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## Export-Oriented Growth and Equity in Korea

Wontack Hong

Numerous literatures have documented that Korea's rapid growth since the early 1960s is owed almost entirely to its export-oriented growth strategy. According to Samuelson's static factor price equalization theorem, free trade with incomplete specialization can lead to the equalization of absolute factor returns among trading countries. In the early 1960s, Korea commenced its export-oriented growth by promoting exports of labor-intensive products on the basis of abundant cheap labor. By opening up and integrating its economy into the world market and trading directly with the most advanced countries in the world, the returns to the most abundant factor of production in Korea (i.e., the returns to labor) began to catch up with those of the advanced countries. Indeed, the average wage rate in the Korean manufacturing sector amounted to mere one-twenty-third of that of the U.S. manufacturing sector in 1960 (\$2.30 per hour) but grew to one-seventeenth of the latter (\$3.35 per hour) in 1970 and to one-quarter of the latter (\$14.31) by 1989. Even after making due allowance for autonomous capital accumulation and technical progress, such a steady and rapid rise in the rate of return on labor suggests the enormous absolute magnitude of gains from trade that Korea has been reaping over time through an export-oriented growth strategy based on comparative advantage.

In the process of export-oriented growth in Korea (1962–91), the rapid expansion of productive employment opportunities and the steady rise in real wage rates of various labor groups did contribute positively to the reduction of inequality in the distribution of income. The Korean government, however, has pursued this export-oriented growth strategy without paying much attention to the distributional aspect of the growth process. Critics have accused the Korean government of promoting export expansion by using various

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second-best or third-best policy measures that have generated all kinds of undesirable side effects, such as the concentration of production activities in the hands of a small number of big business groups (*Jae-buls*), worsening the distribution of income and wealth, proliferating unearned incomes, institutionalizing rent seeking, hostile and unstable labor relations, maintenance of a command economy for the banking sector, excessive dependence on the U.S. and Japanese economies, and so on. Presumably in order to take advantage of the scale economies in production activities, the government has deliberately concentrated economic power in the hands of a small number of *Jae-buls*; presumably in order to enhance national savings, it has minimized the taxation on capital gains and on incomes arising from the ownership of property and financial assets; and perhaps in order to take advantage of some kinds of scale economies that might arise from the concentration of wealth, it has minimized the effort to collect inheritance and gift taxes. Three decades of rapid economic growth seem to have generated politically powerful groups who have vested interests in the continuation of such an economic regime. Consequently, it is argued that, in spite of such a brilliant growth performance, Korea now experiences magnified internal conflicts and social unrest, making the prospect of its continued prosperity anything but a certainty.

The objectives of this paper are to examine the changing pattern of various published distributional statistics of Korea over the last three decades, the problems associated with such estimates, the government policies to concentrate economic power, the tax and public expenditure system, and the political economy of distribution policies. I conclude, first, that difficulties with Korea's income distribution are not the result of the export-oriented growth strategy itself and, second, that an export orientation alone, however, is not enough to result in a more equitable distribution of income and wealth.

### 15.1 Distribution Statistics on Income and Wealth

We may define the wage elasticity of productivity (WEP) as the percentage change in the wage rate (in manufacturing) divided by the percentage change in the average value added per employed person (of the whole economy). This index shows the relation between the speed of increase in the average labor productivity of the whole economy and the speed of increase in the average return to labor. The WEP amounted to 1.08 in 1965–70, 0.93 in 1970–76, 1.16 in 1976–80, 0.95 in 1980–85, and 1.22 in 1985–91. During 1965–91, labor productivity (i.e., value added per employed person) increased by about 4.3 times and the wage rate (in manufacturing) by about 5.8 times.<sup>1</sup>

1. The average annual wage rate in manufacturing amounted to \$1,992 (in 1991 prices) in 1965, which became \$11,500 in 1991. The value added per employed person amounted to \$3,543 (in 1991 prices) in 1965, which became \$15,116 in 1991. Data are from BOK, *Economic Statistics Yearbook*; MOF, *Fiscal and Monetary Statistics*; and BOK (1990).

The shift in the Gini coefficient from 0.344 in 1965 to 0.332 in 1970 may reflect the positive contribution to income distribution in the latter half of the 1960s of the rapid increase in employment opportunities that commenced after the early 1960s and the significant rise in real wages every year after 1965. The shift in the Gini coefficient to 0.391 in 1976 and 0.389 in 1980 may reflect the negative contribution to the distribution of income of the amplified concentration of economic power in the hands of big business groups and of the increased skewedness in wage rates among labor groups as well as of the increasing income disparity between farm households and urban households (during 1970–76). The shift in the Gini coefficient to 0.345 in 1985 and 0.336 in 1988 may reflect the positive contribution of the active labor union movement in the late 1980s on labor's share of national income.<sup>2</sup> Studies by Choo and Yoon (1984) and Yoo (1990) show a similar trend of inequality over time.

It may not, however, be wise to attempt to explain changes in a Gini coefficient of 0.002 or 0.012 or even 0.053. All estimates tend to seriously underestimate the actual degree of inequality because the basic data for these estimates exclude most of the very rich and the very poor (particularly during 1965–76), do not report the income figures of self-employed households (such as private businessmen, doctors, and lawyers), do not include nonfarm households in rural areas and farm households in urban areas, and, while including various unrealized incomes in farm households associated with their production activities, do not properly cover capital gains, inheritance, and property income.<sup>3</sup> The size of Korea's underground economy is estimated to be very substantial, and of course its existence could not be taken account of in these estimates.

On the other hand, a sample survey by the Bank of Korea shows a Gini coefficient of 0.56 for financial asset ownership in 1988 compared to that of 0.30 for income distribution of the households included in the survey (see Kang 1989, 76). According to a sample survey conducted by the Korea Development Institute in May 1989, the Gini coefficient for financial assets was 0.77 and that for physical assets was 0.60, while the Gini coefficient for income distribution of the households included in the survey amounted to 0.40 in 1988 (see Soonwon Kwon 1990).<sup>4</sup> Including the imputed rents from owner-

2. Data are from EPB (1989, 101). In 1965, the income of the wealthiest 20 percent was about 2.2 times that of the poorest 40 percent. In 1970, the ratio fell slightly to about 2.0, but it rose to about 2.7 in 1976 and to about 2.8 by 1980. By 1985, the ratio had fallen to about 2.5 to 1.

3. Nor is the imputed income from owner-occupied housing included in each household's total income figure. Furthermore, the basic data report only the mean income of each income bracket instead of the income of individual families belonging to each bracket. Since these studies assume that the mean income is the representative of each income bracket, the results are bound to lead to the underestimation of the inequality in Korea.

4. Since the KDI sample survey includes a larger number of rich and poor households than the government sample survey, the degree of income inequality is greater than other estimates based on government survey data. Capital gains are not counted in household surveys.

occupied housing as well as capital gains arising from the increase in housing prices, the Gini coefficient for income distribution computed on the basis of KDI survey data amounted to 0.436 in 1988. According to the Securities and Exchange Commission, about 91.56 percent of total *listed* stocks in Korea were owned by 0.264 million (juridical and nonjuridical) persons as of December 1990.

As of 1988, the total number of people economically active in Korea was 17.3 million. According to the *Report* of the Land Committee (Land Committee 1989), as of June 1988 in Korea, 0.54 million persons (i.e., equivalent to 3.1 percent of the economically active population) owned 65.2 percent of total private land, and 1.08 million persons (i.e., the upper 6.2 percent group) owned 76.9 percent of private land. The Gini coefficient of land ownership, computed without including about 6.5 million adults who do not own any land at all, amounted to 0.85 (see Land Committee 1989, 4).

By the end of 1988, the most plausible estimate for total value of privately owned land in Korea amounted to about 8.1 times GNP, which became about 9.4 times GNP by the end of 1990 (see estimate C of table 15.1).<sup>5</sup> The average land price increased by about 7 percent in 1985 and 1986, 14.7 percent in 1987, 27.5 percent in 1988, 32.0 percent in 1989, and 20.6 percent in 1990.<sup>6</sup> The most plausible estimates of (realized plus unrealized) "real" capital gains (i.e., taking account of overall inflation) arising from land ownership were equivalent to about 99 percent of GNP in 1983, about 74 percent of GNP in 1987, about 137 percent of GNP in 1988, about 199 percent of GNP in 1989, and about 79 percent of GNP in 1990 (see table 15.1).

In 1988, about 66 percent of total land in Korea was owned by private citizens, about 24 percent by the public sector, and about 4 percent by corporations. Among the land owned by corporations, about 67 percent was owned by the largest 403 firms, and about 88 percent was owned by the 2,174 largest firms (see Land Committee 1989, 244–46). As of 1988, about 90 percent of property-tax payers in Korea owned land whose assessed value amounted to less than 11.8 million won (about \$17,000) and paid less than 40,000 won (about \$58.00) as property taxes per annum. On the other hand, less than 2 percent of property-tax payers owned land whose assessed value exceeded 31.1 million won (about \$45,000) and paid more than 60,000 won (about

5. Estimates B are based on the facts that the total amount of land value assessed by the Ministry of Home Affairs for the purpose of local tax collection amounted to 84.2 trillion won as of 1 May 1989, that the average rate of increase in land price in 1989 was 32.0 percent ( $\times 0.6666 = 0.21333$ ), and that the average ratio of assessed value to market value estimated by the Korea Research Institute of Human Settlement amounted to 0.137 as of 1 January 1990.

6. The rapid increases in land price are often explained by the severe restrictions imposed on land use in Korea (such as the *absolute farmland* system), which inhibit land supply, and the fact that land itself became the object of speculative activities. One might, however, contend that the heavy protection of agricultural production in Korea has been the real cause of the rapid rise in land prices. This is because, with free trade in agricultural products, the rates of return on farming as well as the land prices themselves would be drastically driven down.

**Table 15.1 Increase in Stock and Land Prices and Associated Capital Gains**

|   | 1983  | 1984  | 1985  | 1986  | 1987  | 1988    | 1989    | 1990    |
|---|-------|-------|-------|-------|-------|---------|---------|---------|
| Rate of inflation (%) <sup>a</sup>        | 5.0   | 3.9   | 4.1   | 2.8   | 3.5   | 5.9     | 5.2     | 10.6    |
| Increase in land price (%):               |       |       |       |       |       |         |         |         |
| Nominal rate ( $n$ )                      | 18.5  | 13.2  | 7.0   | 7.3   | 14.7  | 27.5    | 32.0    | 20.6    |
| Real rate ( $r$ ) <sup>b</sup>            | 13.5  | 9.3   | 2.9   | 4.5   | 11.2  | 21.6    | 26.8    | 10.0    |
| Estimates (in trillion won) of (year-end) |       |       |       |       |       |         |         |         |
| Land value (A) <sup>c</sup>               | 139.8 | 158.2 | 169.1 | 181.4 | 216.2 | 275.7   | 363.9   | 438.9   |
| Land value (B) <sup>d</sup>               | 297.2 | 336.4 | 360.0 | 386.2 | 443.0 | 564.9   | 745.6   | 899.2   |
| Land value (C) <sup>e</sup>               | 538.6 | 609.7 | 652.3 | 700.0 | 802.9 | 1,023.6 | 1,351.2 | 1,614.5 |
| Real capital gains (in trillion won):     |       |       |       |       |       |         |         |         |
| $rA_{t-1}$                                | 15.9  | 13.0  | 4.6   | 7.6   | 20.3  | 46.7    | 73.9    | 36.4    |
| $rB_{t-1}$                                | 33.9  | 27.6  | 9.8   | 16.2  | 43.3  | 95.7    | 151.4   | 74.6    |
| $rC_{t-1}$                                | 61.3  | 50.1  | 17.7  | 29.4  | 78.4  | 173.4   | 274.3   | 135.1   |
| GNP (current price in trillion won)       | 61.7  | 70.1  | 78.1  | 90.6  | 106.0 | 126.2   | 141.8   | 171.5   |
| Land value/GNP:                           |       |       |       |       |       |         |         |         |
| Estimate A                                | 2.3   | 2.3   | 2.2   | 2.0   | 2.0   | 2.2     | 2.6     | 2.6     |
| Estimate B                                | 4.8   | 4.8   | 4.6   | 4.3   | 4.2   | 4.5     | 5.3     | 5.2     |
| Estimate C                                | 8.7   | 8.7   | 8.4   | 7.7   | 7.6   | 8.1     | 9.5     | 9.4     |
| Capital Gains/GNP (%):                    |       |       |       |       |       |         |         |         |
| Estimate $rA_{t-1}$                       | 26    | 19    | 6     | 8     | 19    | 37      | 52      | 21      |
| Estimate $rB_{t-1}$                       | 55    | 39    | 13    | 18    | 41    | 76      | 107     | 44      |
| Estimate $rC_{t-1}$                       | 99    | 72    | 23    | 33    | 74    | 137     | 193     | 79      |

*(continued)*

**Table 15.1** (continued)

|  | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 | 1990  |
|--|------|------|------|------|------|------|------|-------|
| Increase in stock price (%)              | 4.7  | 3.3  | 5.3  | 64.0 | 83.3 | 66.0 | 32.5 | -18.7 |
| Paid-in assets (in trillion won)         | 3.2  | 4.3  | 4.7  | 5.7  | 7.6  | 12.6 | 21.2 | 24.0  |
| Market value of stocks (in trillion won) | 3.5  | 5.2  | 6.6  | 12.0 | 26.2 | 64.5 | 95.5 | 79.0  |
| Stock value/GNP (%)                      | 5.7  | 7.4  | 8.5  | 13.3 | 24.7 | 51.1 | 67.4 | 46.1  |
| Capital gains in stock (in trillion won) | .1   | .6   | 1.1  | 4.4  | 12.3 | 33.3 | 22.4 | -19.3 |
| Capital gains/GNP (%)                    | .2   | .9   | 1.4  | 4.9  | 11.6 | 26.4 | 15.8 | -11.3 |

Sources: MOF, *Fiscal and Monetary Statistics*; Land Committee (1989); Jin Soon Lee (1990, 45, 63); Ministry of Home Affairs, *Yearbook of Local Tax Administration: 1990*; and Bank of Korea, *Monthly Bulletin*.

\*Rate of change in GNP deflator each year.

<sup>b</sup>The difference between the rate of increase in land price and that of GNP deflator each year.

<sup>c</sup>Figures for 1984-87 were obtained from Land Committee (1989, 238), and figures for other years were obtained by applying the rates of change in nominal land price.

<sup>d</sup>Total land value at the end of 1989 was estimated by using the total assessed value of land as of 1 May 1989 (i.e., 84,185.6 billion won), the average rate of increase in land price in 1989 (32.0 percent  $\times$  0.666 = 0.21333), and the average ratio of assessed value to market value as of 1 January 1990 (13.7 percent). Earlier data were obtained from Ministry of Home Affairs, *Yearbook of Local Tax Administration: 1990*, and the Korea Research Institute for Human Settlements.

<sup>e</sup>Total land values at the end of 1989 and 1990 were estimated by the Ministry of Construction and announced on 28 October 1991.

\$87.00) as property taxes per annum (see Kang 1989, 163). In 1990, only 3.43 percent of property-tax payers (334,806 out of 9,732,001 persons) paid more than \$140 under the new global land tax system (see Tae Dong Kim 1990, 36). This may imply that land ownership by value is more concentrated than land ownership by area.

## 15.2 Concentration of Economic Power in Production Activities

As of 1985, the largest thirty big business groups (*Jae-bul*) produced 40 percent of Korea's total manufacturing value added (see Young Ki Lee 1990, 327), and, as of 1989, the largest fifty big business groups comprising 520 companies produced 16 percent of Korea's GNP (see KIS 1990, 58). In 1985, the thirty largest business groups (comprising 270 firms) possessed 40 percent of total tangible fixed assets and hired 17.6 percent of total employees in the Korean manufacturing sector (see Cho 1990, 138, 143). These thirty largest business groups contributed 38.5 percent of Korea's total commodity exports in 1977 and 41.3 percent in 1985 (see EPB 1989, 238).<sup>7</sup>

As of 1991, about 47 percent of the stocks of the thirty largest business groups are apparently owned directly or indirectly (through the intragroup cross shareholdings) by the major owner families of each group (see Yoo 1992). In Korea, however, the listed stocks can be purchased anonymously or in someone else's name; hence, should we take account of hidden ownership, most of the owner families are likely to own much more than 50 percent of the stocks of each group on average. Including the stocks owned by the nonprofit foundations that are controlled by *Jae-bul* families, studies of stock ownership show that the share of the major owner family of each *Jae-bul* group amounted to about 39–61 percent in 1985–86 (see Cho 1990, 399–400).<sup>8</sup>

Since conglomerates enjoy greater financial resources and market dominance, their behavior makes entry by new firms difficult and inhibits the growth of small and medium-sized firms. The corporate empires of big business groups dominate markets not only for manufacturing but also for sales, trade, finance, and real estate by taking advantage of superior financing ability and information resources. Such domination results in abuse of market power, collusive action, and excessive monopolistic profits, reducing the gains of

7. Throughout the period 1962–91, these highly diversified *Jae-buls* have been expanding rapidly in terms of aggregate sales volume and value added, yet their share in total manufacturing employment has been declining since the beginning of the 1980s owing to their active participation in capital and technology-intensive industries.

8. Young Ki Lee (1990, 334) notes that "cross-holding of shares among member companies of a group is one common means of interlocking member companies, thus reinforcing the controlling power of the owner [without requiring additional equity contribution]. In the mid-1980s, the share of equity shares exchanged among affiliated companies within a group was, on average, close to 50 percent of the total outstanding shares of the group."



production specialization.<sup>9</sup> The market domination of large firms is revealed by the fact that competitive markets, defined as those in which the three largest firms account for less than 60 percent of total shipment value, amounted to only 22.3 percent of all commodity items and 37.8 percent of total shipment value as of 1985 (see PCER 1989, 72–73).

During the period 1961–79, bureaucrats led by President Park enforced the export-oriented growth strategy in Korea, but the core agents who actually executed the investment and production activities were the individual entrepreneurs. The bureaucracy and business both had to recruit the necessary manpower among the existing pool of labor. Owing to the scarcity of qualified manpower, the rent for the people with the proper educational background and managerial talent rapidly increased. Although economic power in Korea had mostly been concentrated in the hands of a small number of successful entrepreneurs through investment licensing and credit rationing, a large number of decision-making politicians and bureaucrats as well as people with managerial talents could also claim a substantial share of economic power.

The overambitious investment plans of the Korean government induced not only large inflows of foreign capital but also chronic inflation. Inflation not only perpetuated the negative bank interest rate regime that discouraged household savings but also constantly pushed up land prices and encouraged real estate speculation. The real estate speculation generated large windfall wealth in the hands of individuals who, in many cases, did not possess any entrepreneurial ability and consequently resulted in a waste of resources. On the other hand, a large number of privileged entrepreneurs has been actively involved not only in curb market lending activities but also in real estate speculation on a massive scale with bank loans that were officially earmarked for productive investment activities. This helped accelerate wealth accumulation in the hands of a privileged few businessmen in Korea.

The government believed that taxing the interest income of large-scale curb market lenders and exposing their identities would disrupt the operation of entire curb markets and hence greatly jeopardize the national economy. In Korea, most interest and dividend income has not been subject to the progressive global income tax, all kinds of capital gains have been almost free from formal taxation, and profit income has enjoyed extensive tax-exemption privileges. Government revenue has been raised mostly through regressive indirect taxes.

9. Perhaps because of the snowballing effect of wealth accumulation, there has been an extreme concentration of economic power in the hands of a small number of big business groups that goes well beyond the limits justified by scale economies. Extreme overextension of a given entrepreneurial talent implies poor management of the extended group's business activities and frequent cases of failure on a gigantic scale. In Korea, the entrepreneurial ability of the chosen few businessmen has been unreasonably exaggerated, and a tremendous waste of resources in the hands of some of these chosen few has often occurred.

### 15.3 Most Favorite Tax Treatment for Unearned Incomes

As of 1989, the total (central and local) government tax revenue amounted to 18.6 percent of GNP, and only about 39 percent of this revenue was raised from various direct taxes, including corporation income tax (12 percent), global income tax (2.8 percent), and withheld income tax on wages and salaries (5.8 percent). Taxes on various asset incomes amounted to only about 10.6 percent of the total tax revenue: 2.5 percent from the property tax (including the city planning tax and defense surtax), 3.0 percent from the capital gains tax on individual real estate transactions (including the inhabitant tax and defense surtax), 0.4 percent from the corporate special additional tax (the corporate capital gains tax) on corporate real estate transactions, 3.8 percent from withheld income taxes on interest and dividends (including the defense and education surtaxes and inhabitant taxes), and 0.7 percent from the inheritance tax.<sup>10</sup> Quite a few tax experts contend that many of the so-called direct taxes are transferred to consumers and hence should be regarded as indirect taxes.

According to Kwack and Lee (1991, 14–15), “As of 1987, less than 2 percent of GDP was collected as personal income tax, while in most Western countries the level is around 10 percent. With this low share of the personal income tax it is impossible to significantly affect the size distribution of income through tax policies. . . . First, though the marginal tax rate is very high and progressive, the exemption level is also very high. . . . Second, most interest income and about half of dividend income is taxed separately at a low flat rate. Third, capital gains from financial asset transactions are completely untaxed and those from real asset transactions are known to be under-taxed. Probably most importantly, the general level of income tax compliance and administration is very low. In particular, proprietors’ income is notorious for escaping taxation.”<sup>11</sup>

Capital gains arising from stock transactions were not subject to income tax, while the estimated (realized and unrealized) capital gains from the price increases of listed stocks amounted to about 19–38.4 trillion won in 1988 (i.e., 15–31 percent of GNP). Most of the interest and dividend income was separately assessed from global income and subject to a separate taxation of

10. Allegedly in order to encourage financial savings, the military government introduced a system in 1961 under which financial transactions in fictitious names were allowed. In 1982, a law barring financial transactions in fictitious names was passed in the National Assembly, but actual implementation of the law was suspended indefinitely.

11. “An unincorporated firm whose annual sale is below 36 million won is eligible for the *special taxation* program of the VAT (2 percent of total sales). . . . This sales information is also used in estimating the firm’s income tax base by applying the *standard income ratio*. If the ratio is 10 percent, monthly taxable income of such business owner is only 300 thousand won which is even lower than the starting salary of a typical highschool-graduated worker. About 70 percent of the unincorporated firms in Korea are covered under the special tax program. As a result about 65 percent of proprietors belong to the zero (income tax) bracket” (Kwack and Lee 1991, 14–15).

16.75–17.75 percent (including defense and education surtaxes and the inhabitant tax), withheld at source, while the maximum global income tax rate applied to income exceeding 50 million won amounted to 63.75 percent (including a 10–20 percent defense surtax and a 7.5 percent inhabitant tax). The Korean government still does not enforce the use of real names in financial transactions and allows the ownership of savings accounts in financial institutions, stocks, and bonds in false or borrowed names, effectively placing this income beyond the reach of the global income tax system and rendering the inheritance and gift tax system ineffective. It is estimated that only 11.8 percent of rent income in 1983 and only 33.4 percent of interest income and 36–54 percent of dividend income in 1987 were subject to tax and that the rest escaped any kind of taxation. Among those incomes captured by tax authority, 99.1 percent of interest income and 63.6 percent of dividend income were subject to separate taxation withheld at the source in 1987 (see FKI 1988, 1:21; and Kwack and Lee 1988, 194, 198).

The typical property tax rate that was applied to most land in Korea had been 0.3 percent of the assessed value.<sup>12</sup> Since, according to government statistics, the assessed value amounted to about 32.9 percent of market value in 1988, the real average property tax rate should have amounted to less than 0.1 percent of the market value of land.<sup>13</sup> Tax statistics show that the real average property tax rate on land could not have exceeded 0.04 percent in 1987. The nominal capital gains tax amounted to 51–76.5 percent of assessed capital gains, including the defense surtax and inhabitant tax, implying approximately 16.8–25.2 percent of real capital gains arising from land transactions. However, owing to extremely unrealistic assessment of land values and various tax exemption clauses, the ratio of capital gains tax actually collected to actual (realized plus unrealized) capital gains from land ownership could not have exceeded 1 percent in 1987.<sup>14</sup> It is not very difficult for corporations to make capital gains arising from real estate transactions look like those arising from stock transactions, which are tax exempt (see Hong 1990b).

In the face of growing public sentiment against enormous windfall gains arising from land speculations, the Korean government introduced in 1990 a series of reform measures such as a more realistic assessment of land prices for tax purposes, a global land tax system, a progressive capital gains tax on land transactions, an upper limit on the size of dwelling sites, taxes on unreal-

12. The typical nominal rate of property tax became 0.56 percent of the assessed value if we include the city planning tax (0.2 percent) and defense surtax (0.06 percent). In Korea, the base date of assessment of land value is 1 May each year. In Taiwan, the basic rate of property tax amounted to 1.5–3.0 percent, and the assessed property value amounted, on average, to about 50 percent of market value. In Japan, the basic property tax rate amounted to 1.4 percent (see FKI 1988, 2:104–35; and Jene K. Kwon 1990, 25).

13. As a percentage of GNP, property tax revenue amounted to 0.5 percent in Korea in 1989, 1.1 percent in Taiwan, 3.4 percent in Japan, 3.1 percent in the United States, and 4.7 percent in the United Kingdom in 1988. Data are from the Korean Ministry of Finance FKI (1988, 1:26, 47), and OECD (1991, 73).

ized capital gains generated by land price increases, and a levy on land development profits arising from land price increases. The government target for a realistic assessment of land prices for tax purposes is to raise them from 32.9 percent, that is, supposedly the average level of assessed land price compared to the real market price in 1988, to the level of 48 percent of market value by 1994, that is, to apply 60 percent of the unified land prices assessed by the government (the so-called publicly announced land price that amounts to approximately 80 percent of market values) as the tax basis by 1994.<sup>15</sup> Even if this target is achieved by 1994, however, the government will collect only about 0.54 percent of market value per annum from those who own as much as \$3 million worth of land purely for speculative purposes (such as forest and dry and paddy fields) through the new global land tax system.<sup>16</sup> The upper limit on dwelling sites is enforced only in the six largest cities in Korea. The 50 percent tax on unrealized capital gains (in excess of normal gains) arising from increased land prices (the so-called excessive land profit tax) is to be applied only in very limited cases and anyway harbors all the problems inherent in taxing unrealized gains. The 50 percent special levies on land development profits are imposed only on a small number of large land development firms, and the base price of land in computing the rate of increase in land prices is the price at the beginning date of development instead of the real acquisition price. Furthermore, the government is to continue to maintain the system that tolerates land ownership in someone else's name, although such an act is subject to nominal fines. This system dilutes the effectiveness of the global land tax. The government also wants to maintain the system that defines a factory lot (which is subject to the flat 0.3 percent rate of property tax) on the basis of the size of the factory's ground structure irrespective of its scale of productive activities (i.e., value added).

In 1991, the separate tax rate on interest and dividend income (including the inhabitant tax) was merely raised from 16.75 percent (or 17.75 percent for income exceeding 8.4 million won) to 21.5 percent. The hitherto tax-exempt capital gains realized from stock transactions became subject to a proportional tax as far as the capital gains arising from the transactions of unlisted stocks

14. The magnitude of the capital gains tax on land transactions amounted to about 0.5 percent of GNP in 1989 in Korea and about 3.0 percent of GNP in 1988 in Taiwan.

15. According to the Korea Research Institute for Human Settlements, the assessed value amounted to 13.7 percent of market value on average for the whole nation as of 1 January 1990. Then the assessed value amounting to 32.9 percent of market value may more likely correspond to that for, say, January 1985 rather than that for 1988. Under the new global land tax system in 1990, the average effective rate of property tax on land amounted to 0.04 percent, while that in Taiwan amounted to about 0.2 percent (in 1988), in Japan to about 0.2 percent (in 1985), and in the United States and the United Kingdom to about 1.4 percent (in 1985).

16. Since the maximum capital gains tax on land transactions became 64.5 percent of the publicly announced land price (owing to the abolition of the defense surtax in 1991), the maximum effective rate of the capital gains tax on land transactions will be 51.6 percent. Increases only in the capital gains tax while very low property tax rates on land ownership are maintained are likely to result in, first, a *lock-in effect* (reduced supply of land) and, consequently, a shifting of most tax burdens to buyers.

of closed corporations are concerned: 20 percent for those of large corporations and 10 percent for those of small corporations. The effective rates of these capital gains taxes are, however, even lower than the previous taxes on retained earnings that were replaced by these.

#### 15.4 Subsidized Credit Rationing to Selected Sectors and Firms

This section examines credit rationing, one of the major economic policy instruments adopted by the Korean government for the sake of the country's export-oriented growth, and the consequences of such a policy measure. Although the Korean government has reached far down into the activities of individual entrepreneurs with its manipulation of incentive schemes, the Korean economy in general has been far from a command economy. The most conspicuous exception was the banking sector. Until the early 1980s, the government was the single major shareholder in all nationwide commercial banks. By the early 1980s, these banks were privatized, placing a ceiling of 8 percent on individual shareholdings. The activities of the so-called privatized commercial banks as well as the government-owned specialized banks, however, continued to be subject to tight government control. Indeed, the banking activities are still those of a command economy in Korea.

Since the early 1960s, the Korean government has emphasized the need to mobilize domestic household savings as much as possible. The government indeed had enforced an interest rate reform in 1965 that was designed to mobilize household savings through formal monetary financial institutions essentially by maintaining significantly positive real interest rates on time deposits. There arose tremendous increases in bank savings as well as in the money/GNP ratio itself, implying an increased supply of loanable funds through the formal financial institutions. The period 1965–72 is called the high interest rate era for the Korean economy. However, the government soon came under heavy pressure from the privileged entrepreneurs, who had been using large bank loans, to reduce their financial costs by lowering the real interest rates on bank loans. The government eventually succumbed to this pressure on 3 August 1972 and resumed the negative real interest rate regime. Perhaps the decree of 3 August constituted the point of departure for the Korean economy from what is called the Taiwan model. There arose enormous disparities between the negative bank interest rates and the positive curb market rates. Except for a limited amount of captive bank savings, household savings tended to stay away from the banking institutions as much as possible, and the curb loan markets flourished.<sup>17</sup> Loanable funds in banks stopped growing rapidly.

17. The real interest rate on one-year time deposits jumped from –8 percent per annum on average in 1961–64 to about 11 percent in 1965–71 and then fell to about –5 percent per annum on average in 1972–81. The M2/GNP ratio rose from about 0.12 in 1961–65 to 0.35 in 1972 but was still about 0.34 in 1981. During 1982–89, however, the real interest rate on time deposits was maintained at about 5 percent per annum, and the M2/GNP ratio (on a year-end basis) rose to 0.41 by 1989.

The available loanable funds were mostly rationed to selected sectors and firms at negative real interest rates.

The average ratio of net worth to total assets of the fifty largest business groups was 23.6 percent in 1989 without taking account of intragroup cross shareholdings and about 20 percent taking account of cross holdings (see KIS 1990, 61, 73).<sup>18</sup> On the other hand, as of 1990, the thirty largest business groups absorbed 41.6 percent of total credits provided by commercial banks, specialized banks, provincial banks, and foreign bank branches and about 43.6 percent of the credits provided by the nonmonetary financial institutions such as investment and finance companies and insurance companies.<sup>19</sup> The nonbank financial institutions are mostly controlled by *Jae-buls*. The ratio of direct financing (i.e., net working capital raised by issuing stocks divided by total net working capital raised) by the thirty largest business groups amounted to only about 10.7 percent as of 1987 (see Cho 1990, 156). It was only after 1988 that these highly leveraged big business groups in Korea started to raise large amounts of capital through direct financing in the stock market.

The negative bank interest rate regime discouraged the efforts of low-income households to increase their savings rates and moreover reduced the proportion of their savings that they put into bank deposits. According to Scitovsky (1985), "The absence of an attractive and reliable repository for personal savings may well be the main reason for the slowness with which the saving habit is taking root and spreading in Korea" (p. 252).<sup>20</sup> Scitovsky further contends that "growth Taiwanese-style kept business firms small and encouraged personal saving by the newly entering or about-to-enter small businessmen; growth Korean-style discouraged new entrants and their saving, and

18. Young Ki Lee (1990, 334) notes that "share cross-holding inflates the capital base of the companies involved without any corresponding increase in actual investment. Since book-value-based debt-equity ratios of borrowing firms are an important lending criterion used by banks, an inflated equity capital base will increase the borrowing limit of each company [creating additional fictitious borrowing capacity]." E. Han Kim (1990, 343) shows that the (market-value-based) mean equity to total value (equity plus debt) ratios for all nonfinancial firms listed on the Stock Exchange amounted to only 16.3 percent in Korea during 1977-86, while the comparable figures for Japan and the United States amounted to 44.2 percent and 45.3 percent, respectively. Furthermore, in Korea, the largest firms had the weakest financial structure. (During 1984-86, more than one-third of the largest 10 percent of listed firms in Korea had an equity ratio below 5 percent.) Similar figures based on book value show 21.4 percent for Korea, 29.4 percent for Japan, and 46.9 percent for the United States.

19. Excluding credits that are not subject to the credit management program, the share of the thirty largest business groups in total credits amounted to 16.81 percent by the end of 1990. Figures are those that were presented to the National Assembly by the superintendent of banks and published in the *Korea Economic Daily*, (2 February 1991), and the *Chosun Ilbo* (2 February 1991).

20. In 1980, the household saving rate in Korea (6.6 percent) amounted to 56 percent of that in Taiwan (11.9 percent) and 38 percent of that in Japan (17.3 percent), while the corporation saving rate in Korea (8.8 percent) amounted to 67 percent of that in Taiwan and 83 percent of that in Japan. By 1985, the corporation saving rate became similar in these countries, but the household saving rate in Korea (10.6 percent) still amounted to less than 70 percent of those in Taiwan and Japan (data from BOK 1988, 10).

made it easy for [already] established firms to grow without generating their own saving" (p. 248) through the government rationing of loans on concessionary terms.

The negative real interest rate policy was coupled with chronic and self-defeating inflationary development financing, resulting in cumulating foreign debt. Furthermore, the extreme disparities between the private rates of return on investment and the real interest rates on bank loans have generated a built-in incentive mechanism for the privileged entrepreneurs to maximize debt-equity ratios and minimize direct financing, critically weakening in the long run the financial status of the so-called leading business groups and amplifying out of proportion their dependence on government credit rationing policy.<sup>21</sup> The rationing of low-interest loans to privileged firms also encouraged them, by providing arbitrage profit opportunities, to smuggle out the low-cost funds into speculative activities in securities and real estate. After all, the income arising from such speculative assets has been receiving the most preferential treatment in the Korean tax system.

In Korea, the influential entrepreneurs seem to have been willing to surrender their decision-making power in the financial market without active resistance and to have willingly accepted the government as the ultimate unit of control in the financial market. This acquiescence was due to the fact that the chosen few, who turned out to be the existing group of influential big entrepreneurs, enjoyed access to very low-cost capital. Apparently, this low interest rate regime helped generate an investment climate that encouraged the privileged businessmen to expand their sphere of investment activities. On the other hand, the unprivileged small entrepreneurs had to depend on self-financing and informal curb market loans, and nonentrepreneurial households had to accept amplified risk taking in their savings activities (see Hong 1986). According to data filed by the superintendent of banks, about 51 percent of total bank loans in 1988 were provided without collateral or payment guarantees. For small and medium-sized firms, however, the proportion of loans without collateral amounted to a mere 7.8 percent of total bank loans in 1988 (see Kang et al. 1990, 48).

Since the late 1970s, there has been a rapid expansion of the nonmonetary financial institutions in the form of investment and finance companies, mutual savings and finance companies, merchant banking corporations, mutual credit facilities, life insurance companies, etc. In order to reduce the risk element, the curb market lenders actively utilized these new institutions in undertaking their informal lending activities. Thus, it has become extremely difficult to ascertain to what extent the activities of these institutions represent the curb lending activities in disguise. One may argue that the only significant development that has occurred in Korea's financial sector since the late 1970s is the

21. Furthermore, in Korea, corporate interest payments are tax deductible, whereas dividends are not.

tremendously reduced risk element in curb lending activities and more efficient intermediation of the curb markets through their alliance with the rapidly expanding nonmonetary financial institutions.<sup>22</sup> These nonmonetary financial institutions are mostly controlled by the *Jae-buls*, which have been seeking alternative outlets that can reduce their dependence on the government-controlled banks.

Under the negative real interest rate system in banking institutions, the typical saver was the low-income household, and the typical borrower was the privileged big businessman, so that negative interest rates enhanced the profits of the latter through income transfer from the former. In the high real interest rate curb markets, the typical lender was the rich capitalist, and the typical borrower was the unprivileged small businessman, so that the high interest rates favor what the Marxists call the "unproductive capitalist class" at the expense of the poor small entrepreneurs (see Scitovsky 1985).

Taking the difference between the estimated rate of return on capital and the weighted-average real interest rate on domestic bank loans to be the subsidy associated with credit rationing, Hong (1990c, 117–19) estimates the annual provision of interest subsidies in Korea to have amounted to about 3 percent of GNP in 1962–71 and about 10 percent of GNP in 1972–79, on average. The interest subsidies associated with foreign loan allocations are estimated to have amounted to about 6 percent of GNP each year on average in the 1970s.

The successful control of inflation by the Korean government during 1982–89 terminated the negative real interest regime, brought about a drastic increase in the domestic savings propensity (from about 28 percent of GNP in 1983 to about 36 percent in 1989), and generated surpluses in trade accounts during 1986–89. All these changes suggest that Korea had unnecessarily underutilized its savings potential before 1982 by adopting an improper set of policies.<sup>23</sup>

In the 1980s, the Korean government introduced various reform measures in the name of financial liberalization and internationalization. Yet the bank-

22. The M3/GNP ratio amounted to about 0.40 on average in 1971–76, while the M2/GNP ratio amounted to about 0.33. The M3/GNP ratio began to rise rapidly from 0.42 in 1977 to 0.49 in 1980, to 0.61 in 1981, and to 0.70 in 1985, reaching 1.18 by 1991, while M2/GNP still amounted to only 0.41 in 1991. That is, deposits in nonmonetary financial institutions (including debentures issued, commercial bills sold, commercial paper, and repurchase agreements) became 1.9 times larger than those in deposits at monetary institutions (data from BOK, *Economic Statistics Yearbook*). As of 1991, only about 22 percent of total financial saving (which amounted to 280 trillion won) took the form of savings deposits in banks, while 60 percent took the form of savings in nonbank financial institutions, 12 percent in stocks, 11 percent in corporate bonds, 7 percent in government bonds, and 15 percent in overlapping intersectoral transactions (double-counted) (data from MOF, *Fiscal and Monetary Statistics* [March 1992], 41–42).

23. The domestic savings ratio increased steadily from about 3 percent of GNP in 1961 to about 9 percent in 1963, about 15 percent in 1968, about 22 percent in 1973, and about 28 percent in 1979. However, Korea maintained net foreign capital inflows amounting to about 7 percent of GNP on average throughout the period 1961–81. The magnitude of foreign saving began to decline drastically only after 1982.



ing institutions are still tightly controlled, and the nonbank financial institutions are heavily manipulated by the government. The Korean government still does not show any visible intention of dismantling the credit rationing system or really modernizing the financial sector on the basis of the competitive market principle.

### 15.5 The Growth-Oriented Government Expenditure System and Labor Policy

During 1976–91, the ratio of gross tax burden to GNP amounted to 18 percent on average (fluctuating within the range of 16.3–19.7 percent), while the ratio of general government expenditure to GNP amounted to about 23 percent (fluctuating within the range of 20–26 percent). The ratio of general government expenditure on social security to GNP increased from 0.88 percent in 1977 to 1.63 percent in 1989, which still amounted to far below the average ratio in advanced countries, which exceeded 12 percent of GNP, and even below the average ratio in developing countries, which was close to 5 percent of GNP. As of 1986, the ratio of general government expenditure on health to GNP amounted to a mere 0.5 percent in Korea while that in advanced countries amounted to 5.4 percent on average (see MOF, *Fiscal and Monetary Statistics*; NTA, *Statistical Yearbook*; and Song and Kwon 1990, 72–77).<sup>24</sup> According to data provided by the Korea Education Development Institute, the ratio of general government expenditures on education to GNP amounted to 5.1 percent in 1991, while the individual household expenditure on education amounted to 5.5 percent.

The Korean government wanted by all means to prevent labor disputes, which would hinder economic growth and export expansion. However, it seems to have adopted a rather shortsighted approach by directly intervening and preventing actual and potential labor disputes on behalf of the entrepreneurs. As a result, Korean entrepreneurs developed a habit of delegating intra-firm labor-relations problems to the government and of devoting minimal efforts to reducing potential sources of labor disputes. Consequently, one often hears the argument that it is rare to find workers in Korean firms who really identify their personal welfare with the prosperity of the firm for which they work. Most of the workers do not seem to be convinced that a higher rate of return to the firm is by any means directly related to the improvement of the

24. The ratio of total social security expenditure to GNP in Korea increased from 0.89 percent in 1975 to 2.56 percent in 1987, and the government share in these social security expenditures increased from 49 to 64 percent. The social security expenditure level in other developing countries amounts to about 7 percent of GNP on average and, in advanced countries, to about 10–15 percent of GNP. In Korea, social security expenditures consist of social insurance, which in principle is financed by government subsidy, and the social welfare service, which is given little support by the government (see PCER 1988, 119–21).

welfare of the workers themselves. The fact that Korean products still suffer from a cursory handling at the final finishing process might reflect the absence of such an identification effect, which may be a crucial ingredient in generating devotion from the workers.

Under the authoritarian regimes, labor disputes could have been ruthlessly controlled. With the progress in democratization since 1987, however, the latent grievances of the workers have exploded into extremely violent and destructive disputes. Prior to 1987, the success or failure of an entrepreneur was unrelated to his ability to maintain peaceful intrafirm labor relations; the Korean government had enforced peaceful relations in each firm using naked power. Since late 1987, not only the success of individual entrepreneurs but also the growth performance of the Korean economy in general are determined by the development of nationwide labor disputes and the speed of learning-by-doing by the related parties. Employers, employees, and the government have yet to learn the advantages of free collective bargaining, how to handle disputes and grievances in an orderly fashion, and how to institutionalize harmonious labor-management relations.

### **15.6 A System of Government Picking the Winners**

In Korea, the efficiency gains associated with the long process of opening up a semiautarkic economy to free trade have materialized not only in the form of rapidly rising real wages but also in the form of high rates of return on investment. These enhanced rates of return in turn seem to have generated vigorous investment activities in Korea over the past three decades. The big efficiency gains associated with the initial phase of the opening up to trade, however, must have been more or less exhausted.<sup>25</sup> In this sense, Korea might have to worry about the weakening vigor of entrepreneurs' investment activities in the 1990s. One may yet argue that, with the vast amount of positive experience and kinetic energy accumulated during the past three decades, the gains from "marginal" structural adjustment can be amplified continuously. For this purpose, however, Korea may have to pay more attention to "marginal" efficiency and the more active role of the competitive market mechanism in general (see Hong 1990a).

Ever since 1962, planning in Korea entailed essentially the setting up of aggregate as well as sectoral targets of outputs and exports and the setting up of construction targets for various social overhead capital (SOC) facilities. The execution of planning implied mostly the actual execution of investments

25. The commodity-export/GNP ratio reached a peak of 37 percent by 1987, but began to decrease afterward, reaching 26 percent in 1991. According to estimates of the Korea Foreign Trade Association, however, the import content of Korea's exports still amounted to 32 percent in 1991. In this sense, one might argue that there still exists substantial room to increase the net value-added content of exports in Korea.

for the planned (or supposedly planned) project “by all possible means” and, in the 1970s, through hand-picked entrepreneurs.<sup>26</sup> Indeed, the Korean government promoted the expansion of domestic production and the exports of selected industries by directly intervening in the market; however, this policy damaged the competitive market mechanism and the long-term allocative efficiency of the economy.<sup>27</sup>

Not only has the Korean government indulged in efficiency-damaging second-best policy measures, but it has almost completely ignored the equity aspect of export-oriented growth. It is high time to change the essential mode of planning and its execution. The highlights of planning should now become a set of concrete time-phased schedules to implement various efficiency-enhancing and equity-improving systems. Any system that is meant to enhance the equity and the efficiency of resource allocations, however, can seldom be enforced overnight. One cannot ignore the past and its legacy to the present. It takes time to implement a lasting, effective system. Therefore, five-year planning seems to be the ideal instrument to carry out such schemes. The prime objective of the government’s five-year planning may have to become the step-by-step enforcement of an equitable tax system that can eliminate rampant unearned income, a self-sustaining market system that can select the correct industries and penalize inefficient entrepreneurs more efficiently, a financial system based on the market mechanism, a system conducive to peaceful labor relations that maximizes workers’ devotion and entrepreneurial creativity, and so on.

If people believe in the fairness of the economic rules of the game, wealth accumulation can be seen as the result of the free market mechanism, and unequal distribution can be tolerated as a by-product.<sup>28</sup> However, many of the policy measures for export promotion in Korea, such as subsidized credit rationing and investment licensing, have been implemented by the government in such a way as to give the general public an impression of wanton favoritism. As a result, the wealth accumulated by successful entrepreneurs is often

26. As of 1991, one may readily say that, from now on, Korea will increasingly have comparative advantages in more physical and human capital-intensive goods and in more technology- (or knowledge-) intensive goods than before (see Hong 1987). As of the year 2000, or even in later years, we will be saying more or less the same thing. Armed with only such vague and catchall concepts, the government cannot continue selecting specific industries and the *right* entrepreneurs (to carry out the selected production activities) without repeating the late 1970s disaster.

27. Yet one may still say that Korea was extremely fortunate to make all kinds of policy mistakes in the name of export promotion and not in the name of import substitution and self-sufficiency. Had the Korean government instead pursued the Latin American-style import-substitution-oriented growth strategy, Korea might never have been able to escape the Lewis-type economy of massive disguised unemployment even by the 1980s, and the limited supply of physical and human capital would have exerted a critical constraint on rapid growth.

28. According to Krueger (1974, 302), government intervention in the market mechanism leads people to compete for rents, and “the existence of rent seeking surely affects people’s perception of the economic system. If income distribution is viewed as the outcome of a lottery where wealthy individuals are successful (or lucky) rent seekers . . . the market mechanism is bound to be suspect.”

regarded as a political reward rather than as the reward for Schumpeterian entrepreneurship. Consequently, the export-oriented growth strategy and even the market mechanism itself have become suspect for many Korean people. Unfortunately, most of the big businessmen themselves, who recently came to wield great political influence, do not seem to recognize that the private property system can prosper without intermittent violations only if the general public believes in the objectivity and fairness of the economic system and hence that it is in their long-term interest to help maintain a competitive market mechanism untainted by crony capitalism.

### **15.7 The Political Economy of Distribution Policies**

In the name of export-oriented growth, the Korean government has concentrated production activities in the hands of a small number of big business groups through investment licensing and credit rationing. Although the government has always stated that the promotion of small firms is necessary in order to strengthen the foundation of the nation's economy and export base, it seems to have found relief in various sets of conspicuous but ineffective policy measures to promote small firms throughout the last three decades.

On the other hand, the magnitude of capital gains associated with the ownership of real estate and financial assets has recently been comparable to or greater than the magnitude of GNP each year. Furthermore, most of these capital gains have accrued to the upper 5 percent of the population and been taxed at extremely low rates. In spite of the popular clamor against this state of affairs, the Korean government has been very reluctant to initiate any fundamental reform of the existing system.

In Korea, it is not only the government but also political groups (including the national assemblymen of both the ruling and the opposition parties), business, and the press that have avoided taking up the equity issue seriously, not to mention making any concerted effort to initiate institutional reform. The members of these upper echelons in Korea (i.e., government officials, politicians, businessmen, and press people) seem to constitute the upper 5 percent who could have consolidated the political and economic power of the nation in their hands in the process of export-oriented growth, forming an intricate partnership among themselves and enjoying the existing system of prolific capital gains, economic rents, and wealth concentration.

On the other hand, the antiestablishment groups are so thoroughly indoctrinated with obsolete Marxist-Leninist-Maoist ideologies as to be unable to make any rational analysis of the real economy. The ideology of these antiestablishment groups has always been a variation on the theme of nationalization, central planning, autarky, and proletarian dictatorship. They have completely ignored the recent revolution in socialist countries and consequently have been unable to offer any realistic policy alternatives that can appeal to the unsophisticated masses.

In Korea, neither the establishment nor the antiestablishment seems to enjoy much popular support, yet the people are not able to find any effective means of initiating institutional reform, although they could cast out a dictator and produce the semblance of a democratic political system.

### 15.8 Conclusion

Korea has begun to experience extremely militant labor disputes and serious social unrest since its political democratization in 1988. Yet, during the 1990s, the Korean economy must transform its output and export composition, moving from the traditional simple labor-intensive consumption goods toward more capital intensive and more technology-intensive intermediate and investment goods (as well as high-quality durable consumption goods), waging fierce battles against the established Japanese manufacturers, who dominate the international market.

Korea has arrived at the stage that requires concentrated investment of human and physical resources in research and development and new high-technology export manufacturing activities in order to upgrade productivity and international competitive power. The Korean government, however, continues to maintain a tax system that provides the highest rate of return on financial assets and speculative real estate activities. The Korean tax system has been, intentionally or unintentionally, designed to provide the most preferential treatment for capital gains arising from stock transactions, the second most preferential treatment for capital gains arising from real estate transactions, and the third most preferential treatment for income from the ownership of financial assets such as interest and dividend income. The effect of such a distorted tax system has become very conspicuous since the beginning of the 1980s, from which time we can observe Korean entrepreneurs (as well as wealthy nonentrepreneurial families) being more active in speculative activities with financial assets and real estate than in the productive investment activities in research and development and export production that would be necessary to upgrade the productivity and international competitive power of Korean industries. If the Korean government does not enforce a fundamental reform, restructuring the rates of return on various economic activities so as to induce a more equitable distribution of income and wealth and at the same time induce most of the investment funds and human resources to flow into nonspeculative productive activities, the magnified internal conflicts and waste of resources will jeopardize Korea's long-term growth prospects.

Raising the relative rates of return on investment for, say, research and development and high-technology export manufacturing activities, while lowering the relative rates of return on, say, the simple ownership of financial assets and real estate transactions, will promote economic growth by channeling available human and physical resources in the country into productive activities; at the same time it will help achieve a more equitable distribution

of income by providing relatively preferential treatment for wage and entrepreneurial income. In this sense, there is a need for the Korean government to actively implement *growth-promoting redistribution policies*.

We can conclude that difficulties with Korea's income distribution are not the result of the export-oriented growth strategy itself, but we can also conclude that export orientation alone is not enough to result in a more equitable distribution of income and wealth.

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## Comment Motoshige Itoh

It is not clear to me what effects “export orientation” had on income distribution. Most of the phenomena discussed in the paper seem to be observable in many other countries (e.g., Japan) and to be explained by such domestic structures as taxes.

In order to make the discussion of the paper clearer, it is useful to compare the Korean experience with the Japanese experience, where the latter can be considered a typical case of domestic-market-oriented growth. (I must confess that I do not know much about the Korean economy.) In spite of the fact that the pattern of economic growth is quite different between the two countries, the phenomena discussed in Hong's paper can be observed in Japan.

I do agree with the author's point that some fundamental reforms are nec-

essary. But, to have more realistic future perspectives, it is constructive to consider the possibility that market forces will work to correct the various kinds of distortions in the Korean economy. The fact that there are serious distortions in the Korean economy reflects the fact that the economy is still closed (just like Japan's). If the economy becomes more open to the rest of the world, some parts of the distortion will be corrected.

## Comment Richard H. Snape

This is an interesting paper, one that makes its point forcefully. It draws attention to socially destructive forces. However, in reading it I sometimes wondered which country I was reading about: "The overambitious investment plans . . . induced not only large inflows of foreign capital but also chronic inflation"; "large windfall wealth in the hands of individuals who, in many cases, did not possess any entrepreneurial ability and consequently resulted in unproductive waste of resources"; "entrepreneurs . . . more active in speculative activities with financial assets and real estate than in productive investment activities in research and development and export production . . . to upgrade the productivity and international competitive power"; "chronic and self-defeating inflationary development financing, resulting in cumulating foreign debt." Surely this is some highly inflationary, stagnant country, not a country that quadrupled its real per capita income over a twenty-year period.

Hong points to social unrest and resentment in Korea and sees it as threatening future growth. He sees many of the export-promotion measures as having been implemented in "such a way as to give the general public an impression of wanton favoritism. As a result, the wealth accumulated by successful entrepreneurs is often regarded as a political reward rather than as the reward for Schumpeterian entrepreneurship. Consequently, the export-oriented growth strategy . . . [has] become suspect for many Korean people."

This view of Korean attitudes contrasts with that reported by Hong twelve years ago: "Not only [do] the Korean exporters always get the immediate and close attention of the president, but the successful ones are regularly honored with honor medals. As a result, anyone who has accumulated wealth via export activities is almost considered a patriot and he is assured that he has the blessing of the government. This has an immense psychological impact in a society which still carries remnants of traditional Confucianism" (Hong 1979, 58). I would be interested to hear more of the reasons for this change in attitude of the Korean public—is it a high income elasticity of demand for equality?

The wage elasticity of productivity has been greater than one over the



whole period, suggesting that the wage share of output has grown, so it would appear that the relative position of the employed has increased rather than decreased: I would be interested to hear more on which groups have lost in real or proportionate terms. I am not suggesting that the tax system does not have huge gaps, inequities, and inefficiencies, but are they overstated?

On more specific points, I do not think that a Gini coefficient of land ownership by area is informative. How would one compare a hectare of land on Manhattan with one hundred hectares in Nevada?

Land prices have increased rapidly in Korea, Japan, and elsewhere. The increase in Korea is no doubt associated with the tax system. But presumably there is a limit to this, just as tax-encouraged land booms in other countries have burst. At least some of this increase would be due to a high income elasticity of demand for space. One expects the price of land to increase in real terms in a rapidly growing economy, and I am surprised that it has not increased more rapidly: the increases relative to GNP (see table 15.1) on all three estimates are quite modest. Similarly, the capital gains on stocks reported in table 15.1 may not be out of line with many other countries. We might note also the 19 percent loss of value in 1990.

Hong mentions the market dominance and advantages of the conglomerates (*Jae-buls*). Without questioning his statements regarding their favored access to credit (and even that they may not always use the funds for the purposes specified), are there not also diseconomies of scale and opportunities for small enterprises among these huge, favored, corrupt (perhaps) giants? Have small entrepreneurs in fact entered Korean industry and grown large?

Some smaller points: I do not think it wise to attempt to explain changes in a Gini coefficient of .002 or .009. Why should the law on the upper limit of dwelling sites be enforced? Some people like big cars, others big houses; one does not fix income or wealth distribution by restricting the quantity or quality of one item of expenditure.

Finally, in note 25 Hong seems to suggest that Korea should encourage the domestic content of exports—that is, it should import final rather than intermediate products. It is not clear why Korea should want to do this.

## Reference

Hong, Wontack. 1979. *Trade, distortions and employment growth in Korea*. Seoul: Korea Development Institute.