Entrepreneurship (Observatoire des Pratiques Pédagogiques en Entrepreneuriat), which is an online resource centre for innovative and pertinent teaching material and which organises regular networking events for teachers and staff from entrepreneurship support organisations.
- **Fostering early development of entrepreneurship support services and opening to private financing.** Public kick-off funding for university entrepreneurship support is common to many OECD countries. Key to their success is a balance between long-term public support, for core staff and overhead costs, and openness to private-sector financing. Activities to attract private financing vary widely across universities. They range from seeking revenues from licenses and a sale of shares in spin-off companies as is common practice in the *United States* and, increasingly, in universities in *Northern Europe*, to offering entrepreneurship training courses and business consultancy at market rates, as for example in the *United Kingdom*. The trend towards engagement with private sector financing is also emerging in countries such as *Germany* and *Italy*, where public-private co-financing at universities is less frequent.



- **Increase cross-campus participation in entrepreneurship activities.** Students should have access to a wide range of entrepreneurial learning opportunities inside and outside their courses of study. Traditionally entrepreneurship education has been integrated in curricula of business and management courses, as well as engineering studies. Lately, however, this is opening into the humanities. Many universities across OECD countries are actively promoting team start-ups by people from different faculties to stimulate innovative entrepreneurship that provides interdisciplinary solutions to complex problems.

For supporting evidence and further reading see: OECD (2010), “Universities, Innovation and Entrepreneurship: Criteria and Examples of Good Practice”, *OECD Local Economic and Employment Development (LEED) Working Papers*, 2010/10, OECD Publishing. OECD (2008), *Entrepreneurship and Higher Education*, OECD Publishing.

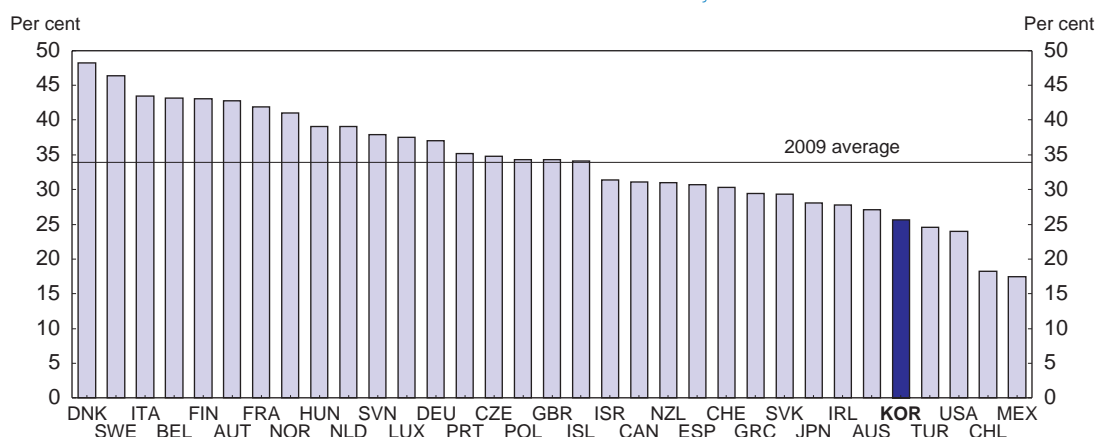


# How to Finance Rising Social Spending?

## Reforming the Korean Tax System

Korea has one of the lowest tax burdens in the OECD area, reflecting its relatively young population and low level of social spending. Indeed, in 2008, it amounted to only 27% of GDP, well below the OECD average of 34% (Chart 21). The low tax burden has created strong work incentives, helping Korea to achieve rapid economic growth over the past five decades. However, rapid population ageing and the development of social insurance systems and social welfare will put significant upward pressure on government spending in the decades to come. Korea's challenge is to meet the long-run need for greater additional revenue to finance these expenditures while sustaining economic growth.

**Chart 21. International comparison of total tax revenue <sup>1</sup>**  
Per cent of GDP in 2009 or latest year



1. Including social security contributions.

Source: OECD, *Revenue Statistics 1965-2009* (edition 2010).

### Main OECD Policy Recommendations on How to Finance Rising Social Spending and Reform the Korean Tax System are summarised below:

- Broaden the personal income tax base, in part by increasing the compliance of self-employed workers by enhancing transparency about their income, while keeping tax rates low.
- Limit increases in the tax wedge on labour to encourage employment, saving, capital investment, working hours, entrepreneurship, FDI and education.
- Keep the corporate tax rate low to promote investment in fixed capital.
- Make the value-added tax the main source of additional government revenue by increasing the rate from its relatively low level of 10%, while maintaining a unified rate and further broadening the base.
- Increase environmental taxes as part of the Green Growth Strategy.
- Boost property holding taxes, which would also address concerns about rising real estate prices.
- Address equity concerns related to rising indirect taxes through well-targeted social programmes and expanding the earned income tax credit.

- Enhance the compliance and coverage of non-regular workers and employees at small firms with the tax and social insurance systems.

## The tax burden on workers

The low tax burden reflects the small share of direct taxes on households and social security contributions. Only 60% of workers pay personal income tax (PIT) due to generous deductions and exemptions, in part aimed at creating a level playing field with the self-employed, who tend to pay less income tax. Consequently, direct taxes on households, including social security contributions, amounted to only 4% of GDP in 2008, less than half of the OECD average of 9% (Table 3). Social security contributions in Korea were larger, at 5.9% of GDP, but are also far below the OECD average of 9.4%, reflecting relatively low contribution rates and weak compliance with the public pension system.

**Table 3. The tax mix in OECD countries**

Tax revenue as a per cent of GDP

	2000		2008			Change 2000-2008 <sup>1</sup>
	Korea	OECD	Korea	Rank	OECD	
Direct taxes on households	3.3	9.5	4.0	27	9.0	0.7
Direct taxes on firms	3.2	3.5	4.2	10	3.5	1.0
Social security and payroll	3.8	9.3	5.9	22	9.4	2.1
Goods and services	8.7	11.3	8.1	26	10.8	0.3
Of which: Value-added tax	3.8	0.8	4.3	24	0.7	0.5
Property	2.8	1.9	3.2	3	1.8	0.4
Recurrent taxes	0.6	0.9	1.0	12	1.0	0.4
Taxes on property transactions	2.0	0.7	1.9	1	0.5	-0.1
Estate, inheritance and gift taxes	0.3	0.3	0.3	7	0.1	0.0
Other	0.9	0.3	0.9	4	0.2	0.0
<b>Total</b>	<b>22.6</b>	<b>35.5</b>	<b>26.5</b>	<b>26</b>	<b>34.8</b>	<b>3.9</b>

1. In percentage points.

Source: OECD, *Revenue Statistics 1965-2009 (edition 2010)*.

As a result, the overall “tax wedge”, including social security contributions, was only 20% in 2009, the third lowest among OECD countries (Chart 22). The decision to lower the PIT tax rates by two percentage points, from a range of 8% to 35% in 2008 to 6% to 33% between by 2010 (2012 for the top rate), will lower the tax wedge.

Low taxes on labour are an important factor contributing to high labour inputs and rapid economic growth in Korea. Cross-country research by the OECD demonstrates that taxes on labour reduce labour supply and demand, saving and capital investment, thereby reducing potential growth. According to an OECD study, a 10 percentage point reduction in the tax wedge on labour (including social security contributions) would boost the employment rate by 3.7 percentage points.<sup>1</sup> Another OECD work found that a one percentage point increase in the tax wedge on labour income would lower overall employment by 0.25% (Bassanini and Duval, 2006).<sup>2</sup>

<sup>1</sup> OECD (2006), *OECD Employment Outlook*, OECD, Paris.

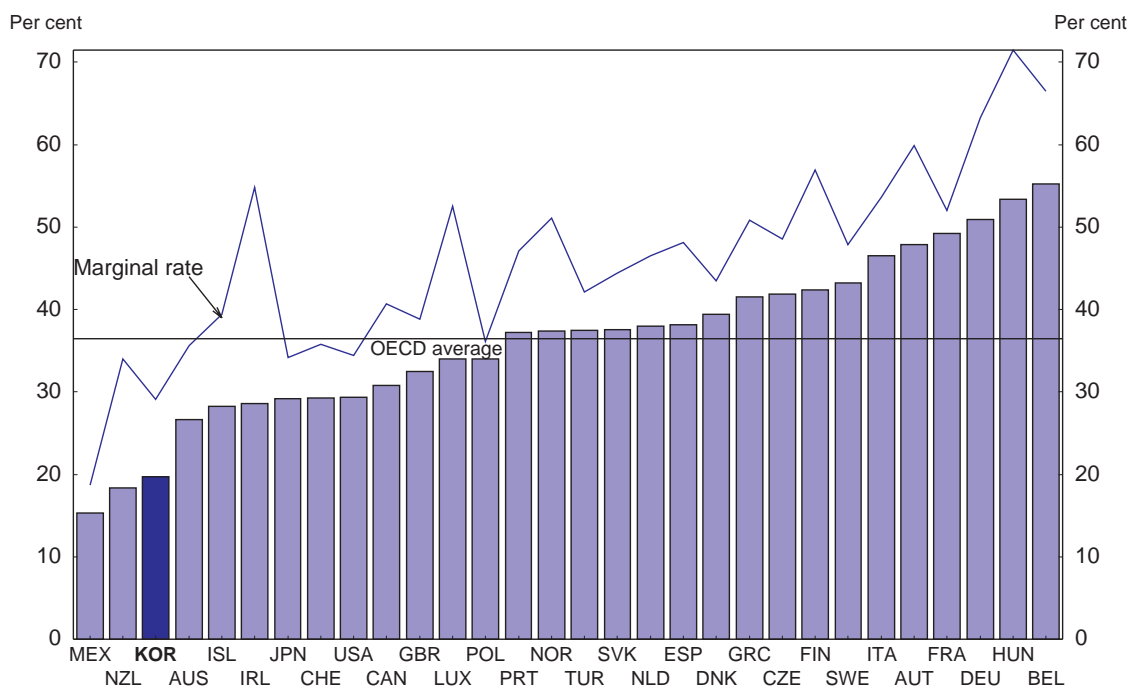
<sup>2</sup> Bassanini, A. and R. Duval (2006), “The Determinants of Unemployment Across OECD Countries: Reassessing the Role of Policies and Institutions”, *OECD Economic Studies*, No. 42, OECD, Paris.

Taxes on labour also tend to reduce hours worked, especially for women (Causa, 2008).<sup>3</sup> Korea's low marginal tax rate thus boosts working hours and may help explain why the incidence of part-time work among female employees is only 12.5%, about half of the OECD average. Moreover, Korea's PIT system does not discourage second-earner participation in the labour force to any significant degree, as the tax unit is the individual rather than the household, as in many OECD countries (Jaumotte, 2003).<sup>4</sup> Moreover, the spouse allowance in Korea is relatively low and does not favour non-working spouses. While the female labour force participation rate is low in Korea, it cannot be attributed to the tax system.

A low tax burden is also positive for economic growth by enhancing entrepreneurship and incentives for foreign direct investment and education. An OECD study shows that a five percentage-point decrease in the marginal tax rate leads to a 0.3 percentage point rise in the graduation rate from tertiary education (Oliveira Martins *et al.*, 2007).<sup>5</sup> Another study found that the impact of labour taxes on FDI inflows is substantially larger than that of corporate tax rates (Hajkova *et al.*, 2006).<sup>6</sup> As for entrepreneurship, reductions in top PIT rates have been shown to raise productivity in industries with high rates of enterprise creation (Johansson *et al.*, 2008).<sup>7</sup>

**Chart 22. Tax wedge on labour <sup>1</sup>**

As a per cent of gross labour costs in 2009 for a worker with average earnings



1. The average tax wedge is defined as the share of income tax and all social security contributions minus benefits in gross labour costs. Marginal rates are defined as the increase in income tax and all social security contributions minus benefits as a share of the related increase in gross labour costs.

Source: OECD, Tax Database ([www.oecd.org/ctp/taxdatabase](http://www.oecd.org/ctp/taxdatabase)).

3 Causa, O. (2008), "Explaining Differences in Hours Worked Among OECD Countries: An Empirical Analysis", *OECD Economics Department Working Paper No. 596*, OECD, Paris.

4 Jaumotte, F. (2003), "Labour Force Participation of Women: Empirical Evidence on the Role of Policy and Other Determinants in OECD Countries", *OECD Economic Studies*, No. 37, OECD, Paris.

5 Oliveira Martins, J., R. Boarini, H. Strauss, C. de la Maisonnette and C. Saadi (2007), "The Policy Determinants of Investment in Tertiary Education", *OECD Economics Department Working Paper No. 576*, OECD, Paris.

6 Hajkova, D., G. Nicoletti, L. Vartia and K. Yoo (2006), "Taxation, Business Environment and FDI Location in OECD Countries", *Economics Department Working Paper No. 502*, OECD, Paris.

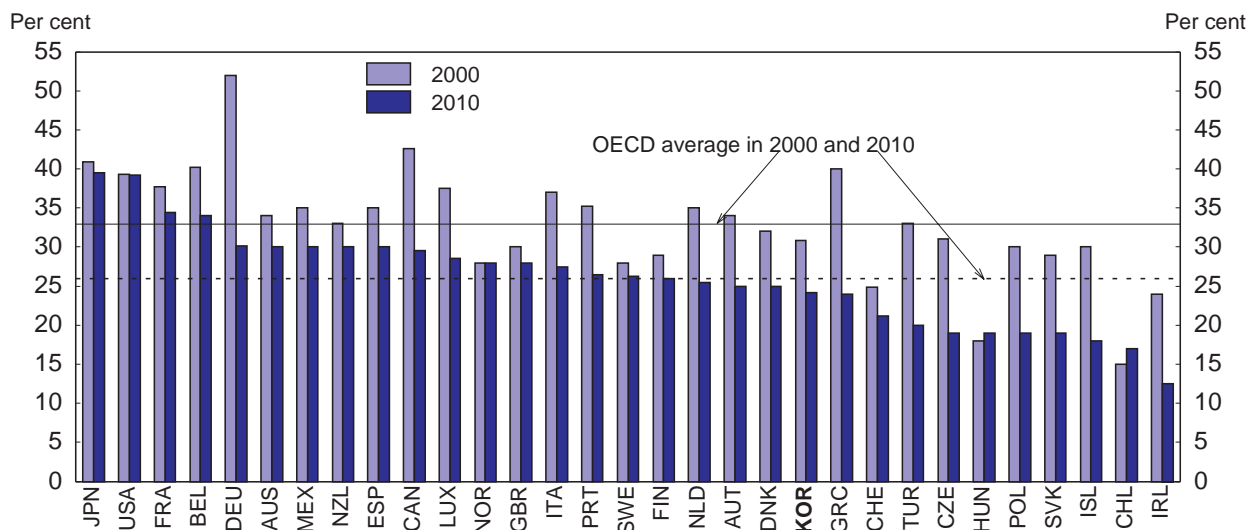
7 Johansson, Å., C. Heady, J. Arnold, B. Brys and L. Vartia (2008), "Tax end Economic Growth", *OECD Economics Department Working Paper No. 620*, OECD, Paris.

## Corporate income taxes

Statutory corporate tax rates have fallen in the OECD area, reflecting a growing recognition that such taxes distort saving and investment decisions, thereby reducing economic growth. In addition, there has been active competition to lower rates to attract FDI, given evidence that differences in corporate tax rates affect international flows of capital and profits and the location decisions of firms. For example, an OECD study found that a one percentage-point increase in the effective corporate tax rate reduces the stock of FDI by between 1% and 2% (Hajkova *et al.*, 2006).<sup>8</sup>

Korea has participated in the global trend toward lower corporate tax rates. Its statutory rate fell from 30.8% (including the local government tax) in 2000 to 24.2% by 2010, slightly below the OECD average (Chart 23). The government's concern is to compete with other Asian countries, notably China (with a rate of 25%), Taiwan, China (19%), Singapore (18%) and Hong Kong, China (16.5%). The reduction in the corporate tax rate may help increase the stock of FDI in Korea, which is the second lowest in the OECD area at 2% of GDP.

Chart 23. International comparison of statutory corporate income tax rates <sup>1</sup>



1. Basic combined central and sub-central (statutory) CIT rate. Averages are unweighted.  
Source: OECD, Tax Database ([www.oecd.org/ctp/taxdatabase](http://www.oecd.org/ctp/taxdatabase)).

## OECD key messages

### Raising revenue while sustaining growth

Korea's potential growth rate is projected to decline from about 4% at present to less than 2% in the 2030s, according to the Korea Development Institute. It is important to pursue policies that favour growth, including in the area of taxes, thereby easing the burden of coping with the fastest population ageing in the OECD area over the next 40 years. Pro-growth tax policy would call for maintaining a low

<sup>8</sup> Hajkova, D., G. Nicoletti, L. Vartia and K. Yoo (2006), "Taxation, Business Environment and FDI Location in OECD Countries", *Economics Department Working Paper No. 502*, OECD, Paris.

tax wedge on labour income, thereby helping to sustain labour input, which is currently the highest in the OECD area in terms of hours worked relative to the population. At the same time, base-broadening to increase the share of wages subject to income tax from around one-half toward the OECD average of more than 80% would reduce distortions and help keep marginal tax rates low. In addition, a low corporate tax rate would favour growth, as noted above. Keeping direct taxes low implies that revenue increases should come primarily from the value-added tax (VAT), environmental taxes and property taxes, while broadening the base of labour income taxes,

Korea's VAT rate is currently 10%, the fourth lowest among OECD countries that use a VAT, and well below the OECD average of 18%. Although consumption taxes lower the real after-tax wage and thereby have a negative effect on labour supply, the extent of the distortion is less than for income taxes. Another advantage is that the VAT is simple and relatively difficult to avoid or evade in Korea. While the tax base is already relatively broad, the base should be expanded by scaling back the scope of exemptions and limiting the use of the simplified scheme for small businesses.

Revenue from environmental taxes in Korea rose from 2% of GDP in 1994 to 2.5% in 2008, thus surpassing the OECD average of 2.2%. The increase reflects tax reforms to encourage energy conservation and protect the environment. Between 2001 and 2007, the government raised the tax on diesel by 2.4 times in real terms and the tax on LPG butane by 6.8 times, boosting the share of taxes in energy prices above that in North America and Japan, although still below Europe. Energy taxation should be an important source of additional revenue, while addressing environmental externalities. Korea set a goal in 2009 to cut its greenhouse gas emissions by 30% relative to a "business as usual" baseline by 2020, which implies a 4% reduction relative to 2005. Meeting this target will be challenging, as emissions almost doubled between 1990 and 2005, making Korea one of the fastest-growing source of emissions in the OECD area. Moreover, Korea has one of the highest levels of energy intensity in the OECD area, reflecting its concentration in energy-intensive industries. Achieving the 2020 target in a cost-effective manner requires improving the policy framework by introducing market-based instruments – notably a carbon tax and an emissions trading system (which generates revenue if the permits are auctioned) -- to reduce emissions.

Property-related taxes are high in Korea, at 3.2% of GDP in 2008 compared with an OECD average of 1.8% (Table 1). However, their prominent role is primarily due to taxes on transactions – 1.9% of GDP, the highest in the OECD area – which hamper mobility by creating lock-in effects. In contrast to transaction taxes, taxes on property holding were much lower at 1.0% of GDP. A tax on property holding is more favourable for growth than other taxes as it has less impact on decisions to supply labour, produce, invest and innovate (Johansson *et al.*, 2008). Increasing the share of property tax in the overall tax mix would reduce the need for other more distorting taxes, in addition to promoting the efficient use of land and addressing the persistent concern about real estate prices in Korea.

### **Promoting income equality**

A shift in the tax structure from income to consumption taxes would reduce the tax system's already low redistributive impact, with negative implications for income equality and Korea's already high rate of relative poverty. The need to boost the VAT rate raises the issue of whether Korea should introduce multiple rates in order to limit its regressive impact by exempting or imposing lower rates on food and other necessities. Such an approach is used in some European countries, which have standard VAT rates as high as 25%. However, differentiating VAT rates is not an efficient way to provide assistance



to those who need it. High-income households tend to benefit most from lower rates on some items because their level of consumption is higher. In addition, introducing multiple VAT rates has a number of drawbacks. First, it would entail higher administrative and compliance costs. Second, it would provide opportunities for fraud through the misclassification of items. Third, it would have to be compensated by a higher standard rate. Fourth, it would reduce the neutrality of the VAT, thus distorting consumption decisions and decreasing welfare. In sum, it is important to maintain a single rate, while limiting the number of zero-rate products.

Instead, income distribution should be addressed through well-targeted social welfare programmes and expanding the earned income tax credit (EITC). In 2008, Korea introduced an EITC, an in-work tax credit that is used in a number of OECD countries. The EITC was expanded in 2009 to include salaried workers with at least one child, who do not own a home (or own one worth less than 50 million won) and have assets of less than 100 million won (\$68 000). The EITC is primarily targeted at the 7.4 million daily and temporary workers. The government estimated that 0.6 million households (3.6% of the total) received the EITC in 2009, with total payments of 430 billion won (0.1% of total government spending). The impact of an EITC in terms of increasing total labour supply and decreasing unemployment is greater in countries with a wide earnings distribution, low tax rates on labour and low benefits for the non-employed (Bassanini *et al.*, 1999).<sup>9</sup> This suggests that the EITC will also be particularly beneficial in Korea. The major challenge to successfully implementing and expanding the EITC is the lack of transparency about the income of daily and temporary workers. Another way to improve income distribution would be to increase taxes on fringe benefits. At present, many benefits, such as subsidies for employees buying houses or using lodging or cars owned by their employer, are deductible for firms and not taxable for employees.

### **Improving compliance with the tax and social insurance systems**

The collection processes differed in terms of the definition of the wage base, the payment intervals, end-year adjustments, employer ID codes and other features. These problems have contributed to low insurance coverage, particularly for non-regular workers and employees at small firms. About 64% of the working-age population is contributing to the social insurance system and the participation of self-employed and non-regular workers needs to be improved. While more than three-quarters of regular workers were covered by pension and medical insurance at their workplace and employment insurance in 2010, the share was only around 40% for non-regular workers. At small firms, only 30% of regular workers and 15% of non-regular workers were covered. Beginning in January 2011, the collection of social insurance was combined under the NHI, which should enhance transparency about income and improve compliance. Unifying the collection of social insurance systems and the National Tax Service in the long run would further enhance compliance.

<sup>9</sup> Bassanini, A., J. Rasmussen and S. Scarpetta (1999), "The Economic Effects of Employment-Conditional Income Support Schemes for the Low-Paid: An Illustration from a CGE Model Applied to Four OECD Countries", *OECD Economics Department Working Paper No. 224*, OECD, Paris.



# Annex 1

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## Brief overview of Korea's rapid economic development

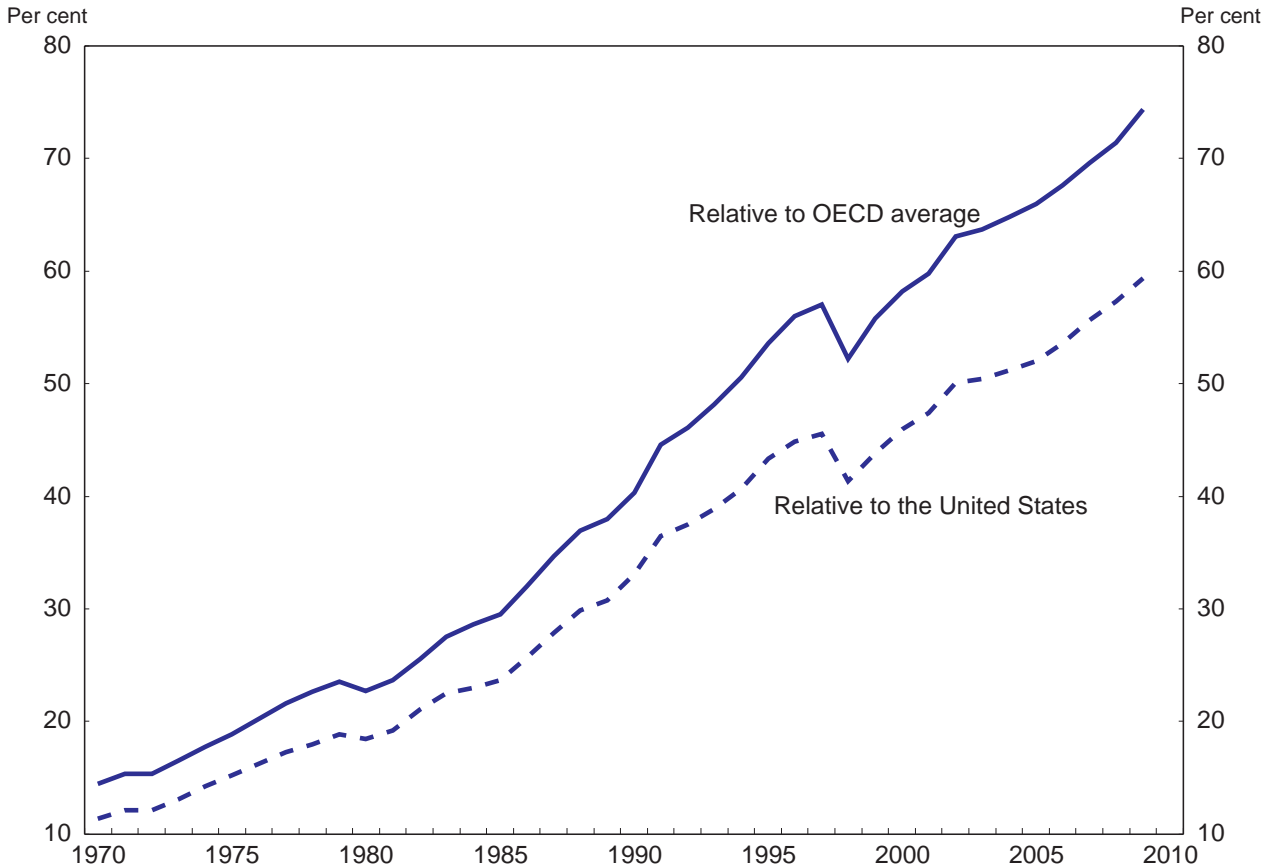
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The economic development of Korea over the past fifty years has been among the most rapid and sustained ever seen. Since 1960, Korea has been transformed from one of the poorest countries on earth to a leading industrial nation and the world's eighth-largest exporter. Rapid output growth boosted Korea's per capita income from less than 15% of the OECD average in 1970 to nearly 60% by the time of the Asian financial crisis in 1997 (Chart 24).

Korea's income distribution over that period stands out as one of the most equitable among developing countries, reflecting its outward-looking development strategy focused primarily on labour-intensive manufacturing industries. This approach boosted employment and wages, helping to spread the benefits of growth widely throughout the population. Such a strategy was facilitated by investment in basic education. In short, economic growth promoted social progress, creating a virtuous circle of rising living standards for an increasingly healthy and well-educated labour force, thus favouring further productivity increases.

The 1997 crisis marked a turning point in Korea's economic history. Development prior to that point had been achieved without some of the necessary rules and principles of a market economy. Korea was hampered by collusive ties between government and businesses and a "too big to fail" mentality that resulted in an excessively indebted corporate sector, with weak profitability, and a poorly supervised and shaky financial system. Korea's response to the crisis included a wide range of reforms in the corporate and financial sectors, as well as the labour market. In particular, barriers to trade and foreign investment were liberalised, promoting Korea's integration into the world economy. The post-1997 reforms, in which the OECD played a key role, laid the foundations for renewed growth and further convergence towards the high-income countries. With growth at a 5.4% annual rate in the decade from 1998, Korea's per capita income climbed to 70% of the OECD average by the 2008 global financial crisis.

Chart 24. Korea's per capita income has converged rapidly toward the OECD average <sup>1</sup>



1. Based on 2009 purchasing power parity exchange rates.  
Source: OECD Economic Outlook database.

Korea's trade-dependent economy was profoundly tested by the 2008 economic and financial crisis, resulting in exceptionally sharp declines in exports and output. The recession was accompanied by financial turbulence and large capital outflows, which pushed equity prices down and led to a 25% depreciation of the won in effective terms. Capital flight and the plunge in the exchange rate rekindled memories of the 1997 crisis that had brought the country close to economic and financial collapse.

In the event, the economy and financial system weathered the shock quite well, thanks in part to a prompt and effective policy response and the improved financial health of firms and financial institutions since the 1997 crisis. With large-scale fiscal stimulus, aimed in particular at supporting employment, and the competitiveness gains resulting from the depreciation of the won, Korea achieved one of the fastest recoveries in the OECD area from the crisis, with output expanding by 6.2% in 2010.

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