ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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Korea Policy Brief

OECD Better Policies Series

October 2016

www.oecd.org/korea

Economy

RAISING PRODUCTIVITY THROUGH INNOVATION AND STRUCTURAL REFORM

- Labour productivity per hour worked in Korea is only half of that in the top half of OECD countries, mainly explained by the service sector.
- With Korea facing the most rapid population ageing in the OECD area, narrowing the productivity gap is essential to sustain output growth and boost living standards.
- Korea has a number of strengths: Its R&D intensity and university graduation rate for youth are the highest in the OECD and the country has a large number of firms at the technology frontier.
- To make the most of these strengths, Korea needs a range of reforms to promote competition and innovation, and improve SME performance.
- Korea would benefit from participating the OECD's Global Forum on Productivity, which enables countries to exchange lessons on policies to boost productivity growth.

What's the issue?

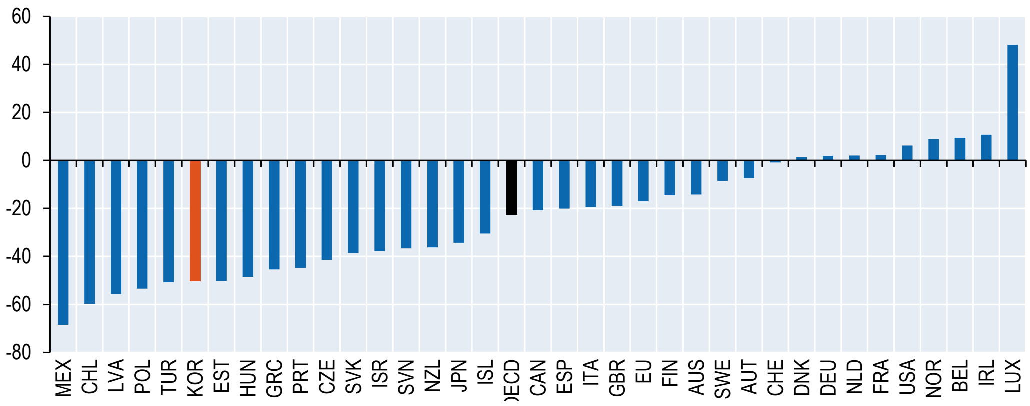
Korea is facing strong competition in global markets from other economies, notably China. Meanwhile, high household debt, stagnant service-sector productivity and struggling SMEs have constrained domestic demand. Productivity growth, which was the fastest in the OECD area between 1990 and 2010, averaging more than 5% a year, has fallen to 0.8% since 2011, close to the OECD average.

Labour productivity is only half of that in the top half of OECD countries (see Figure), although it is partially offset by an exceptionally large input of labour. Low productivity is mainly due to the service sector, where output per hour of labour input was only 45% of that in Korea's manufacturing sector in 2014. In contrast, service-sector productivity in the OECD area is 90% of that in manufacturing. Low productivity in services reflects Korea's export-led development, which has siphoned capital, talent and other resources away from services and toward manufacturing. In addition, R&D investment is low in services, accounting for only 8% of total business R&D in 2014, compared to one-third or more in most OECD countries.

The service sector is dominated by SMEs, which account for around 90% of service-sector jobs. Labour productivity in SMEs has fallen from 53.8% of that in large companies

Labour productivity in Korea is only half of the top half of OECD countries

GDP per hour worked, percentage difference with top half of OECD countries, 2015



Note: Compared to the weighted average using population weights of the 17 OECD countries with the highest GDP per capita in 2015 (based on 2015 purchasing power parities).
Source: OECD, National Accounts, Productivity, Employment Outlook and Economic Outlook Databases.

in 1988 to only 30.5% in 2014, as large firms have expanded investment in labour-saving technology. Converging to productivity levels in the most advanced countries requires narrowing the productivity gaps between manufacturing and services and between large and small firms.

To achieve higher productivity, the government has introduced policies, such as the 2013 creative economy initiative, which calls for "combining science, technology and ICT to energise existing industries". While such policy initiatives to boost innovation are welcome, low service-sector productivity is also explained by weaker competitive pressures and relatively stringent regulations, resulting in a less efficient use of resources. Korea's product market regulation indicator was the fourth most stringent in the OECD in 2013 and the service sector is subject to four times more regulations than manufacturing. In addition, entry barriers impede the creative destruction needed to boost productivity growth. Barriers to entrepreneurship in Korea were the seventh highest in the OECD area in 2013. Entry and exit rates in both manufacturing and services – a measure of economic dynamism – fell markedly between 2001 and 2013, though they picked up somewhat in 2014-15. Lower entry barriers would raise both employment and productivity growth.

Why is this important for Korea?

Korea needs sustained growth to achieve convergence to the highest-income countries and to cope with rapid population ageing, which is projected to be the fastest in the OECD area. Korea's population, currently the fourth youngest in the OECD, is expected to be the third oldest by 2050. With the working-age population peaking in 2016, there will be downward pressure on the size of the labour force. Policies to reduce obstacles to the employment of women, youth and older persons are important to slow the decline in the labour force. However, even with a rise in labour force participation, productivity will remain the main source of growth for Korea.

Higher productivity would enhance well-being if it were accompanied by a reduction in working hours and, hence, improvements in work-life balance. Working hours are currently 17% above the OECD average. Long hours for Korean men limit their role in family responsibilities and constrain the employment choices of women. For women in the labour force, working time is the longest in the OECD and three-quarters work more than 40 hours per week. Long hours reduce the quality of life, discourage female employment and reduce the fertility rate, which is the lowest in the OECD area.

What should policy makers do?

- Promote a culture of work-life balance and high productivity, with a special focus on the public sector.
- Relax remaining barriers to trade and investment to help firms better connect to global innovation networks.
- Strengthen R&D links between academia, business and government by promoting the mobility of researchers.
- Use the new "cost-in, cost-out" system to reduce the regulatory burden, focusing on the service sector, based on accurate Regulatory Impact Assessments.
- Gradually scale back and streamline government support to SMEs, while concentrating it on firms at an early stage of development and avoiding long-term public support.
- Develop the service sector by levelling the playing field with manufacturing and strengthening competition through the elimination of entry barriers.

Further reading

Jones, R. and J. Lee (2016), "Raising Korea's Productivity through Innovation and Structural Reform", *OECD Economics Department Working Papers*, No. 1324, OECD Publishing. http://www.oecd-ilibrary.org/economics/raising-korea-s-productivity-through-innovation-and-structural-reform_5jlr3tl19gkd-en

OECD (2015), *The Future of Productivity*, OECD Publishing. http://www.oecd-ilibrary.org/economics/the-future-of-productivity_9789264248533-en