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April 2013

Beyond Korean style: Shaping a new growth formula



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The Seoul Office provides pro bono assistance to various national and municipal governmental organizations, chairing committees such as the Foreign Investment Advisory Council and the Seoul International Business Advisory Council. The office also supported the Seoul G20 Business Summit and contributes to the world’s understanding of Korea with publications such as this report and *Korea 2020: Global perspective for the next decade*. The office is headed by McKinsey Director Wonsik Choi, who was appointed McKinsey Korea managing director in 2012.

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Beyond Korean style: Shaping a new growth formula

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Executive summary

South Korea has set many records for economic and social achievement. From one of the world's poorest nations in the 1960s, it has grown to be the 12th-largest economy in GDP (about \$1.1 trillion), with \$30,000 of GDP per capita.¹ It is the only nation to go from a recipient of the Organization for Economic Co-operation and Development (OECD) Development Assistance Committee's aid to becoming a member of the donor committee. It is a global leader in the manufacture of ship building, LCD screens, mobile handsets, and memory chips, and is the fifth-largest global automaker. Its corporations have become global leaders, and its athletes win Olympic medals and golf championships. The heads of both the World Bank and United Nations were born in Korea, and the K-pop music and Korean entertainment waves have swept Asia and the world.

Yet South Korea also has the highest suicide rate among OECD nations. Its divorce rate has soared, and the fertility rate has fallen to the lowest in the OECD. These are symptoms of a society in stress. The cause of that stress is largely economic: slowing wage growth and soaring spending on housing and education have left more than half of middle-income households cashflow-constrained. Household debt has more than doubled, and South Korea's household saving rate has plummeted from among the world's highest to the lowest among the OECD nations.²

It is increasingly apparent that the export-oriented growth formula that helped the large Korean conglomerates drive economic development and raise incomes is running out of steam: GDP continues to grow, but the progress of the national economy has begun to decouple from the lives of many South Koreans, who have seen their fortunes wane. The current trajectory leads to growing inequality, falling consumption growth, and—eventually—a population that is too small to sustain GDP growth.

This report, prepared by the McKinsey Global Institute (MGI), arrives 15 years after MGI's first report on South Korea in 1998. Then the most pressing issues for the economy were the heavy reliance on debt by South Korea's large industrial corporations and their declining productivity. Those issues have been resolved. In the past decade, South Korea's largest manufacturing companies have raised productivity by more than 9 percent annually and have become leading global competitors. Corporate debt ratios have fallen from around 300 percent of company net worth to 110 percent.³

1 2012 estimate adjusted for purchasing power parity, World Economic Outlook Database, International Monetary Fund, October 2012.

2 For details on growth of household debt see, *Debt and deleveraging: The global credit bubble and its economic consequences*, McKinsey Global Institute, January 2010. See also *Debt and deleveraging: Uneven progress on the path to growth*, McKinsey Global Institute, January 2012.

3 Statistics Korea (KOSTAT), 2012.

However, as the largest companies have become more productive and more globalized, they have hired fewer workers at home; their share of domestic employment has fallen by one-third from 18 percent to 12 percent, even as they have expanded rapidly overseas (Exhibit E1). Job creation now falls to the service sector and South Korea's small and medium-sized enterprises (SMEs), and this has exposed the weakness of both sectors. While the service sector has some globally competitive players, notably in air transportation, engineering, and construction, most of the sector is concentrated in low value-added local businesses, such as restaurants and small shops.

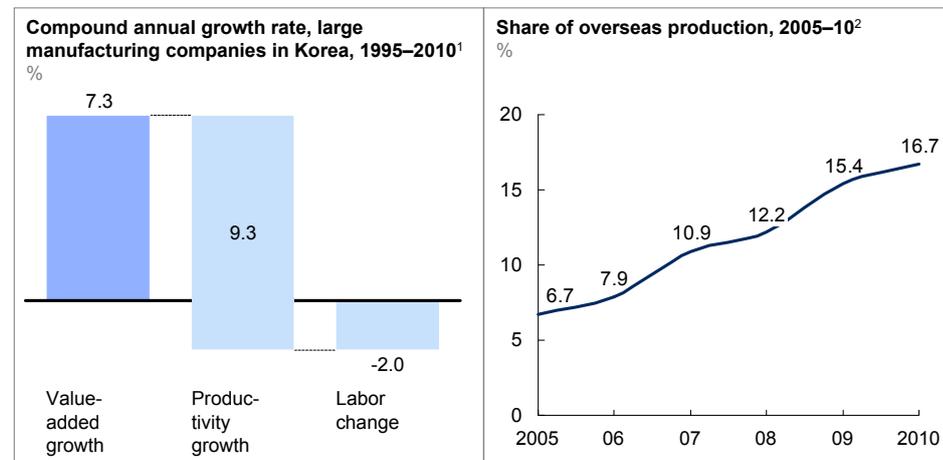
The SME sector is made up almost entirely of very small enterprises, with very few companies growing to mid-sized or large businesses. Korea today is missing the entrepreneurial culture that is seen in other nations and that once helped create the great chaebol. As a result, service companies and SMEs have only 35 to 40 percent of the productivity of large companies and do not offer the high-paying, long-term employment that South Korea's major corporations have provided and that raised living standards for middle-income households for 30 years.

Exhibit E1

Large Korean manufacturing companies have grown rapidly, but productivity gains and overseas expansion have made it “jobless growth” at home

Large manufacturing companies have raised productivity and cut domestic employment ...

... while growing overseas operations rapidly



¹ Manufacturing companies with more than 300 employees from Mining and Manufacturing Business Survey.

² Share of total revenue from overseas operations, 2010.

SOURCE: Statistics Korea; Export-Import Bank of Korea; McKinsey Global Institute analysis

The central message of this report is that South Korea needs a new growth model that restores the financial health of middle-income families, raises consumption, and addresses social and structural problems that threaten the nation's long-term prospects. This message, it should be noted, also has relevance for China and other rapidly developing nations that will likely face similar challenges as they reach South Korea's per capita income level. As these economies mature and are less able to sustain growth from exporting manufactured goods, they, too, will need to raise domestic consumption and build up non-manufacturing sectors.

To move forward, South Korea needs to go back and build the sectors and institutions that did not develop fully as it pursued its economic “miracle” with export-driven industrialization. It must pay more attention to non-tradable sectors

that are essential for generating domestic demand and job creation, but which have not benefited from consistent and well-executed government policy. The nation can no longer afford to have a service sector that is heavily dominated by low-productivity local businesses. Nor can it depend on millions of tiny enterprises to provide jobs for middle-income families. A new growth model is needed that builds up high-value services, enables small businesses to flourish and expand, taps the talents of South Korea's highly educated workforce, and restores financial strength to middle-income families. Such a plan can unleash a virtuous cycle in which rising incomes lead to higher rates of consumption and investment, enabling more growth and further income gains.

THE FINANCIAL CRUNCH ON SOUTH KOREA'S MIDDLE-INCOME HOUSEHOLDS

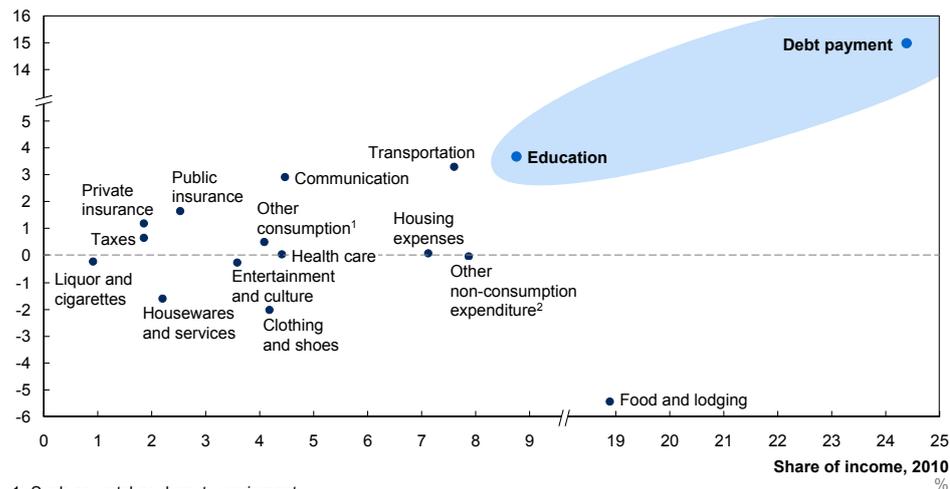
Many of Korea's problems cause or emanate from the rising financial stresses on middle-income households. The root causes begin with slowing income growth, which is the result of the shift in the sources of job creation to lower-paying services and SMEs. This is compounded by lifestyle choices: most South Korean families cling to a traditional family economic structure, with a single male wage earner. Only about 44 percent of South Korean households have two incomes, compared with an average of 57 percent across OECD nations. South Koreans also shoulder high monthly payments for housing loans and spend more on private education than almost any society on earth. This spending on housing debt and education has risen sharply in the past 15 years (Exhibit E2).

Exhibit E2

Debt payment and education fees are the largest and fastest-growing expenditures for South Korean middle-income households

Based on top 40–60% income level

Change in share of income, 1990–2010
Percentage points



1 Such as watches, beauty equipment.

2 Such as transfer payments between households, donations to nonprofit organizations.

SOURCE: Statistics Korea; McKinsey Global Institute analysis

As a result of this pattern in income growth and spending, the financial situation of middle-income households (those earning from 50 to 150 percent of the median income of \$37,000) has deteriorated substantially over the past two decades.⁴ Because of slowing income growth, the number of households in

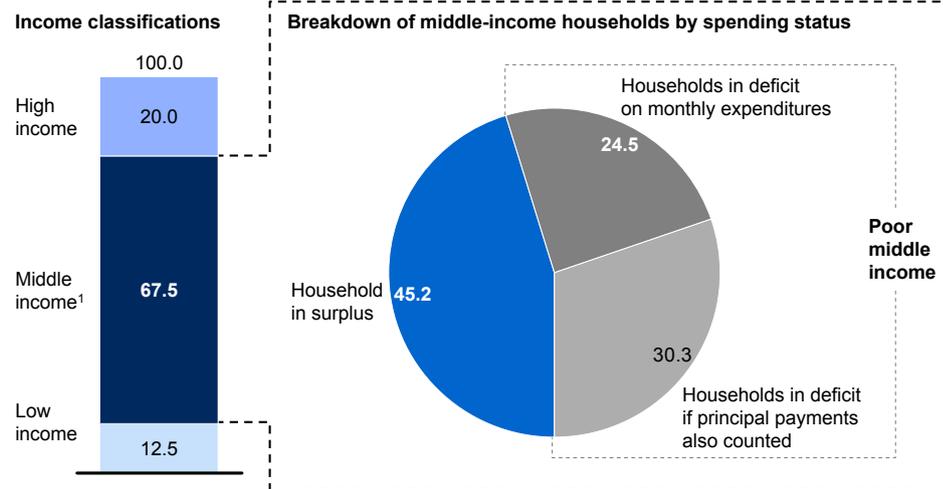
4 In this report, we use Korean won and US dollars. We translate won into dollars using the average Won-Dollar exchange rate from Bank of Korea for 2012.

the middle-income cohort has fallen from 75.4 percent of the population to 67.5 percent, and a rising share of those who remain are cashflow-constrained. They face sharply higher costs for home loans, and families with children are engaged in an education “arms race”—laying out large sums for years of private schooling and tutoring to prepare children for college entrance examinations. South Korea’s household saving rate has plunged from around 19 percent in 1988 to 4 percent in 2012, among the lowest in the OECD group, and the proportion of middle-income households operating in deficit—paying out more in expenses every month than they take in—has jumped from 15 percent to 25 percent. Even this understates the magnitude of the problem. Most South Korean mortgages are of short duration and require high monthly principal payments that are not counted in the monthly expenditure data. If these payments were counted, nearly 55 percent of middle-income households could be considered to be in deficit—part of a growing “poor middle-income” cohort (Exhibit E3).

Exhibit E3

The proportion of middle-income households in deficit would be 54.8 percent if all expenditures and debt payment costs were counted

2010
%



¹ 50–150% of median income.

SOURCE: Statistics Korea; McKinsey Global Institute analysis

Middle-income South Koreans face both high housing prices and high financing costs. Home prices in South Korea are 7.7 times the median income, far higher than in other advanced economies, and the wealth of South Korean families is nearly three times as concentrated in real estate as the wealth of US families (Exhibit E4). And around 53 percent of household debt is housing-related, or more than twice the US level.

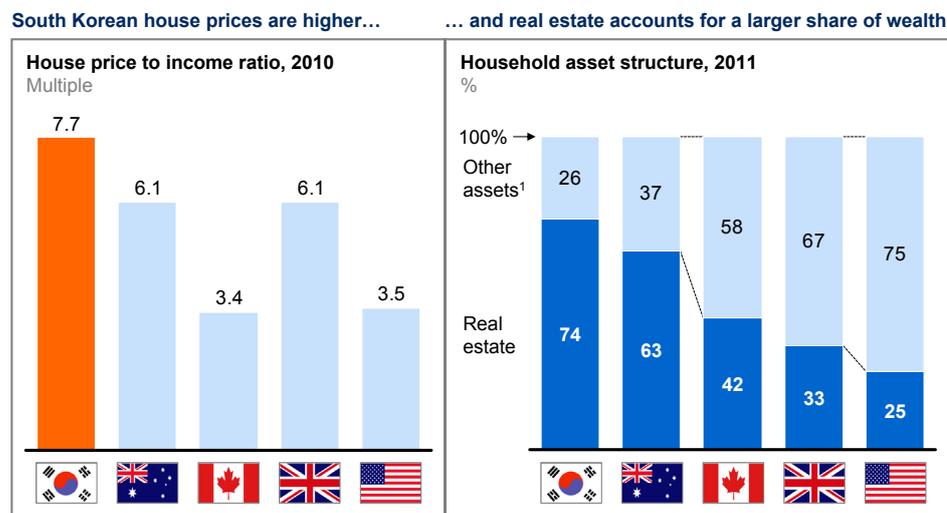
The high degree of urbanization in South Korea helps explain why house prices are relatively high. But the ways in which South Koreans finance home purchases add additional costs. Most mortgages are of short maturities—about ten years—requiring large monthly principal payments.⁵ About 90 percent of loans have floating interest rates, exposing borrowers to surges in interest payments. In addition, a policy of tight loan-to-value (LTV) limits, which was intended to avoid a housing bubble and problems in the banking system, has inadvertently caused

⁵ Research on household finance, NICE Credit Rating, 2011.

a rise in high-cost housing debt. The average mortgage is for 51 percent of the home price and many purchasers—particularly young families—take out additional higher-cost loans from second-tier banks and other financial institutions to finance more of the purchase price. The spread on a loan to cover 80 to 90 percent of a purchase price is 4 percentage points over a 50 percent LTV loan, or twice the premium charged in the United States.⁶ This is one reason why Koreans spend twice as much on debt service (as a share of income) than the average US household does.

Exhibit E4

House prices are high, as a multiple of income, and South Koreans have more wealth tied up in housing than do citizens of other advanced economies



¹ Real assets including financial assets and equipment.
SOURCE: Central banks and data agencies of respective countries; Haver Analytics; McKinsey Global Institute analysis

Regulatory measures to curb the growth of household debt have added more complications. In 2011, authorities announced “soft landing” measures to relieve some of the burden on homeowners. The intent was to encourage issuance of long-term, non-deferral loans to reduce monthly debt payments. However, the officials also removed the grace period for low- and middle-income households that were paying only interest on their mortgages. This has forced more of them to make early principal payments when housing values fell and LTV ratios rose; unlike in almost any other country in the developed world, South Korean mortgage lenders can demand equity payments whenever LTV ratios exceed 50 percent.

South Korean families also place an extremely high value on higher education and have engaged in an “education arms race”. These families are willing to pay fees for private after school classes and hire private tutors to give their children a chance to enter an elite university. They believe, with justification, that the public education system does not prepare students adequately for rigorous university entrance exams. The high cost of education is a clear factor in limiting family size and depressing the fertility rate.

⁶ SNL Financial, Federal Reserve websites, 2012.

Unfortunately, because of the high cost of private education, the net present value of lifetime earnings for a student who attends private college and works to the average retirement age of 57 now trails that of students who go directly from high school to employment.⁷ Nevertheless, South Korea has the highest rate of college attendance among OECD nations: 71 percent of high school graduates are admitted to four-year colleges.

As long as South Koreans overextend themselves to finance homes and educational expenses, growth in the consumer economy will be limited. Housing and tuition payments will continue to crowd out other types of spending, and South Korea will struggle to create a more balanced economy that relies on both consumer spending and exports.

SOUTH KOREA'S UNDERDEVELOPED SERVICES SECTOR AND SMALL SMES ARE NOT CREATING HIGH-PAYING JOBS

A prime cause of the financial straits of middle-income South Koreans is the state of the nation's service sector and its SMEs. Because of the weakness in these kinds of companies, South Korea is more vulnerable to the effects on income from the decline in manufacturing employment. Across economies, employment in manufacturing rises quickly as a share of total employment as nations industrialize, but the share of GDP and employment contributed by manufacturing declines as economies become wealthier and their service sectors grow.⁸

South Korea has a few standout service industries, such as air transportation, engineering, and construction, that are globally competitive and provide high-value services and create high-paying jobs. However, most of the service sector remains concentrated in low value-added industries, particularly "local services" such as retail, transportation, and restaurants, which are often one-person establishments (Exhibit E5). The productivity level of South Korean services is only 40 percent of that of manufacturing industries, a larger gap than in other nations. Overall, service-sector productivity, measured as value added per employee, is 30 to 57 percent below levels in the United States, the United Kingdom, and Germany.⁹

South Korea's SME sector is also less developed than that of other advanced economies: the productivity of SMEs is only 35 percent that of large companies and small and medium-sized manufacturing companies are only 27 percent as productive as large ones.¹⁰ The SME population is dominated by very small enterprises, and many business owners have no entrepreneurial aspirations; only 0.07 percent of SMEs grow to become large companies.¹¹ This reflects both a lack of entrepreneurial culture and the significant challenges that small companies face in Korea. In particular, the high degree of trading between companies within the same chaebol limits the available market for many SMEs. For example, more

7 *Monthly labor review*, Korea Labor Institute, May 2011.

8 See *Manufacturing the future: The next era of global growth and innovation*, McKinsey Global Institute, November 2012.

9 OECD STAN data (Rev. 4) for sector employment and GDP in 2009 (purchasing power parity-adjusted using EU KLEMS data).

10 Statistics Korea. Definitions of SMEs are derived from the SME Basic Law, under which definitions vary by industry. For instance, manufacturing SMEs are defined as companies with fewer than 300 full-time employees or less than \$7 million of capital (8 billion Korean won). Labor productivity figures do not include public administration and defense sectors.

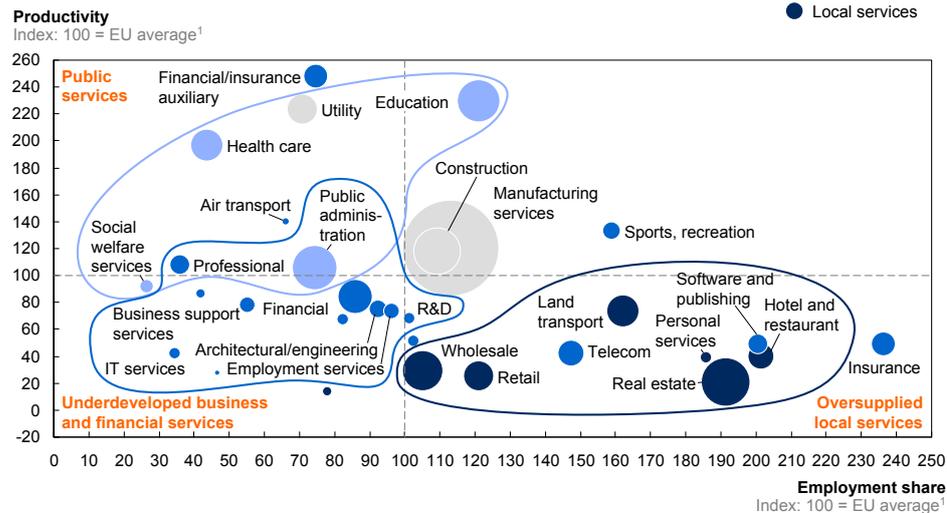
11 *The Korean Hidden Champion Strategy*, Ministry of Strategy and Finance (MOSF), Ministry of Knowledge Economy (MKE), Financial Services Commission (FSC); March 2010.

than half of IT services in South Korea are purchased by large corporations from “captive” supplier companies in their groups.¹² SMEs face additional challenges to fund the R&D investments that would lead to innovations that would make them more competitive. Also, with low salaries and limited potential for career growth, SMEs have difficulty in competing for the most highly skilled talent.

Exhibit E5

South Korea has too many low value-added local services and few high-value services

Employment share and productivity of Korea vs. EU average, 2009



1 Average of six European countries (Denmark, Finland, France, Germany, Italy, Netherlands) in 2009.
SOURCE: EU KLEMS; OECD STAN (ISIC Rev.4); McKinsey Global Institute analysis

LABOR MARKET CHALLENGES CAUSED BY FAMILY STRUCTURE AND LOW FERTILITY RATES

A final set of challenges arises from patterns of participation in the labor market and family formation. While South Korea has an enviable unemployment rate (about 3.9 percent, or half the OECD average), that figure obscures a more complex reality. According to the Hyundai Research Institute, the unemployment rate would be closer to 11 percent if a full accounting were made of the unemployed and underemployed.¹³ There are large clusters of the hidden unemployed, including more than 900,000 college students who have left school temporarily to seek work to support their education or are studying for exams to pursue specialized training (e.g., law).¹⁴ Other members of the uncoun- ted unemployed include discouraged workers who have ceased to seek employment. The underemployed include many part-time workers, most of whom would prefer full-time work—about 803,000 South Koreans are involuntary part-timers, according to the Korea Employment Information Service. The hourly pay gap between full- and part-time workers has widened in the past decade—today part-timers make 65 percent of full-time pay, down from 81 percent.¹⁵

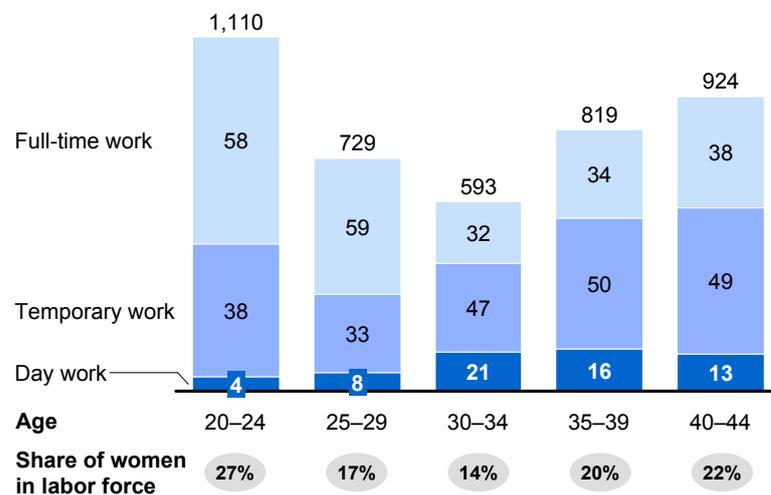
12 Fair Trade Commission of Korea, 2012.
13 *Long-term unemployment since the 2012 global crisis*, Hyundai Research Institute, 2012.
14 *Employment trend research*, Statistics Korea, 2012.
15 J. M. Fournier and I. Koske, *Less income inequality and more growth—Are they compatible? Part 7. The Drivers of labour earnings inequality—An analysis based on conditional and unconditional quantile regressions*, OECD Economics Department working paper, number 930, 2012.

As noted, South Korea has far fewer dual-income households than other advanced economies. Most South Korean women withdraw from the labor force when they marry or have their first child. Female labor participation rates for women aged 30 to 39 are 15 percentage points below the national average (of just 57 percent).¹⁶ There is little effort by employers or the state to help mothers return to their jobs. The long working hours expected by Korean employers also make it difficult for two parents to work full time and it is the woman who inevitably stays home, where she takes on the full-time work of managing her child's education. When women do eventually return to the labor force, it is often in part-time and/or low-skill work, regardless of education and previous experience (Exhibit E6).

Exhibit E6

Women over 30 and mothers returning to the labor force are more likely to take temporary or day work

Female employment by job type, 1992–2011¹
Thousand



1 20- to 24-year-old women in 1992, tracked through 2011.

SOURCE: Statistics Korea; Korean Women's Development Institute; McKinsey Global Institute analysis

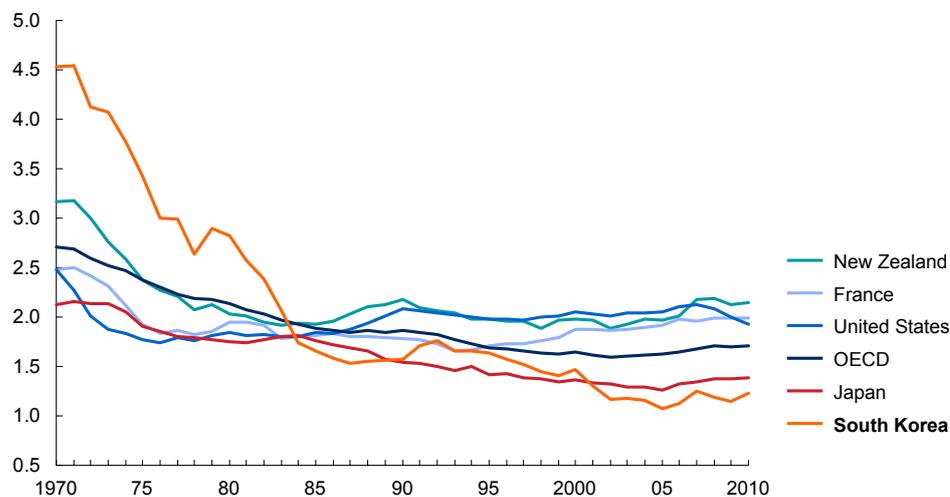
Plunging fertility rates are perhaps the most troubling outcome of the financial crunch that is decimating the middle-income families in South Korea. Births have been trending down since the 1980s across advanced economies, partly as a natural outcome of rising wealth. However, in South Korea's case, the birth rate has fallen even more than in other advanced economies (Exhibit E7). To accumulate savings to fund home purchases and private educational services, South Korean couples are marrying later and limiting family size. The impact of the low birth rate is already seen in a shrinking working-age population; the contribution of working-age population to GDP in South Korea is falling by 1.1 percent annually, a more severe impact than in Germany and other aging advanced economies. The result is a soaring dependency rate (the number of retirees for every active worker). While the government has put into force policies to increase fertility in various ways, it is unclear whether the policies have been effective.

¹⁶ OECD statistics on employment, 2011.

Exhibit E7

The South Korean fertility rate has fallen by two-thirds since the 1970s

Total fertility rate¹



¹ Number of children a woman would bear if she experienced, at each age, the current period age-specific fertility rates (and she survived to the end of her child-bearing years, ages 15–49).

SOURCE: Eurostat New Cronos Database; Statistics Korea; Organisation for Economic Co-operation and Development (OECD); McKinsey Global Institute analysis

DESIGNING A NEW SOUTH KOREAN GROWTH PLAN

It will take efforts on several fronts to put South Korea back on a sustainable growth path. It will require changes both in policy and in the behavior of private-sector players, as well as citizens. We suggest initiatives in four areas: repairing middle-income finances, creating high-quality service-sector jobs, bolstering the SME sector, and addressing demographic/household structure issues such as low fertility rates.

Strengthen middle-income household finances

To foster stronger middle-income households that can boost domestic consumption and create a virtual cycle of growth, job creation, and investment, middle-income families must get out from under the excessive burdens they take on to buy homes and educate children.

We recommend two approaches for reducing the cost of borrowing. The first is to move to the longer-term, fixed-rate mortgages that are common in other developed economies. The second recommendation is to reduce the share of high-cost lending from second-tier banks and non-financial companies by loosening loan-to-value standards. If homeowners who now use high-cost secondary loans in addition to mortgages could roll that debt into higher-LTV mortgages, we estimate that the burden on households could be reduced by an estimated \$8 billion (around 9 trillion Korean won) annually.

To enable longer-duration, higher-LTV lending without introducing excessive risk for first-tier banks, South Korea may need to explore some type of mortgage securitization system. One option is issuance of government-backed “covered” bonds such as Germany uses or a mortgage-backed securities market. Either scheme would allow banks to share or offload the risk.

Other policies to reduce housing payments include encouraging a stronger rental-housing sector by allowing more kinds of institutions to invest in apartment projects. Also, South Korea can consider a shared ownership program, such as the one used in the United Kingdom, which allows families to purchase a partial interest in a property. This can help existing homeowners to reduce their monthly payments (by selling a share in their homes to an investor) and makes homes more affordable to first-time buyers.

To reduce the amount that middle-income families spend on private education—upwards of \$100,000 per child—will require both creative policies and an awareness campaign to prompt South Koreans to re-evaluate their assumptions about higher education. Koreans continue to believe that a university education is the only route to a good job, despite mounting evidence to the contrary. Even though college graduates have higher lifetime earnings, because of the large investments that families make in preparing children for university and the tuition that many families pay at private universities, the net present value of a university education now trails the value of a high school diploma. This reality is not well understood. To convince those who fear that not having a college education will mean “losing face,” it must be shown that jobs that do not require a college degree can provide rewards and social status that are similar to those of jobs that do require tertiary education.

In order to reduce spending on private education by middle-income families, South Korea should invest in a dual-track system for secondary and post-secondary education, with a rigorous vocational track that begins in high school. In South Korea, only 28 percent of students receive vocational training in high school, a smaller share than in other OECD nations.¹⁷ Working with corporations and SME associations, educators can tailor vocational curricula to the specific needs of employers. The recently introduced “Meister” high school program is a good start, but it is at an embryonic stage and will require more intensive support from the Korean government to take root and bring vocational training up to OECD levels.

Expand and strengthen the service sector

A central goal of national economic policy should be to improve the capabilities of the service sector, raise productivity, and create high value-added jobs. Building the size and competitiveness of the service sector is a critical economic priority in itself. As is the case in other advanced economies, South Korea’s future will be determined largely by how strong its service sector is. By 2030, we project that a third of exports from advanced economies will be in services, ranging from tourism to business services.

This effort will require a commitment by government to support service industries as it has supported manufacturing and to remove obstacles to growth. It will also require a change in mindsets among South Korean leaders, companies, workers, and civil servants about the potential of the service sector. They need to have confidence in the nation’s ability to adapt and excel in high-quality services. And they need to overcome the lingering belief that the “real” economy involves only heavy industry and manufacturing.

¹⁷ *Students enrolled by type of institution*, OECD statistics on education, 2011.

We identify four segments within the service sector whose potential for growth and job creation warrant special attention: health care, social welfare services, financial services, and tourism.

Even though South Korea is known for providing quality health services through a national insurance system, while spending a modest 6.9 percent of GDP, there are gaps in service quality and health outcomes that can be filled and opportunities that have not been exploited. In particular, South Korea has an underdeveloped primary-care system and limited convalescence-care capacity. These capabilities will become more important as the population ages and the incidence of chronic diseases rises. Even now, emergency hospital admissions for patients with chronic diseases such as diabetes are far higher in South Korea than in other advanced economies. Despite recent increases in capacity, South Korea also has a shortage of convalescence-care facilities, which provide long-term, post-acute care (e.g., for recovery from major surgery or for patients with conditions such as dementia). South Korea's health-care industry also has the potential to get a larger share of the rising flow of medical tourists who come to Asia. South Korea should take advantage of all these opportunities to expand health care and create new employment in the sector.

South Korea is also under-investing in both private and public social welfare services such as child care and elder care. South Korea spends about 6 percent of GDP on social welfare services, compared with 9 percent across OECD nations.¹⁸ Building up public-sector and private-sector social service capabilities would both open up new job opportunities in such organizations and help relieve women of child-care and elder-care duties that keep them from participating more fully in the workplace. Because social welfare services are so labor-intensive, they have a very high multiplier effect: currently for each 1 billion Korean won (or \$900,000) in additional output, social welfare services require nearly 40 new workers, more than three times the rate across industries.

The financial services industry in South Korea is relatively small for an advanced economy. While high value-added financial services such as banking and asset management contribute more than 7 percent of GDP in the United Kingdom, Singapore, and Hong Kong, they generate only about 4.7 percent of South Korean GDP.¹⁹ A stronger financial services sector not only would create more high value-added jobs, but also could play an instrumental role in facilitating growth across the economy. A national goal should be to lay the foundation that attracts or nurtures financial players that can join the ranks of Asia's top financial institutions. South Korea would need a change in mindset to treat financial services as a source of growth as opposed to simply a support for the "real" economy. Then policy makers might encourage consolidation of its domestic financial sector and support Korean players to scale up regionally in selected niches where they can win, and also to address regulation and governance issues.

The final major opportunity for growth in the service sector is tourism, which amounts to about 2.4 percent of South Korean GDP, compared with nearly 4 percent on average in OECD nations in 2010. South Korea is an increasingly

¹⁸ Social transfers intended to relieve households of the financial burden of social risks or needs.

¹⁹ This analysis of higher value-added financial services includes banking, asset management, and related financial services. Low-value job sectors such as insurance and pension sales are excluded. Source: Global Insight.

popular destination for tourists, but its tourism market is dominated by low-budget tours and the number of repeat visitors has been falling.

We believe that South Korea can increase repeat visits and compete for higher-spending tourists by competing for the MICE (meetings, incentives, conventions, and exhibitions) business, diversifying tourist attractions, and addressing the inconvenience foreigners encounter in getting around. To attract more business meetings and conferences, South Korea would need to invest in new infrastructure, such as convention centers, which has worked in places such as Singapore. Today, 80 percent of tourists do not venture beyond Seoul. To change that, greater diversity of attractions is needed. One promising additional category is winter sports resorts. The number of foreign visitors to the nation's ski resorts more than doubled from 190,000 in 2007 to 400,000 in 2011. The 2018 Pyeongchang Winter Olympics will put the South Korean ski facilities in the global spotlight.

In addition to policies targeted at these four industries, South Korea's leaders should look for ways to help services industries such as the design engineering and construction business and the entertainment industry to build on their strengths.

Bolster the SME sector

The South Korean economy is dominated by SMEs, which account for 90 percent of employment. A large portion of these businesses are owned by the self-employed, who launch or buy a business due to lack of job opportunities. There are few role models of successful entrepreneurs, and parents would rather see their children strive for job security at a big company than take risks and try to be the next Steve Jobs.

The lack of entrepreneurial capability and innovation in small and medium-sized businesses now stands in the way of economic progress. South Korea needs a dynamic SME sector to create high value-added jobs that will help repair middle-income finances and contribute to services exports. It needs more small companies to survive and grow into mid-sized enterprises, and it needs larger mid-sized companies that can create good jobs and can evolve into large companies.

To bolster the SME sector, policy makers will need to clear the path to entrepreneurship and provide assistance to help small and medium-sized businesses scale up. To start, the government can correct policies that discourage small businesses from expanding. Currently business owners whose companies are in operation for at least ten years can pass on their companies to their children without incurring inheritance taxes if the enterprise is below a certain value. This discourages owners from taking on partners to expand or merging.

A thriving SME sector also requires modern bankruptcy laws that make it easier to recover from the inevitable failures that occur when entrepreneurs try to innovate. And innovators need strong protection for their intellectual property.

To encourage entrepreneurialism, particularly in technology sectors, we would recommend using government-sponsored (sovereign) investment funds to acquire enabling technologies for small companies. This can be done by purchasing or taking stakes in overseas companies that have leadership in promising new

areas. As in the financial services industry, a Temasek-like institution could play an instrumental role in nurturing new companies and technologies. To raise operational and strategy-crafting skills, South Korea should create the equivalent of Japan's SME University system.

Finally, as Israel has done, South Korea can jump-start a robust venture capital industry with state-owned funds. A venture capital community would not only improve access to private equity funding, but also could play a critical role in developing sectors through mergers and acquisitions (M&A). Additional reforms, such as making leveraged buyouts easier, can help spur innovation and activate M&A between small and medium-sized companies.

Raise female labor participation and address falling fertility rate

South Korean families continue to arrange their lives as if they were still living in the days when a single wage-earner (invariably male) could support a middle-income family and pay for a home and educational expenses. Because women continue to drop out of the labor force to marry and raise children at higher rates than in other nations, middle-income families expose themselves to higher levels of financial stress, and the economy is deprived of the productive power of millions of able workers.

The government has recognized the need to make it easier for mothers to choose to work outside the home and recently raised child-care subsidies by more than 20 percent a year.²⁰ Yet the number of dual-income families has not risen significantly. South Korea needs a series of initiatives that will enable women to work up to their capabilities, even after the birth of a child. This will mean flexible work schedules, more generous maternity benefits, and prioritized access to child care and after-school care. There are many models, from Sweden, the Netherlands, and other advanced economies, for how to bring mothers into the labor force and create better work/life balance for all families.



South Korea has been sitting at an economic crossroads for many years now. By itself, the growth formula that brought the nation out of poverty and into wealth no longer serves the overall society. The large companies and global manufacturers that produced the economic miracle—and the system that supports them—will continue to make enormous contributions. But South Korea needs to find another route to prosperity that will work for all its citizens. A long-term plan is urgently needed to ease the burden of housing and private education costs that are depressing family finances and sapping economic vitality. At the same time, the barriers to success of service companies and SMEs must be removed. The growth of the conglomerates that drove the economy in the past should be balanced with growth among SMEs and service industries to write another success story for South Korea.

²⁰ Ministry of Health and Welfare, October 2012.

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