From Rapid, Shared Growth to Slow Unshared Growth?

Wonhyuk Lim *Director and Vice President, Department of Competition Policy, Korea Development Institute (KDI)*

According to the Commission on Growth and Development (2008), since 1950, there have been only 13 economies that have grown at an average of 7 percent or more a year for 25 years or longer. Nine of them are in Asia. Even within this high-growth group, the successful Asian economies have distinguished themselves by their relatively equitable income distribution. In fact, as the World Bank (1993) emphasized, "rapid, shared growth" was the key feature of the East Asian miracle. Some of these economies, including China, Japan and Korea, got rid of their traditional social hierarchy and carried out land reform in one form or another to change people's expectations for social mobility and improve wealth distribution. All successful Asian economies invested in people and actively engaged in international trade to exploit their comparative advantage in labor-intensive manufacturing and produce broad-based growth and dynamic learning opportunities. They also adopted proactive policy measures to ensure social cohesion, while staying away from European-style welfare state models.

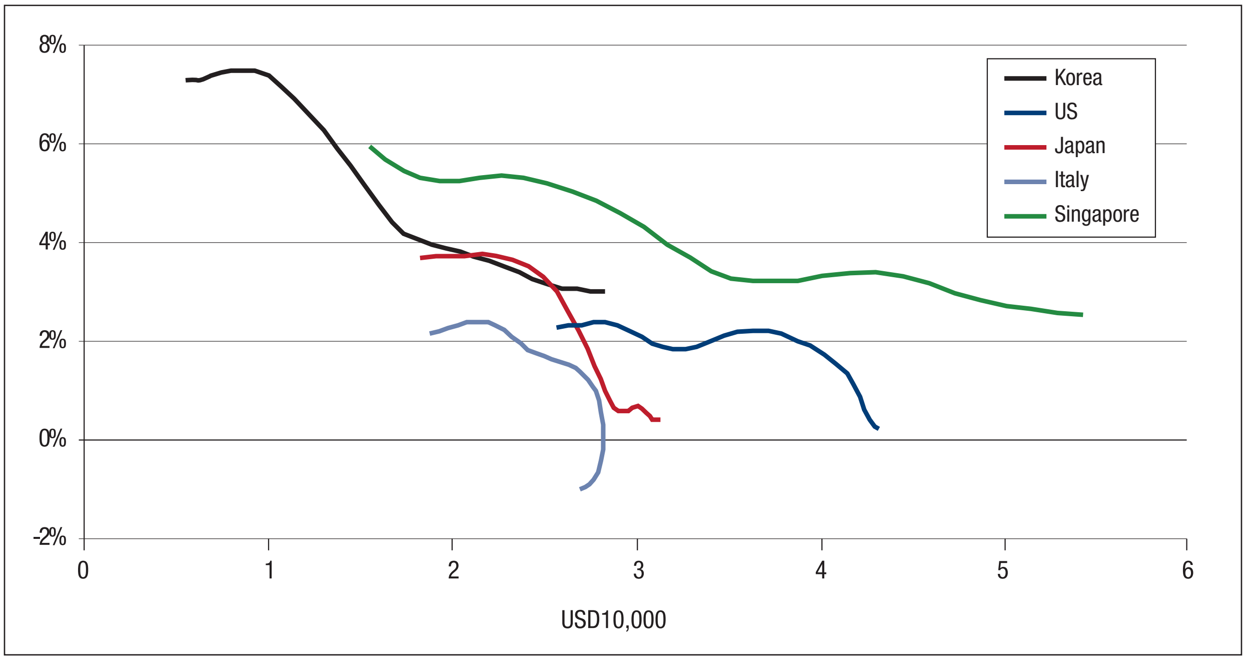
However, it is becoming increasingly clear that the past catch-up strategy based on human resource development and export-oriented industrialization, with some measures for social cohesion, may not be enough to sustain rapid, shared growth. As the Asian economies approach the technology frontier, they must move from emulation to innovation to generate growth and stay ahead of late-developing countries. At the same time, because skill-biased technical change tends to aggravate income distribution, they must redouble their efforts to strengthen education and address economic and social disparities.

Korea is a prime example of a country that was able to achieve rapid, shared growth, but is now facing the challenge of what appears to be slow, unshared growth. As shown in Figure 1, the question for Korea is whether it can continue to grow strongly over time like Singapore, or whether its growth will fall as has happened in Japan, Italy and perhaps now the United States. It provides a number of lessons for maturing economies that are going through a midlife crisis of their own.

From a starting point as one of the world's poorest countries ravaged by war, Korea has raised its per capita income to more than $20,000 at the market exchange rate and around $30,000 in purchasing power parity (PPP) terms. While countries that belonged to low-, middle-, and high-income groups in 1962 respectively raised their per capita income at 2.0, 2.1, and 2.0 percent per year between 1960 and 2007, Korea's per capita income increased at 5.7 percent per year over the same period.[1] Korea indeed was one of the most successful cases of convergence, whereas most of its low- and middle-income cohorts in 1962 hardly converged with the high-income countries. In addition, according to the World Bank (1993), the income of the top 20 percent was less than seven times the income of the bottom 20 percent over the 1965-1989 period in Korea; whereas the top-to-bottom income quintile ratio exceeded 25 in such high-growth countries as Brazil and Botswana over the same period.

What was the formula for this rapid, shared growth in Korea? Initial wealth redistribution changed expectations for social mobility and helped to facilitate human resource development in the 1950s, which in turn created comparative advantage in labor-intensive manufacturing. Export-oriented in-

FIGURE 1. INTRA-REGIONA OR EXTRA-REGIONAL CONVERGENCE?
PER CAPITA INCOME TRAJECTORY: LEVEL VS. GROWTH RATE (1980-2012)



Note: Based on 2005 PPP exchange rates. Per capita income was smoothed out using the Hodrick-Prescott filter.

dustrialization then began to generate broad-based growth in the 1960s. In subsequent decades, Korea successfully upgraded its comparative advantage with a view toward increasing the domestic value added of its exports, while adopting some proactive measures to address economic and social disparities.

The collapse of Korea's traditional hierarchy during Japanese colonial rule (1910-1945), combined with the leveling effect of the 1949 land reform and the Korean War (1950-1953), essentially placed all Koreans at the same starting point in the 1950s. These initial conditions had tremendous implications for human resource development, because Koreans came to believe that hard work in school would pay off in the form of upward social mobility.

Although Korea was one of the poorest countries in the world in the 1950s, it invested its limited resources to promote human resource development. With the introduction of universal primary education in 1950, Korea's primary school enrollment rate increased from 59.6 percent in 1953 to 86.2 percent in 1960. The illiteracy rate dropped from 78 percent in 1945 to 28 percent in 1960.[2] As a result, by 1960, Korea had primary and secondary school enrollment rates similar to those in countries with two or three times its per capita income.[3] Although investing in people alone was not enough to promote growth in the absence of complementary industrial and trade developments, it provided the basis for Korea's initial takeoff.

After changes in political economy introduced by the student revolution of 1960 and military coup of 1961, Korea was able to exploit its latent comparative advantage through export-oriented industrialization. It is important to note that for a country that has a comparative advantage in the labor-intensive sector, as Korea did in the 1960s, export orientation can improve the welfare of workers. The reason is that international trade allows a country to provide greater opportunities for its relatively more abundant factor of production. As a result, Korea's switch to export-oriented industrialization in the early 1960s supported broad-based growth.

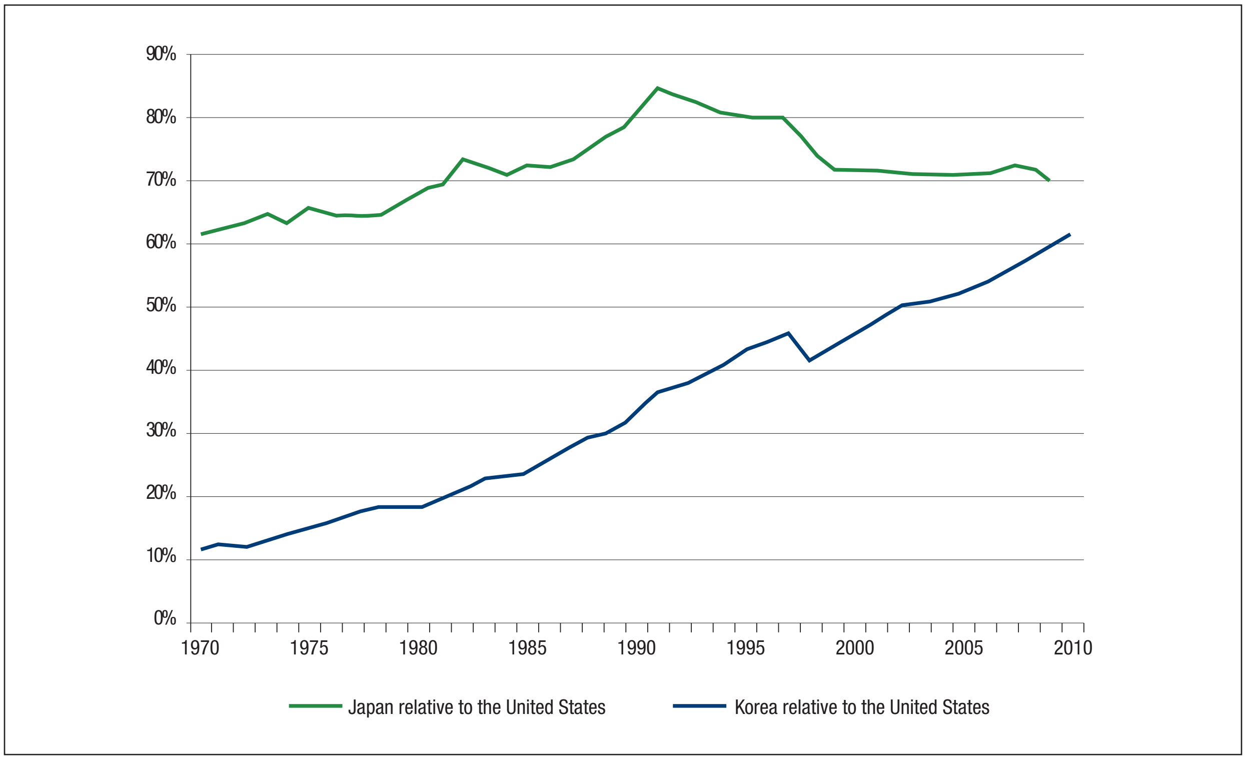
Even as Korea embarked on its export-oriented industrialization, it also made serious efforts to raise agricultural productivity and narrow the urban-rural income gap, which had widened from zero to 33 percent over the course of the 1960s.

In 1970, Korea adopted *Saemaul Undong* (New Village Movement), of which the core elements included community empowerment under the principles of "diligence, self-help, and cooperation"; peer learning and inspiration; and performance-based support from the government.[4] In addition, the construction of multi-purpose dams and other infrastructure, combined with the green revolution, helped to increase agricultural productivity. A dual grain price system, through which the government procured grain at higher prices than it subsequently sold for, further supported rural income, even though it increasingly became a fiscal burden. Thanks to these efforts, Korea was able to eliminate its urban-rural income gap by the mid-1970s.

In subsequent decades, Korea retained ownership of its development and progressively built domestic anchor institutions and companies that played a leading role in adding value and managing risks, even as it actively learned from, and traded with, the outside world. Through the joint efforts of the government and the private sector, Korea was able to discover and upgrade its comparative advantage, and reinforce successful experiments through rewards based on performance in competitive global markets. Korea's coordinated and broad-based program of trade, industrial, and human resource development generated rapid, shared growth.[5]

In recent years, however, Korea has been faced with diminishing growth prospects and increasing socioeconomic disparities. Korea's potential growth rate was as high as 8.6 percent in the 1980s, but it declined to 6.4 percent in the 1990s and 4.5 percent in the 2000s. It is projected to decline further to 3.6 percent in the 2010s and 2.7 percent in the 2020s. Korea's realized GDP growth rate in the 2010s is even lower than the potential growth rate, and there is an increasing concern that Korea may follow Japan's footsteps and achieve only "club convergence" with Japan (see Figure 2). Meanwhile, Korea's income inequality as measured by the Gini coefficient has increased since the mid-1990s, and among the 34 OECD countries, Korea had the sixth worst income distribution in 2010,

FIGURE 2. INTRA-REGIONAL OR EXTRA-REGIONAL CONVERGENCE?



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

after Chile, Mexico, Turkey, the U.S. and Israel. The question is how to achieve a virtuous cycle between growth and equity on a sustained basis given Korea's changed economic and social conditions. It would be irresponsible to set an unsustainably high annual GDP growth target (for example, 6 to 7 percent) and adopt loose macroeconomic policy (not productivity-enhancing reform) in a vain attempt to try to achieve it—and risk creating a bubble instead. Also, given Korea's changed comparative advantage and global production network, it would be unrealistic to expect international trade to generate broad-based growth. Finally, given Korea's relatively low tax rates, "trickle-down" policy based on tax cuts for the rich would likely aggravate the fiscal situation and worsen income distribution without accelerating economic growth. An effective new policy package would require a nurturing business ecosystem to promote innovation, an integrated labor market to provide compensation linked to productivity, and a proactive public finance system to address economic and social disparities.[6]

Korea's industrial sector is dominated by a handful of family-based business groups, known as the chaebol. They are among the most technologically and commercially sophisticated agents in the Korean economy, but they may unduly concentrate and entrench economic and political power. The best solution for Korea is for the government to strengthen investor protections and make it easier for shareholders to seek private remedies against "tunneling" and breaches of fiduciary duty, while enhancing intellectual property protection, strengthening competition, and expanding access to finance to promote the kind of entrepreneurship and entry that are vital to innovation but threaten to be stifled by the presence of very large business groups.

Korea's labor market is characterized by duality, according to which workers are segmented into regular and non-regular employment, which is a significant source of inefficiency and inequity. Enforcing the principle of equal pay for equal work should help improve productivity as well as income distribution. In addition, overhauling the traditional seniority-based wage system should support sustainable employment. Whereas in most OECD countries the female labor participation rate remains high but hours worked drop for women in their thirties as they have to take care of their young children, in Korea, child-rearing women drop out of the workforce altogether because, under the seniority system, the wage component based on hours worked is not large enough to make up for the childcare cost. Older workers in large firms are forced to retire early, around age 53, because their wages cannot be justified by their productivity. Reforming personnel management practices so that large firms retain more of their still-productive older workers would reduce the pressure to open up mom-and-pop stores in the service sector. Better still would be to adopt salary systems that more closely link pay not to seniority but to productivity.

A final distinctive feature of the Korean economy is an unusually low level of total tax revenue (including social security contributions) and social expenditure (27 percent and 10 percent of GDP, respectively) compared with OECD averages (34 percent and 19 percent, respectively). This tax-benefit system does too little to reduce inequality and promote inclusive growth. Korea needs to restructure the income tax system to increase progressivity and broaden the personal income tax base.[7] Korea also has a low share of social services in employment by OECD standards. This points to the availability of a quick fix where increased tax revenue and social expenditure are used to create jobs in social services and address problems of inequality and poverty.

In short, to go beyond "club convergence" with Japan or "regional convergence" within East Asia, Korea should overhaul the old catch-up strategy. An innovation-promoting business ecosystem should help firms with new ideas to flourish and generate growth. An integrated labor market with productivity-based pay should improve efficiency as well as income distribution. A proactive public finance system should help to achieve a virtuous cycle between growth and equity.

References

Eichengreen, Barry, Wonhyuk Lim, Yung Chul Park, and Dwight Perkins. 2015. *The Korean Economy: From a Miraculous Past to a Sustainable Future*. Cambridge: Harvard University Press.

Lim, Wonhyuk. 2011. "Joint Discovery and Upgrading of Comparative Advantage: Lessons from Korea's Development Experience." In Shahrokh Fardoust, Yongbeom Kim, and Claudia Sepulveda, eds., Postcrisis Growth and Development: A Development Agenda for the G-20 (Washington, DC: The World Bank), pp.173-226.

McGinn, Noel F., Donald R. Snodgrass, Yung Bong Kim, Shin-Bok Kim, and Quee-Young Kim. 1980. Education and Development in Korea. Cambridge: Harvard University Press.

OECD. 2011. "A framework for growth and social cohesion in Korea." Paris: OECD.

Park, Jin-Hwan. 1998. "The Saemaul (New Village) Movement." Seoul: Korea Rural Economic Institute.

Winters, L. Alan, Wonhyuk Lim, Lucia Hanmer, and Sidney Augustin. 2010. "Economic Growth in Low Income Countries: How the G20 Can Help to Raise and Sustain It." Working Paper 2010-01. Seoul: Korea Development Institute.

World Bank. 1993. *The East Asian Miracle: Economic Growth and Public Policy*. New York: Oxford University Press.

Endnotes

1. Winters et al. (2010)
2. McGinn et al. (1980)
3. World Bank (1993)
4. Park (1998)
5. Lim (2011)
6. Policy recommendations contained in the next three paragraphs are based on the conclusion of Eichengreen et al. (2015).
7. OECD (2011)