

East Asian Development Model and South Korea's Labor Productivity in the Service Industry

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1. Introduction

Japan and South Korea are among the most successful cases of economic development. Under the strong leadership of President Park Chung-hee, South Korea used the Japanese economy as a model and cleared the path to industrialization in the 1960s. Despite differences caused by initial conditions and external factors, the two countries have same factors in common in their pursuit of rapid economic growth: (1) a major and proactive role of government in the industrialization process, (2) a close business-government relationship, and (3) a well-timed shift of strategy from Import Substitution Industrialization (ISI) to Export Promoted Industrialization (EPI). Followed by many developing countries across East Asia, this state-driven economic development approach is referred to the East Asian Development Model (hereafter EADM).

However, all is not well with the EADM. The great emphasis upon manufactured goods exports has made countries following the EADM exceptionally vulnerable to swings in world economic conditions. The appreciation of the yen as a result of the Plaza Accord in 1985 worsened the Japanese trade deficit and caused an asset bubble, which resulted in a serious recession. South Korea and three other newly industrialized countries – Thailand, Indonesia, and Malaysia – were also hit by the financial crisis of the late 1990s. Although there has been no consensus on the root causes of this crisis, it exposed firms', financial institutions', and governments' lack of resilience in dealing with foreign capital flows. The recent world recession that started with the US subprime mortgage crisis has also caused a loss of economic momentum in the EADM economies in tandem with a significant decrease in

exports. In this sense, the EADM seems to have little to offer in times of global economic downturn.

This paper aims at finding new strategies to keep the economy of South Korea on an active development trajectory. I argue that increasing labor productivity in the service industry is imperative for South Korea to ensure sustainable economic development. My research will attempt to answer three questions in order to demonstrate my argument: (1) **why** should South Korea strengthen the service industry? (2) **what** should be reformed in the service industry? (3) **how** can labor productivity be increased in the service industry? For the first question, I will show the limits of manufactured goods exports under the EADM in the pursuit of sustainable development. The importance of the service industry as a means of job-creation and GDP-growth will then be explained. For the second question, the OECD and the World Bank researches on the service industry will be discussed. I will then point out low labor productivity as a main cause of low performance in the service industry. For the third question, I will present the main similarities between the Japanese and South Korean labor markets and show how they are different from other OECD countries. I will then suggest a number of policies based on three issues: work hours, wage systems, and entry barriers.

2. The Importance of the Service Industry

2-1. The EADM and South Korea

The spectacular economic performance of East Asian countries during the postwar period has generated a lot of interest in the role of government in the industrialization process. As opposed to the neoliberal economic model based on unconstrained markets with minimal state intervention, the EADM emphasizes government leadership. In this section, I will give an account of South Korean development in the context of the EADM and present its limits for sustainable economic development.

‘Industrial upgrading’ has been the most important feature of South Korean state intervention.¹ When President Park Chung-hee assumed the political leadership of South Korea in 1961, he adopted a model based on the Japanese economy and put it into practice. The Economic Planning Board (EPB) was set up with wide powers to draft overall economic policies, control the national budget, and implement plans. The government selected a few industries as priorities and provided massive support to them. In the first Five Year Economic Development Plan (FYEDP), cement, fertilizer, and oil refining were designated as important industries. In the second FYEDP (1967-71), chemical, steel, and machinery were selected. During the third and fourth FYEDP (1972-81), the heavy chemical industry was promoted and non-ferrous metals, shipbuilding, and electronics were added to the list of priority sectors. These designated industries had priority in acquiring rationed and often subsidized credits and foreign exchange, state investment funds, preferential tax treatments, and other supportive measures including import protection and entry restriction.²

However, a more complex approach is required than a simple government-market dichotomy to understand South Korean economic development. Although economic policies were mainly set by the government, private business leaders were consulted before decisions were made and those policies were ultimately executed by private firms. If desired results did not follow, the government could change the policies through either material or moral persuasion. In the passenger car industry, for instance, Kia was forced to exit and specialize in trucks and buses with a promise that it would be allowed in again when demand conditions improved.³ In 1987, Kia was able to enter into the market again with the consent of the

¹ Chang, Ha-Joon. 2006. *The east asian development experience : The miracle, the crisis and the future*. Penang, Malaysia : Distributed exclusively in the USA by Palgrave Macmillan. P80.

² Chang, Ha-Joon. 2006. *The east asian development experience : The miracle, the crisis and the future*. Penang, Malaysia : Distributed exclusively in the USA by Palgrave Macmillan. P81.

³ Chang, Ha-Joon. 2006. *The east asian development experience : The miracle, the crisis and the future*. Penang, Malaysia : Distributed exclusively in the USA by Palgrave Macmillan. P92-94.

government. Therefore, a strong partnership between the government and private sectors should be emphasized in an explanation of South Korean economic development.

It was a well-timed adoption of the EPI, however, that led the South Korean economy to take off. South Korea's domestic market is very limited as a result of its poor resource endowment and small population. This implies that the world market was essential for South Korea to build up a sufficient scale of production demand. While pursuing an outward oriented development strategy, the government enacted several policy measures: First, the exchange rate system was reformed to peg the Korean *won* to the U.S. dollar. Second, fiscal and monetary stabilization policies were adopted to curb inflation. Third, a negative list system of trade was adopted and tariff rates were lowered to promote trade. At first, South Korea exported mainly primary materials such as low quality textiles, but it succeeded in diversifying, eventually including 983 items which required high skilled labor. As a result, there has been a rapid increase in manufactured goods exports as a share of GDP, from 3.5 percent in 1960 to more than 40 percent in 1987. The EPI strategy enabled South Korea to exploit international economic opportunities to overcome the limits posed by its small domestic market and to benefit from the stimulus associated with greater exposure to international competition.

However, it has been shown that the EADM is highly sensitive to external shocks to those countries which have high export dependence such as South Korea. In the late 1990s, South Korea and three other newly industrialized countries were hit by a financial crisis. Although there has been no consensus on the root causes of this crisis, it exposed firms', financial institutions', and governments' lack of resilience in dealing with foreign capital flows. Risk was concentrated in the banking sector in South Korea due to weak financial supervision and

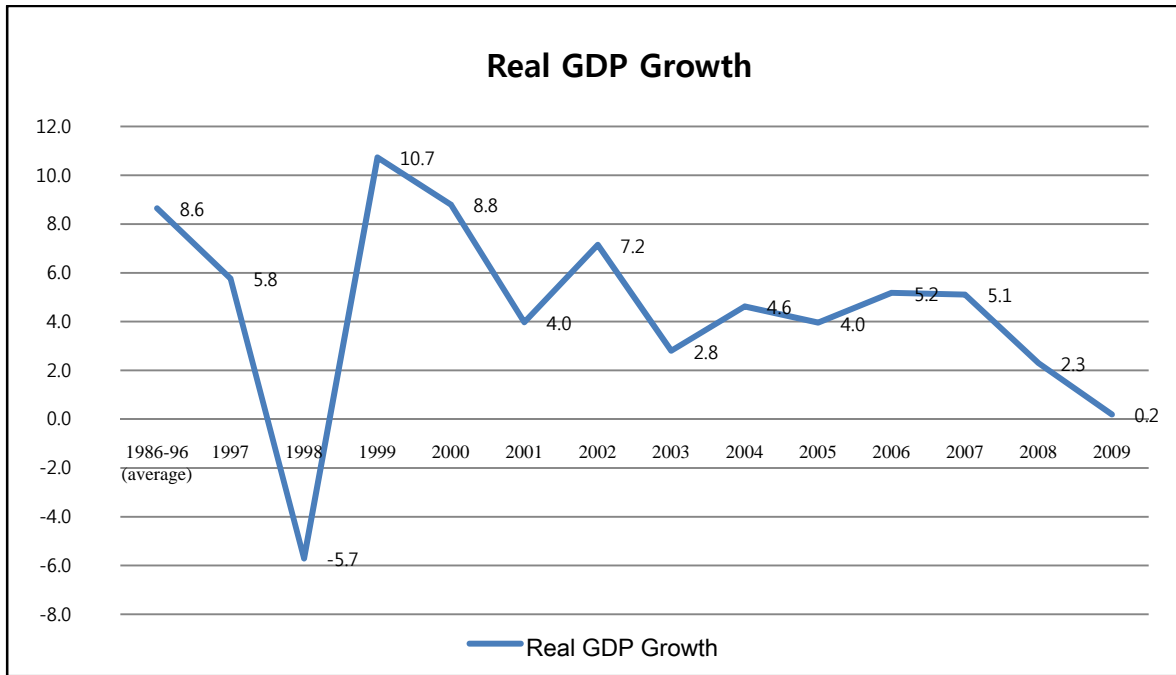
chaebols' high dependence on bank financing.⁴ The average debt-equity ratio for the manufacturing sector reached nearly 400 percent and the average ratio for the top *chaebols* exceeded 500 percent in 1997.⁵ The recent world recession that began with the US subprime mortgage crisis also caused a significant decrease in GDP growth (See Figure 1). The major reason for the pronounced downturn was that a sudden decline in US demand for manufactured products came as a significant blow to export-driven countries like South Korea. The volume of South Korean exports was down by 35 percent in 2009 as compared to the previous year (See Figure 2). Economic growth has slowed and new jobs have not been created.

In the aftermath of several economic crises, a need to reform the development strategy has arisen. Steve Parker, an economist in the Asian Development Bank Institute, has said that "East Asian governments are entering new and uncharted territory. This time around, there is a new dynamism at work. You cannot just invest and save your way out of this crisis."⁶ This implies that South Korea cannot rely on export-led growth to the same extent as before and a new strategy for sustainable economic development is required.

⁴ Kihwan, Kim. 2006. The 1997-9 Korean Financial Crisis: Causes, Policy Responses, and Lessons. The High-Level Seminar on Crisis Prevention in Emerging Markets, The International Monetary Fund. P5.

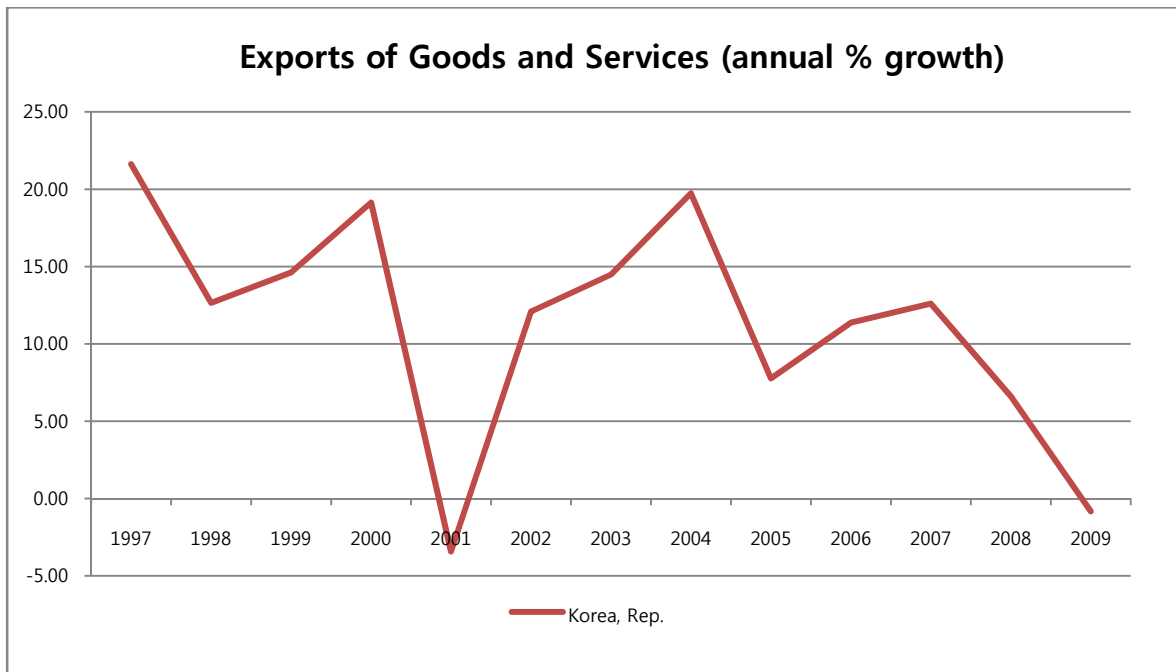
⁵ Kihwan, Kim. 2006. The 1997-9 Korean Financial Crisis: Causes, Policy Responses, and Lessons. The High-Level Seminar on Crisis Prevention in Emerging Markets, The International Monetary Fund. P6.

⁶ Robins, Fred. 2000. Asia's 1997 Crash: its Character, Causes and Consequences, in *The East Asian Development Model: Economic Growth, Institutional Failure and the Aftermath of the Crisis*, P17-52.



Source: OECD Economic Outlook, Volume 2010 Issue 2 - No. 88 - © OECD 2010
 Statistical Annex: 1. Real GDP
 Version 1 - Last updated: 08-Dec-2010

<Figure 1: Real GDP Growth of South Korea>



Source: World Bank National Account Data - © World Bank 2010

<Figure 2: Exports of Goods and Services, annual % growth>

2-2. The Importance of the Service Industry

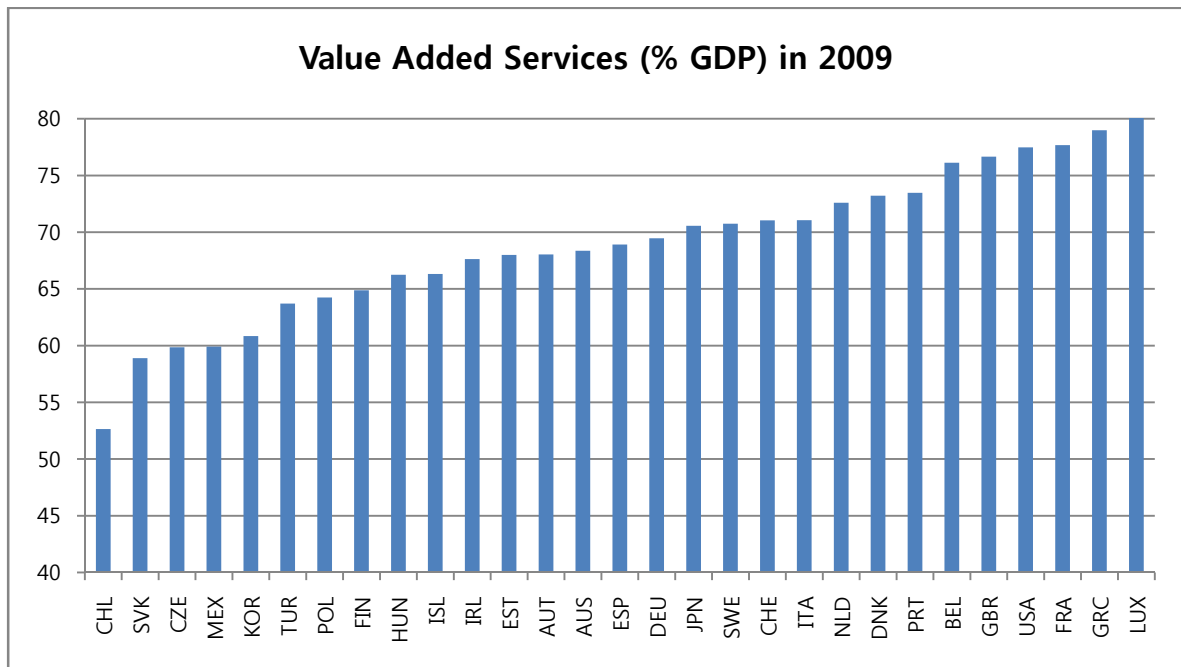
The industrial structure changes in accordance with economic development. The positive relationship between economic development and the share of GDP produced by the service industry has been noted and documented by a number of scholars. The Fisher-Clark Theory regarding development stages suggests that as industrialization takes place in an economy, the share of the agricultural sector in total output and employment gradually diminishes while that of the manufacturing sector increases. The Petty-Clark Law further demonstrates the shift of the working population from the primary industry to the manufacturing sector and then to the service sector by economic development. Empirical studies have corroborated these theories. Since the 1970s, the service sector has become quantitatively the largest sector in most OECD economies.⁷ The share of the service industry in the total output of all OECD countries increased to 74 percent on average in 2009. This demonstrates that it is not the manufacturing sector but services which contribute the most to middle-upper income economies to sustain their growth of GDP and employment.

South Korea is now considered a high income developed economy. South Korea joined the OECD in 1996 and its GDP per capita based on purchasing power parity in US dollars reached \$30,000 as of 2010. South Korea is thus assumed to have developed its service industry as fast as its economy. However, the share of South Korea's service industry in its GDP and employment is still far below the average level of the OECD countries (see Figure 3). The share of the service industry in value added increased only modestly from 46.7 percent in 1981 to 57.6 percent in 2008.⁸ The annual growth rate of the manufacturing sector is far higher than that of services. South Korea's manufacturing industry has grown on

⁷ Wölfl, A. 2003. Productivity Growth in Service Industries: An Assessment of Recent Patterns and the Role of Measurement", *OECD Science, Technology and Industry Working Papers*. 2003/7. OECD Publishing. doi: 10.1787/086461104618.

⁸ Statistical Research Institute. 2005. Service Industry in South Korea

average 7.7 percent per annum since the Asian financial crisis, while its service sector has never shown an annual growth higher than 5 percent except in 2002 when South Korea co-hosted the World Cup with Japan.



Source: World Bank National Account Data - © World Bank 2010

Note: Services correspond to ISIC divisions 50-99 and they include value added in wholesale and retail trade (including hotels and restaurants), transport, and government, financial, professional, and personal services such as education, health care, and real estate services. Also included are imputed bank service charges, import duties, and any statistical discrepancies noted by national compilers as well as discrepancies arising from rescaling. Value added is the net output of a sector after adding up all outputs and subtracting intermediate inputs. It is calculated without making deductions for depreciation of fabricated assets or depletion and degradation of natural resources. The industrial origin of value added is determined by the International Standard Industrial Classification (ISIC), revision 3. Note: For VAB countries, gross value added at factor cost is used as the denominator.

<Figure 3: Value Added Services in 2009>

The EADM may be a main cause of the sluggish development of South Korean service industry. In the pursuit of economic growth, the South Korean government emphasized manufacturing more than other sectors, promoting export of tangible objects such as steel, ships, and appliances. South Korea's three biggest conglomerates – Samsung, Hyundai, and LG – all began as producers of manufactured goods. Therefore, promoting the manufacturing industry has been considered as conventional wisdom for South Korea's sustainable economic development.

However, South Korea cannot count on the manufacturing industry as a means of GDP-growth and job-creation any further. First of all, given the diminished demand for manufactured products in advanced economies such as the US and most European countries, a decrease in exports is inevitable for South Korea. The US, the third largest trading partner with South Korea, has launched several rounds of quantitative easing since the subprime mortgage crisis. The economic growth of Germany, France, and the UK is also faltering in tandem with that of small European economies such as Greece, Spain, and Portugal. Second, intense competition with low cost manufacturers in developing countries like China and Vietnam indicates a decrease of competitive advantage in South Korea's manufacturing industry. Colin C. Williams, a professor of Public Policy at the University of Sheffield, points out that "the new international division of labor has resulted in manufacturing being increasingly located in less economically developed countries."⁹ Therefore, raising public awareness of the importance of the service industry is necessary for sustainable economic development in South Korea.

Promoting the service industry in fact enhances agricultural and manufacturing activities. This is because the growth of the service sector will cause a constant increase in outsourcing for materials, parts, and components. Professor Ian Miles at Manchester Business School argues that "services are increasingly bound up with the activity of all sectors of the economy and show the most rapid growth in employment."¹⁰ The research carried out by the IBM Government Program also corroborated his argument by showing that services account for 25 percent of value added in manufacturing.¹¹ In this sense, the service industry plays a pivotal role not only in overcoming the limits caused by a high dependence on the world market, but

⁹ Williams, C.C. 1997. *Consumer Services and Economic Development*. London: Routledge. P. 20.

¹⁰ Miles, I. 1996. *Innovation in Services: Services in Innovation*, Manchester Statistical Society, 20th February. Page 4.

¹¹ IBM Government Program. *Services and Global Competitiveness: Growth Opportunities for Developing Economies*. Published in October 2006.

also in sustaining development of agricultural and manufacturing industries in South Korea.

3. Labor Productivity in the Service Industry

Greater productivity is a precondition for improving economic performance.¹² Firms usually combine labor and capital to produce output, but it is the labor which utilizes the capital in the production process. McKinsey Global Institute conducted a study on productivity and competitiveness in 1992 and discovered that the variations of performance in the service sector across countries resulted from different level of labor productivity. Services such as education, health, and social work are highly labor intensive and they are particularly affected by labor productivity. Thus, boosting labor productivity is essential for the development of the service industry.

It is noteworthy that Japan and South Korea, two of the most exemplary cases of the EADM, far lag behind in labor productivity in the service industry as compared to other OECD countries. According to a report released by the Ministry of Knowledge Economy and the Korea Productivity Center in 2010, labor productivity in the services sector ranked 18th out of 19 surveyed countries, while that in the manufacturing sector ranked 5th. Japan has also shown a similar result. Japanese labor productivity in services is 30 percent below the US level and ranked 21st out of 31 OECD countries, despite high labor productivity in the manufacturing sector. Japan has experienced a constant decline in productivity growth in the service sector from 3.5 percent in the period between 1976 and 1989 to 0.9 percent between 1999 and 2004.¹³ Hence, I will analyze what Japanese and South Korean labor markets have

¹² Yamada, Hisashi. 2009. A Factorial Analysis of the Decline in Japan's Labor Productivity through an International Comparison by Industry – Strategies for Increasing Productivity in Retail and Services. The Japan Research Institute News Releases. 2009/12. The Japan Research Institute.

¹³ Gurria, Angel. 2008. Economic Survey of Japan 2008, Chapter 5: Enhancing the Productivity in the Service Sector in Japan. OECD Economic Surveys and Country Surveillance. Published on 7 April 2008.

in common and then compare them with the other OECD countries to find main causes of low labor productivity.

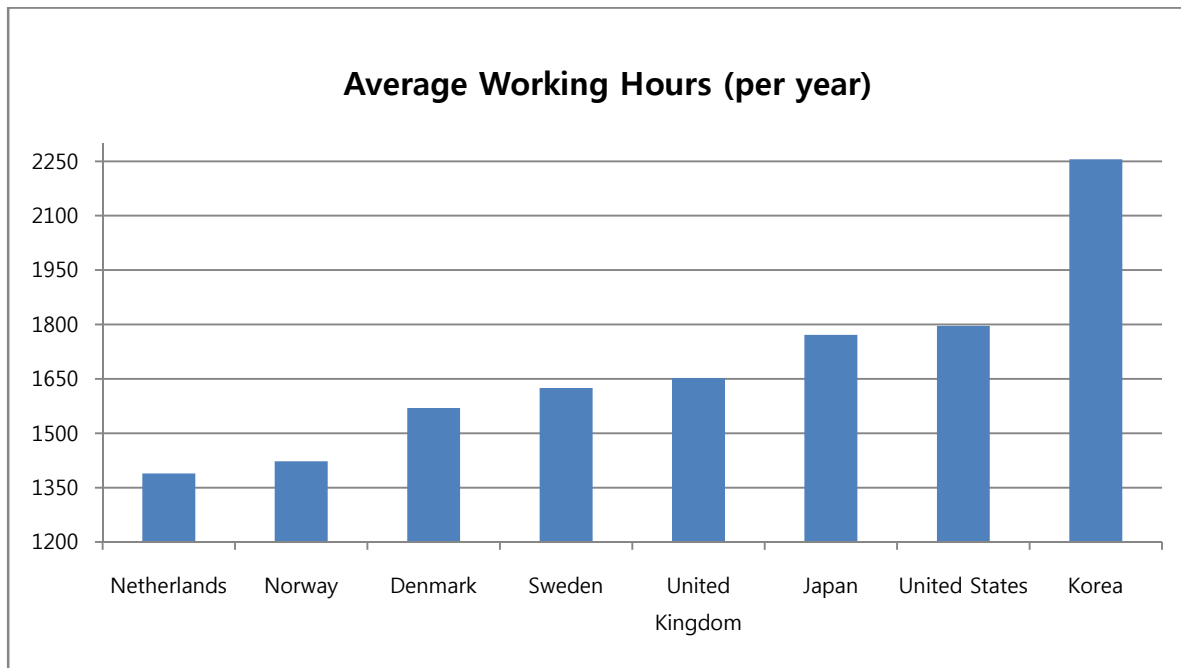
3-1. Causes of Low Labor Productivity

Long Working Hours There has been a constant decline in annual labor hours per employee across countries for a century. Japan and South Korea have also reduced working hours. The working hours for full time employees in Japan have been reduced by 4 percent since 2000. South Korean working hours have also decreased significantly in 2004 and 2005, when the six-day workweek was abolished.

Despite the gradual progress, however, full time employees in Japan and South Korea still have excessive working hours as compared to the average of OECD countries. According to a report released by the OECD, Japanese workers spend the most time working in order to be paid well. The Japanese Ministry of Internal Affairs and Communications also announced that only 4.8 percent of the service industry has a 40 hour work week and most of it has a 60 hour or longer work week. South Korean workers on average work 2255.75 hours per year, which is the longest work hours among OECD member states. This is over 100 hours longer than the next longest-working state, Greece, and 25 percent more hours than the average in the US.

The countries whose labor productivity is above the OECD average – Norway, Denmark, the United Kingdom, Netherlands, Sweden, Canada – have far lower working hours than the average (see Figure 4). The European Union (EU) imposes a 48 hour maximum working week that applies to every member state. Full time workers in France and Germany in particular have a 35 hour workweek. A major reason for the low annual hours worked in Europe is because those countries have statutory minimum tariffs for employee leave from work. Most Scandinavian countries have 25 days legally required minimum leave on average

and some companies tend to offer more time based upon contracts.



Source: OECD Employment Outlook 2008

Note: As opposed to the other countries with high labor productivity, the US full time workers have similar level of working hours with Japanese laborers. A large number of studies have found immigrants from developing countries as a leading factor of long working hours in the US.

<Figure 4: Average Annual Hours Worked>

Seniority-based Wage System A stable labor market is one of the key factors for economic growth. As the EADM has been geared towards rapid economic growth for late developers, Japan and South Korea have used seniority-based wage systems as a main instrument to stabilize labor-management relations. The White Paper on Labor in Japan demonstrates that wages constantly rise until workers reach the age of 50 at large corporations.¹⁴ South Korea has a distinct system called *Hobong* which offers a baseline of labor wages and promotion depending on seniority rather than on performance. The prevalence of Confucianism, which emphasizes reverence for elders, has also contributed to maintaining the seniority-based pay system in Japan and South Korea. Lee and Yoo describe South Korean management as “clan

¹⁴ Ito, Shohei. Japanese Employment Practices, IIRA 12th World Congress Pre-Congress Symposium Keynote Speech, The Japanese Institute for Labor Policy and Training. 05/14/2002

management; top-down decision making; Confucian work ethic; paternalistic leadership; loyalty; compensation based on seniority and merit rating; bureaucratic conflict resolution; highly bureaucratic and yet less formal, and a standardized system; close government-business relationship within the company.”¹⁵ Chris Rowley and John Bae also argue that human resource management in South Korea should be understood in the context of Confucianism. As Confucian traditions place a high value on paternalism and collectivism, both labor and management take seniority-based lifetime employment and tenure-based pay for granted.¹⁶

However, countries like the US and most European countries consider money as a main incentive for increased labor productivity. Thus, performance related pay is more widely used than a tenure-based system. Frederick Winslow Taylor, regarded as the father of scientific management, introduced the concept of *piecework* in which an employee is paid a fixed *piece rate* for each action performed regardless of time.¹⁷ His research on efficiency improvement has been widely studied in the US and France in particular. For instance, the performance matrix, one of the strategic initiatives of Jack Welch, of General Electric, has become prevalent since the 1980s. According to GE’s performance matrix, the top 10-15 percent of employees is rewarded, the middle 70 percent is compensated adequately, and the remaining 10-15 percent is targeted for removal. Although GE is a manufacturing conglomerate corporation, its payment system has also been adopted by the services sector as a method of improving labor productivity. Bonuses based on performance are also on the rise in most European countries. According to a report conducted by the OECD in 1999, a majority of top

¹⁵ Lee, Sang M, Sangjin Yoo. 1987. The K-Type Management: A Driving Force of Korean Prosperity. Management International Review. Vol. 27, No. 4, 1987. P.69.

¹⁶ Rowley Chris, Sohn Tae-Won, Bae Johnseok. 2002. Managing Korean Business: organization, culture, human resources and change. London: Frank Class Pulbishers.

¹⁷ Frederick Winslow Taylor. 2007. The Principles of Scientific Management. Fillguarian Publishing, LLC.

executives in the services received bonuses valued at 25 percent of their base salary on average in Netherlands. The increase of bonuses based upon performance for executive and senior level employees is meant to encourage them to sustain their good work and to keep them in the industry.

Entry Barriers Under the EADM, Japan and South Korea enhanced labor productivity in the manufacturing industry by opening their markets to the world. However, the service industry is still subject to numerous domestic regulations and sheltered from international competition. A survey conducted by the OECD in 2006 points out that strict market regulations and the low levels of import penetration have caused low labor productivity in the Japanese service industry. Koyji Fukao, a faculty fellow at Research Institute for Economy, Trade & Industry (RIETI), argues that investment in the Japanese services sector, particularly in Information and Communication Technology (ICT), has been far lower than the average of OECD countries due to strict regulations on foreign direct investment (FDI). The OECD's indicator of product market regulations for the services sector also ranked South Korea as the fifth-most restrictive country in the OECD countries in 2003.¹⁸ Foreign affiliates accounted for only 8 percent of turnover in the South Korean service industry and 4 percent of employment in 2004, which was far below the OECD averages of 19 percent and 10 percent respectively.¹⁹ The share of FDI in the services sector is also the third lowest among OECD countries. Despite growing complaints from outside for high entry barriers, some scholars and politicians support more regulations of foreign investment. Professor Ha-Joon Chang at Cambridge University argues that South Korea should not only implement a Tobin tax, but

¹⁸ Conway, P. and G. Nicoletti. 2006. Product Market Regulation in the Non-Manufacturing Sectors of OECD Countries: Measurement and Highlights. OECD Economics Department Working Paper. No.530, OECD, Paris.

¹⁹ Jones, R. S. 2008. Economic Survey of Korea 2008, Chapter 4: Boosting productivity in Korea's service sector. OECD Economic Surveys and Country Surveillance. Published on 17 December 2008.

also impose a high bank levy to protect the domestic financial market.

However, the US and most European countries promote greater openness towards the world market. They consider trade and FDI as an important source of productivity gains and economic development. In 2008, the World Bank conducted a study on the time and cost of starting a new business and ranked OECD countries from least to most restrictive.²⁰ It is noteworthy that the top ten least restrictive countries are all European countries except the US and New Zealand. The US has a series of Bilateral Investment Treaties (BITs) as a means to protect private investment and to develop market oriented policies. In the context of establishing an internal market for services, the Treaty on the Functioning of the European Union (TFEU) also mentions FDI as a part of the common commercial policy to facilitate even greater investment abroad. This foreign investment friendly environment has also led the EU and the US to be the most integrated in the world. The FDI from the US to the EU amounts to \$76.5 billion per year on average and that from the EU to the US adds up to \$172.02 billion.

4. A Way towards High Labor Productivity

Working Hours and Wage System Both labor and management have found an excessive amount of work to be a major contributing factor to South Korea's having the longest work hours in the service industry. In 2010, the biggest Enterprise Information Portal (EIP) in South Korea, *Saramin*,²¹ conducted a survey about the working environment of the service industry. The survey showed that 70 percent of full time employees worked overtime at least 3 days in a week because of unfinished work.

Given the circumstances, firms should hire more employees to reduce the workload

²⁰ Jones, R. S. 2008. Economic Survey of Korea 2008, Chapter 4: Boosting productivity in Korea's service sector. OECD Economic Surveys and Country Surveillance. Published on 17 December 2008.

²¹ www.saramin.co.kr

assigned to each worker in the services sector. The former floor leader of German *Sozialdemokratische Partei Deutschlands* (SPD), Peter Struck, also has mentioned that if companies cut one third of overtime hours, Germany would be able to improve labor productivity while creating almost four hundred thousand new jobs.

However, the high rigidity of the South Korean labor market provides the service sectors with no incentive to hire more workers. The Ministry of Employment and Labor finds that high labor costs and environmental uncertainty has discouraged South Korean firms from recruiting new workers while enforcing overtime work.²² In fact, newly employed college graduates on average earn \$24,500 per year, which is 130 percent of South Korean GDP per capita. The starting pay in finance and banking even reaches \$30,000. Given the cases of the US and the UK where the initial pay is around 94 percent and 92 percent of GDP per capita respectively, the South Korean baseline for the starting pay should be moderated.

The high firing cost has also discouraged firms from hiring more workers. According to a research conducted by the World Bank in 2005, South Korea has a far higher rigidity of employment index than the average of OECD member states and the high firing-cost has been singled out as a main reason. The South Korean Labor Standard Acts (LSA) requires that firms should pay fired employees 60 weeks' wages to fire.²³ The OECD member states on average, however, provide workers with 32.6 weeks of wages to fire. This high cost of firing is also connected to seniority-based pay system. The companies have more difficulty in firing executive and senior employees, regardless of their productivity, due to the high costs of firing. This implies that companies pay higher wages to those workers whose productivity may be less than average because of a great sense of security.

²² Bae, Johnseok. 1997. Beyond Seniority-Based Systems: A Paradigm Shift in Korean HRM?. *Asia Pacific Business Review*, 3: 4, 82-110.

²³ The International Bank for Reconstruction and Development and The World Bank. 2005. *Doing Business in 2006*. ISBN 0-8213-5749-2

Since seniority based pay is deeply embedded in South Korean society, replacing the tenure-based pay with a performance-based wage system is challenging. The recent example of the SC First Bank, in which workers protested against performance-based pay, demonstrates the difficulties of introducing a new payment system. It has been reported that around 70 percent of all workers at the bank joined the labor strike. Those workers argue that the new pay system is merely aimed at reducing labor costs.

However, introducing performance-based pay is in fact beneficial for both management and labor. First, if wages are decided based on performance, the employees could enjoy fair treatment regarding promotion and wages regardless of age, tenure, and gender. Second, what is good for the company is good for its workers as well. If the company fails to generate profits for a long time, measures like a wage cut and layoff would be inevitable. Hence, workers should be aware of the fact that improving their performance is beneficial for themselves in the long run.

Providing employees with more information about the wage system is also imperative. In most cases the purpose of performance appraisal has been an administrative one with a minimal developmental purpose and employees have no choice but to acquiesce in their wages.²⁴ If the workers understand how their performance is related to the wages, they would make every effort to yield more economic outcomes while not defying the company's goal. Thus, managers should inform employees how their performance is evaluated, and how their wages are added up in detail.

Entry Barriers The Lee Myung Bak administration has made regulatory reform a top priority to improve the business environment. The Presidential Council on National

²⁴ Ahn, Hee-tak. 1996. The Transition from a Seniority-Based Pay System to an Annual Salary System in Korean Enterprises. KEIO Business Review No. 33, 1996. Pages 1-11.

Competitiveness (PCNC) is currently playing a leading role in regulatory reform, public sector innovation, investment, and legal and institutional advancement. The Regulatory Reform Task Force (RRTF) has implemented 671 reforms, and two-thirds of them were applied to the service industry between 2004 and 2007. According to the Regulatory Reform Committee (RRC), average prices in the major services sector have fallen by 1 percent and output has increased by 3 percent over ten years due to these reforms (See Table 1).²⁵

Rank	Industry	Regulatory Reform Index	Price Change (%)	Output Change (%)
1	Construction	22.0	-1.6	4.1
2	Telecommunication	13.7	-1.2	2.6
3	Financial intermediation	11.8	-1.3	2.9
4	Food and cigarette	11.3	0.9	1.9
5	Public services	8.6	0.8	2.9
6	Oil and chemicals	7.5	0.6	2.8
7	Business services	6.9	0.9	2.5
8	Electronics	6.8	0.7	5.7
9	Transportation equipment	5.2	0.5	2.7
10	Metals	4.7	0.4	2.8
11	Wholesale and retail trade, hotels and restaurants	4.1	0.7	3.0
12	Entertainment	3.9	0.9	2.9
13	Transportation	3.7	0.7	1.4

Note: 1. Regulations are given a weight of 1.0 for prior approval, 0.78 for input standard, 0.64 for output standard and 0.38 for information regulations. This index includes only reforms implemented by the RRTF.
 2. Change in price during the four quarters following the implementation of the reform
 3. Projected increase in output during the decade following the implementation of the reform.
 Source: Regulatory Reform Committee (2007), Regulatory Reform White Book, Seoul

< Table 1: Impact of Regulatory Reform by Services >

It is worth noting that President Lee Myung-bak has used several strategies of the EADM as methods of promoting South Korea's service industry. First, it is the Lee administration

²⁵ Jones, R.S. 2009. Boosting Productivity in Korea's Service Sector. OECD Economics Department Working Papers, No. 673, OECD Publishing. doi: 10.1787/226625875038

which has shown leadership in seeking to upgrade the service sector. The Lee administration has selected 9 service industries – medical, logistics, consulting, design, Information Technology (IT), education, content, and broadcasting-telecommunication services – based upon added value, potential growth, and job-creation. These industries have priority in acquiring such supportive measures as subsidized credits and state investment funds and also enjoy preferential tax treatments. Second, the Lee administration is pursuing greater openness to strengthen the competitiveness of South Korea’s service industry. South Korea has implemented Free Trade Agreements (FTAs) with Chile, Singapore, EFTA, ASEAN and India; the Korea-EU FTA has been provisionally applied since July 1, 2001. The Korea-US (KORUS) FTA is also waiting to be approved for ratification in the Korean National Assembly as of July 2011. The KORUS FTA in particular covers a wide range of services, such as telecommunications, electronic commerce, express delivery, and financial and insurance services. South Korea is currently negotiating FTAs with the countries of the Gulf Cooperation Council, Australia, New Zealand, Colombia, Canada, Turkey and Mexico. In addition, China, Japan, and South Korea have been conducting a joint study for a possible trilateral FTA among government officials, business and academic participants since 2010. These state-driven plans to open up South Korea’s service industry is a significant progress because barriers to foreign competition has sheltered inefficient service providers and inhibited foreign direct investment.

Nonetheless, concerns remain over liberalization policies for the service industry because the export-driven strategy of the EADM has already made South Korea exceptionally vulnerable to external shocks. However, most services are non-tradable and thus further liberalization does not have the same impact on the service sector as on the manufacturing industry. The places where such services as education, health, and social work are produced are the same as those where they are consumed. This means that the demand for services is

less elastic than that for tangible goods regardless of external economic conditions. In addition, according to a research conducted by the Bank of Korea, foreign investment in the service industry has the characteristics of market-seeking and horizontal FDI.²⁶ Therefore, a concern over short term capital-flows should not be a stumbling block to put opening policies into practice for South Korea's service industry.

There are some scholars who argue that South Korea should further promote the manufacturing industry. They believe South Korean services can by no means compete with the other OECD countries. However, South Korea achieved rapid economic growth because it defied comparative advantage. If President Park Chung-hee had not facilitated the development of the manufacturing industry with long term economic plans, South Korea would have remained a poor agricultural country. In addition, given the intense competition with developing countries like China, it is hard for South Korea to maintain its comparative advantage in the manufacturing industry. Furthermore, services such as finance, insurance, and transportation are in fact conducive to growth in agricultural and manufacturing industries, as they increase outsourcing for materials, parts, and components. It is thus imperative for South Korea to inform the public about a correlation among industries and the role of services in facilitating the manufacturing sector in particular. Public consultation on proposed reforms for deregulation and making all comments publicly available are also essential to improve the public's understanding and to gain support from them.

5. Conclusion

South Korea has shifted to a service-based economy. The services sector now takes the highest share of total output and employment, and this upward trend is expected to continue.

²⁶ Kang, Seongjin. 2005. *서비스 산업의 선진화와 외국인 직접 투자의 전략적 유치 방안*. The Bank of Korea, Economic Research Institute. Working Papers. Vol. 227. P. 57.

This paper has singled out three main factors of low labor productivity in the South Korean service industry: long working hours, the seniority based wage system, and high entry barriers and strict regulations. It has been argued that an excessive workload contributed the most to long work hours. I have argued that lowering the costs of hiring and firing is essential to encourage firms to recruit more employees, thereby reducing the workload for each worker. Confucian traditions in South Korea have led both management and labor to take the seniority-based wage system for granted. However, I have argued that a performance-based pay system is not only conducive to improving labor productivity, but it could also give fair treatment to employees regarding wages and promotion. Lastly, a strong concern over liberalization of South Korea's service industry is prevalent, and it has reinforced entry barriers and the regulation of trade and foreign investment. However, I support the idea that strengthening the links to the international market is essential to enhance labor productivity. Thus, the South Korean government should build consensus among the public about the importance of international competition, trade, and investment as a method to enhance labor productivity in the service industry.

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