Beware the Law of Unintended Consequences

Why South Korea’s Income-Led Growth Policy Isn’t Working

By Choong Yong Ahn

During Moon Jae-in’s presidential campaign in 2017, he outlined policies aimed at addressing a range of ills afflicting the South Korean economy, including income inequality and slowing growth rates. In particular, he pledged to pursue ‘income-led growth,’ and shortly after his inauguration, he launched a series of sharp increases in the minimum wage and other measures to achieve his goals. In the view of many critics, the results have been disastrous. Choong Yong Ahn examines what went wrong.

SOUTH KOREA’S economy is at a crossroads. The country needs to make crucial policy corrections to reverse the ongoing recession, otherwise it will helplessly suffer further economic pain amid the US-China trade war and other global economic uncertainties. Like many countries after the global economic meltdown in 2008, South Korea has suffered slower growth, high unemployment and acute income polarization. In the last decade, the country’s “new normal” economic symptoms have been accompanied by a rapidly falling potential growth rate. Against this backdrop, after Moon Jae-in was inaugurated in May 2017 he began a two-pronged economic policy of “income-led growth” together with “innovative growth,” or what is referred to as J-nomics. In essence, the goal of J-nomics appears to be to shift the South Korean economy away from the development model revolving around chaebols (large conglomerates) and experts to a new paradigm that can urgently generate more jobs and equitable growth.

At the outset, the Moon administration emphasized equitable growth and job creation, daily checking a new-hire monitoring board that hung in the presidential office. Under the broad theme of a “people-centered economy,” justice and fairness, this initially had substantial appeal. Indeed, the combined goals of inclusive and sustainable growth rightly identified the Korean economy’s main challenges.

The flagship policy of J-nomics, a key part of Moon’s election campaign, is “income-led growth,” which would mitigate worsening income polarization by raising labor’s share of the national income through wage hikes and increased social expenditures for low- and middle-income individuals. The second pillar, which was introduced about six months after Moon took office, focuses on innovation to spur new businesses, startups and small- medium-sized enterprises (SMEs) by strengthening government support for the so-called fourth industrial revolution. In line with these two pillars, the Moon government also stressed “fair economic surroundings” that would create a level playing field between large and small businesses.

However, by early November 2019, nearly midway into Moon’s five-year presidency, the government’s economic performance record raises some serious and challenging questions. Broadly speaking, the twin policies appear to be contradictory, judging from the rapidly falling economic indicators on almost every front, especially economic symptoms have been accompanied by a rapidly falling potential growth rate. This essay attempts to shed light on Moon’s “income-led growth” policies, their impact on South Korea’s already ill-performing economy and what serious caveats are contained in that policy. Finally, this essay also suggests some drastic policy changes.

In the past half-century, South Korea’s rapid industrialization and export-led development have often been cited as an example of “compressed and equitable growth” in the developing world. But the 1997-1998 Asian financial crisis and the 2008 global economic meltdown hit South Korea hard, miring it in a slow-growth track, or “early high-income trap.” When the Asian crisis erupted, South Korea had no choice but to seek financial help from the International Monetary Fund (IMF), drawing US$54 billion, the largest-ever standby credit for a single country at the time. In return, South Korea carried out comprehensive banking, corporate, labor and public enterprise reforms, in accordance with IMF mandates. A decade later, the global economic crisis hit even harder and faster, resulting in new normal symptoms of slow growth, low employment, and rising income and social inequalities.

Above all, South Korea’s average growth rate in real gross domestic product (GDP) declined by almost half, from 5.4 percent per year from 2000 to 2007, to 2.8 percent on average from 2009 to 2016, according to the Bank of Korea. Prior to the Asian financial crisis, South Korea’s Gini coefficient for urban working households reached about 0.307 in 1980 and gradually declined to 0.281 in 1995, setting a global standard for desirable income equity amid high growth (The World Bank, "The East Asian Economic Miracle," 1993). But the unprecedented shock in 1998, which led to a 5.5 percent contraction in economic growth, quickly resulted in massive unemployment and subsequently led to income polarization due to the restructuring and downsizing of many companies. South Korea’s slow growth and low employment since the Asian financial crisis caused an upsurge in the Gini coefficient to as high as 0.32 in 2008. It improved a little after that, but then worsened in recent years. As a result, South Korea has seen a rapid trend toward a shrinking of the middle class, as seen in Figure 1 overleaf.

South Korea’s rising inequality has also occurred through a rapid increase in the income share of the top decile, similar to global trends. A recent IMF study shows that over the last two decades, the income share of the top decile increased in most Asian countries, with South Korea being the highest, with the top 10 percent income share of the top 10 percent.
earning 45 percent of the national income, up from 29 percent in 1990. Income differentials have caused the deep-seated relative deprivation of low-income South Koreans.

An acute dichotomy between South Korea’s large and small businesses has exacerbated rising income inequality and economic inefficiency. South Korea’s rapid industrial growth was led by the government’s promotion of chaebols to compete in the world market. During the high-growth era, the dominant industrial strategy was for large conglomerates to take a latecomer’s advantage and maximize economies of scale and scope in the global market. As a consequence, South Korea’s SMEs became domestic-oriented, less technologically competent and less profitable relative to chaebols.

South Korea’s SMEs are often characterized by “998833,” meaning that they account for 99 percent of the country’s total business establishments and 88 percent of total jobs, but are only 33 percent as productive as large conglomerates. SME workers increasingly have lower salaries and non-regular working contracts, thus being deprived of the privileges of pensions, insurance and retirement compensation normally provided to “regular” workers.

The country’s SMEs are also at the bottom of the multilayered pyramid structure of business establishments (see Figure 2), ranging from self-employed and family-based micro-businesses to medium-sized firms and near-large enterprises, also called “potential high-income enterprises,” with large conglomerates, or chaebols, on top.

The number of large conglomerates, meanwhile, continues to grow, reaching around 1,600. In recent years, some chaebols’ subsidiary companies, including new ones, have sought quick profits by taking advantage of business opportunities in traditional domestic markets dominated by SMEs. At present, there are around 7 million micro and small businesses, constituting the country’s grassroots economic base.

South Korea’s economy now faces great challenges due to a structural dichotomy that has become gradually and deeply embedded in the labor market, between services and manufacturing, and between SMEs and large conglomerates. In the labor market, there is a significant divide between regular and non-regular workers such as fixed-term, part-time, and dispatched workers. Non-regular workers in South Korea constitute over 20 percent of total employment compared to an average of 11 percent in OECD economies. Non-regular workers on average earn just 66.3 percent of a regular worker’s wages, even though their skills are the same. They are also less likely to enjoy social benefits or on-the-job training.

Another divide is the productivity differential between manufacturing and services. South Korea’s services sector is largely in fragmented, domestic-based and technologically outdated SMEs. Typical services sectors include food and beverages, lodging, retail and sub-tier construction companies. As a result, the productivity of the services sector has been far lower than that of the export-oriented manufacturing sector. The third divide is the level of globalization between export-oriented large conglomerates and domestic market-based SMEs.

These factors have contributed significantly to income inequality, which also matters for growth. Specifically, if the income share of the top 20 percent increases, then GDP growth actually declines over the medium term, suggesting that the benefits of growth do not trickle down. In contrast, an increase in the income share of the bottom 20 percent is associated with higher GDP growth. On top of the serious challenges South Korea faces due to the three divides, one of the most alarming signs for the country’s sustainable growth lies in the rapidly declining potential growth rate. The Bank of Korea estimates that South Korea’s potential growth rate has continuously declined, from 4.8 percent to 5.2 percent for 2001-2005 to 3.7 percent to 3.3 percent for 2006-2010.

**MOON’S INCOME-LED GROWTH POLICY**

To promote income-led growth and more equitable income distribution, the Moon government has initiated a set of new economic policies to raise incomes for individuals in the middle- and low-income brackets by substantially raising minimum wages, raising income taxes for the higher-income bracket and increasing corporate income taxes for large businesses. It is also converting irregular workers to regular workers, capping work hours at 52 hours per week, hiring new public employees to help reduce unemployment and lowering tax benefits on R&D investment, as briefly described in Table 1. It should be noted that these policies were intended to zero in on the key goal of job creation, as evidenced by the establishment of the presidential job creation committee at the start of his administration.

The upshot of J-nomics can be read in Table 1, in the areas of minimum wage, tax, labor and welfare expenditure. Compared to 2017, the government increased the 2018 national budget by 7.1 percent to 429 trillion won (around US$400 billion), with income-led areas seeing the largest increase, going up 12.9 percent to 146.2 trillion won (around US$135 billion) from 2017, whereas innovative growth was stuck at 35.5 trillion won (around US$32 billion). It should also be noted that the budget for job creation is almost the same as the R&D budget.

**MINIMUM WAGE POLICY AND UNINTENDED CONSEQUENCES**

Perhaps the most visible policy change under J-nomics is the minimum wage hike. The Moon administration raised the minimum wage by a record 16.4 percent, effective at the start of 2018, to 7,530 won (around US$7.06) and another hike by 10.9 percent for 2019, with the goal of reaching a minimum wage of 10,000 won per hour by 2020, as promised during his election campaign. Figure 3 shows that increases in minimum wage have consistently been higher than the economic growth rate since 2011, and is exceptionally higher in 2018 and 2019, while labor productivity has remained low or stagnant. Indeed, this turns out to be the most impulsive policy tool within the J-nomics policy package. Evidence up to the second quarter of 2019 suggests that the quick and steep minimum wage hike produced unintended consequences: hiring cuts, business shutdowns, job losses and worsened income polarization.

Although J-nomics intended to help SMEs the most, the record hike in 2018 and another high rise in the minimum wage has burdened SMEs the most. Many retail businesses and contractors have been unable to cover the increased labor costs, taking on fewer people or even freeze-
The intended reduction in working hours also surfaced about six months after Moon took office and aims to encourage business start-ups, including venture businesses and venture capital, and other innovative growth strategies. The innovative growth policy has a variety of fiscal support measures focused on venture start-ups. As a result, it appears that far less attention is being given to technological innovation across existing industries and SMEs compared to the overwhelming emphasis on new start-ups.

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

This is a serious challenge for South Korean firms, especially labor-intensive SMEs. Unless South Korea’s SMEs undergo systematic digitalization, the existing technology divide between large high-tech firms and labor-intensive SMEs will only deepen the divide between large and small businesses, worsening income inequality and employment prospects.

According to the OECD’s Entrepreneurship at a Glance 2014, South Korea’s livelihood-type business start-ups accounted for 63 percent of all start-ups while innovative-type start-ups constituted only 21 percent of total start-ups in 2014. However, high-tech economies such as the United States, Israel, Finland and Sweden show almost the opposite picture. In South Korea, early retirees and semi-skilled people who fail to get decent jobs tend to start easy livelihood-type businesses and are often self-employed with traditional restaurants, bakeries, fried-chicken houses and beverage franchises.

### MOON’S MID-POINT RECORD

Table 2 shows that major economic indicators were on a downward track in 2018 and declined further by July 2019. The figures for economic growth and exports at the end of 2019 are likely to be worse, due to the increasingly negative consequences of the ongoing US-China trade war and recent bilateral trade tensions stemming from Japan’s removal of South Korea from Japan’s export white list, which has allowed the free movement of essential intermediate materials and components to South Korea, including the country’s semiconductor sector, which is the world’s most competitive. Due to domestic policy ineffectiveness and global trade uncertainties, South Korea’s GDP may register less than 2 percent growth, leading to a further rise in youth employment. The country’s global GDP ranking in 2019 might go down from its current 12th rank, while per capita income may fall below US$30,000 again.

Looking further at unemployment, as of July 2019, the unemployment rate rose to 3.9 percent from 3.4 percent in 2017, the highest increase since the Asian financial crisis (Figure 4). The services sector — including retail, wholesale, accommodations and restaurants — has been hit hard, experiencing significant job losses in the past two years.

### TABLE 2 SOUTH KOREAN MACROECONOMIC INDICATORS IN RECENT YEARS

Source: Bank of Korea. Note: 2019 figures are forecast as of July 2019.

<table>
<thead>
<tr>
<th>% chg y-o-y</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
<th>2019 (forecast)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross domestic product</td>
<td>2.9</td>
<td>3.2</td>
<td>2.7</td>
<td>2.2</td>
</tr>
<tr>
<td>Construction investment</td>
<td>-10.0</td>
<td>10.1</td>
<td>-4.3</td>
<td>-3.3</td>
</tr>
<tr>
<td>Facility investment</td>
<td>-1.3</td>
<td>14.1</td>
<td>-2.4</td>
<td>-5.5</td>
</tr>
<tr>
<td>Exports by value</td>
<td>-5.9</td>
<td>15.8</td>
<td>3.3</td>
<td>0.6</td>
</tr>
<tr>
<td>Imports by value</td>
<td>-6.9</td>
<td>17.7</td>
<td>1.6</td>
<td>-0.5</td>
</tr>
</tbody>
</table>

### FIGURE 4 UNEMPLOYMENT TRENDS, 2015-2019

Source: South Korean Office of Government Statistics

Note: 2019 figure is as of end of June
government intends to hire up to 810,000 public employees in general administration, safety, firefighting and healthcare by expanding government organizations through the largest budget increase ever, which entailed tax hikes. The government introduced a rare supertax hike and “wait and see attitude” toward the chaebol-governance policies of the Korea Fair Trade Commission intended to strengthen minority shareholders rights.

In the past 10 years, South Korea’s cumulative FDI outflows have been three times the cumulative FDI inflows, according to the Ministry of Trade, Industry and Energy and Korea EXIM Bank. Increasing wage costs at home, labor market rigidity, ongoing cross-border supply chains and rising protectionism abroad have been pushing more South Korean companies offshore in search of cheaper labor, and income-led growth policies could be exacerbating these trends.

For innovative growth, government policy, including short-term funding, has focused on tech startups. Once government funding runs out in three to four years, many startups will suffer from a “death valley” due to a lack of continued financing from commercial banks and the country’s barren venture capital environment. South Korea’s innovative growth model has not paid enough attention to existing SMEs beyond startups. Further, the deregulation and policy co-ordination necessary to help create innovative startups has yet to be realized.

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

The innovative growth policies lack a new set of initiatives to spur the productivity of traditional industries through new technologies, which are similar to Germany’s “Industry 4.0” or Japan’s “Monozukuri Movement,” in which existing industries underwent digitalization.

**WHAT WENT WRONG?**

The policy effectiveness of J-nomics midway into the Moon presidency can be assessed primarily in terms of job creation and equitable distribution. It is not a pretty picture. Thus far, J-nomics has not produced the desired jobs, income equity or economic recovery, instead it has sometimes moved away from its intended performance targets.

To begin with, the income-led growth model contains built-in caveats in formulating policy for urgent job creation on theoretical and empirical grounds. A demand-side approach aimed at boosting lower- and middle-income household incomes to trigger domestic consumption — leading to more investment, production, and finally jobs — is only temporary and takes time. Simple economic logic tells us that if job creation is the most urgent need, output growth must come first on the supply side by vigorously inducing private investment, thereby creating demand for labor, i.e. job creation. Then, the policy focus should be on an investment-friendly environment through the encouragement of entrepreneurship. In this regard, US President Donald Trump’s policies such as corporate tax cuts could provide important policy insights. Given the job creation target, taking an income-led approach is like trying to move a cart forward by putting the horse at the back.

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**FIGURE 5 HOUSEHOLD INCOME TRENDS OF THE FIRST AND FIFTH QUINTELS**

Source: South Korean Office of Government Statistics, Household Income Survey, fourth quarter 2018
According to conventional labor productivity theory, a wage increase needs to align with labor productivity and economic growth in the medium and long term. Over the 2010-2016 period, South Korean wage costs steadily rose while labor productivity declined. The abrupt and record minimum wage increases have caused many firms to reduce workers to avoid excessive labor costs relative to productivity. The validity of the ILO’s wage growth model might hold if the real wage rate of increase is lower than the economic growth rate and increases labor productivity over a sustained period.

According to data from the Korea Productivity Center, South Korea’s labor productivity grew at an annual average of 0.38 percent from 2009 to 2016 while the annual increase in real wages averaged 1.66 percent. As long as wage hikes outpace increases in labor productivity, South Korea’s competitiveness will diminish. Therefore, the minimum wage should be adjusted in tandem with labor productivity.

Excessive minimum wage hikes tend to distort the market mechanism for wage determination. In the US, workers who receive minimum wage or less constitute about 2-3 percent of the workforce, while their South Korean counterparts account for about 13 percent in entire industries. In a sense, the minimum wage serves as a social safety net for low-skill workers. The ratio of South Korea’s minimum wage recipients goes up even more, to about 30 to 70 percent, in unskilled labor-intensive services such as food and accommodation, retail and wholesale, delivery and household maid services. That is why South Korea’s sudden and excessive minimum wage increases have caused massive layoffs.

In line with the objectives of the Moon administration, structural reforms are vital to mitigate inefficiencies in the labor market, product market and globally oriented business establishments. Structural reforms are particularly necessary for labor productivity, which remains near the bottom among OECD economies. The average value added per hour per South Korean worker was US$33.10, far below the OECD average of US$47.10.10

South Korea’s productivity gap between SMEs and large conglomerates and manufacturing versus services is much larger than that of other OECD countries. The relative labor productivity of small firms to large firms in South Korea is also far lower than the OECD average. The low productivity of SMEs as well as the services sector in South Korea is among the most crucial policy challenges. To enhance low SME productivity, the country’s innovative growth model should focus more on SME globalization and take advantage of rapidly changing global value chains in collaboration with South Korea’s large export-oriented firms and their global networks.

The government-planned increase in public sector jobs will draw college graduates to take exams for government posts at the expense of the private sector, which will continue struggling to find employees who can work with new technologies. Against a backdrop of labor scarcity amid high unemployment, labor supply and manpower development must be realigned. The ongoing fourth industrial revolution calls for labor mobility across industries and working styles, because special tasks and functions are required. There-fore, the mandatory uniform reduction of working hours across industries has overlooked the working-hour flexibility necessary to develop knowledge intensive industries.

As a part of its pro-labor policies, the government has strengthened restrictions on the dismissal of regular workers and working hours. In response to the Moon administration, structural reforms are vital to mitigate inefficiencies in the labor market, product market and globally oriented business establishments. Structural reforms are particularly necessary for labor productivity, which remains near the bottom among OECD economies. The average value added per hour per South Korean worker was US$33.10, far below the OECD average of US$47.10.10

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enting ones. To adapt to a rapidly changing digital economic landscape the government needs more than robust unemployment insurance. It should also push for more flexibility for regular workers and working hours to meet the varying needs of individuals and move away from the strictly seniority-based wage system. More fiscal resources need to be diverted to training, professional schools and life-long learning, especially regarding digitization for job seekers and the self-employed in marginal services rather than direct subsidies to non-competitive firms. Thus, labor market flexibility is crucial for increasing productivity and fostering inclusive growth. The government must pass legislation that revitalizes South Korean businesses. In the absence of a productivity increase, a set of pro-labor policies, including a steep wage hike, will also exacerbate the current trend of Korean firms moving production abroad thus reducing jobs at home.

Entering the third year of the Moon presidency, it is highly recommended that the government carry out structural reforms to induce active business investment for decent job creation by boosting productivity while ensuring that the gains from growth are shared widely through a strengthening of social safety nets and digital retraining of the unemployed.

TOWARD MARKET-DRIVEN INNOVATIVE ECONOMIC GROWTH

The income-led growth model is based on the assumption that an increase in domestic consumption through pro-labor distribution policies, including a record hike in the minimum wage, will trigger growth with equity.

The policy effectiveness of J-nomics midway into the Moon presidency can be assessed primarily in terms of job creation and equitable distribution. However, thus far, J-nomics has not created the expected jobs, income equity, or economic recovery, sometimes moving away, as mentioned earlier, from intended performance targets. South Korea is now experiencing unabated unemployment and widening income polarization, not to mention a slowing growth rate — 2.7 percent for 2018, which is lower than the originally planned 3 percent growth. Consequently, the country needs to change the course of economic policy from “wage-led growth” to investment- and innovation-led growth to create decent jobs — the most important goal of the Moon administration — and to generate sufficient fiscal resources for inclusive growth and social safety nets.

South Korea is a mid-sized open economy in which international competitiveness needs to be emphasized in policy formation. Consequently, capacity building and the competitiveness of large conglomerates as well as SMEs need to be promoted more systematically from the supply side. The Moon administration’s innovative growth policies should be expanded to consider how to induce existing industries to converge with the fourth industrial revolution. Thus, innovative growth requires broad deregulation to remove deeply rooted labor market rigidity and institutional barriers so that new businesses aligned with disruptive digital technologies can develop in a business-friendly environment.

Entering the third year of the Moon presidency, it is highly recommended that the government carry out structural reforms to induce active business investment for decent job creation by boosting productivity while ensuring that the gains from growth are shared widely through a strengthening of social safety nets and digital retraining of the unemployed. At a time of prolonged economic recession and rising economic and social inequality, South Korea’s policy-makers, free from an ideological frame based on government intervention to achieve equality, need to pay attention to Giacomo Corneo,11 who said: “Markets can encourage economic efficiency and frugality, and they can bring about valuable innovation and coherence within complex economies.”

Beyond the government’s macro and micro policies for robust and inclusive growth, a virtuous business ecosystem needs to be cultivated to enable large and small companies to play out a mutually reinforcing positive-sum game instead of the zero-sum relationship that prevailed during the high-growth era. Structural reforms in labor market flexibility, combined with the deregulation necessary for the advent of disruptive fourth industrial revolution technologies, must be expedited.

Resilient economic policies under a free market economy need constant fine-tuning and drastic adjustment, if necessary, to reflect real market signals.12 South Korea was highly practical in the past about encouraging innovation to compete in the world market. Given the fierce competition for technological leadership amid global protectionism, South Korea needs to revive the synergistic partnership between government and business, business and business, and business and consumers to create decent jobs while pursuing inclusive growth with flexible social safety nets. At this critical juncture in the search for sustainable growth, a pro-business policy environment is key for economic vitality.

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