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A Family Divided-Labor Market Duality in Korea

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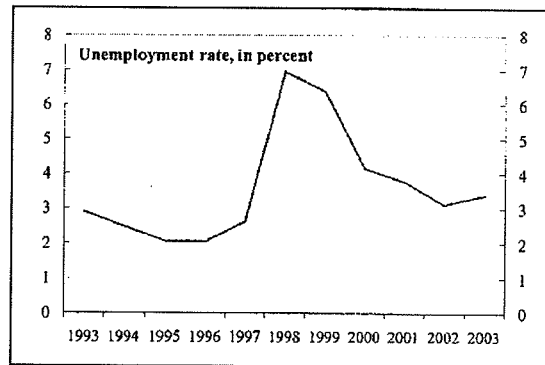
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III. A FAMILY DIVIDED—LABOR MARKET DUALITY IN KOREA¹

A. Introduction

1. **Korea's rapid recovery from the 1997–98 financial crisis was facilitated by labor market reforms.** Such reforms included emergency legislation to allow dismissal of workers for “urgent managerial reasons,” legalization of temporary work, increased government expenditure on labor market programs, the expansion of the Employment Insurance System, and the introduction of a “productive welfare” system through the National Basic Livelihood Security Law (NBL). These steps facilitated corporate and financial restructuring. They also supported the quick return to low unemployment rates, at 3½ percent recently.

2. **While total unemployment rate has been low in Korea, the labor market is increasingly characterized by a high degree of “duality.”** There is a core of regular workers, who are harder to dismiss than their counterparts in most other OECD countries, partly because employers are required to “exhaust all means” before laying off workers. Moreover, procedures for dismissals can be particularly cumbersome. Because of the high cost of regular workers, employers increasingly have turned to nonregular workers to fill positions, raising their share to one-third of total employees, one of the highest in the OECD. Nonregular workers, especially in small and medium enterprises (SMEs), face job insecurity and weak enforcement of minimum labor standards, lower wages, and low levels of social protection.



3. **The government has recognized the problems associated with the divided labor market, releasing in late 2003 a “Reform Proposal for Industrial Relations.”** This proposal aims to create a new framework for industrial relations that would allow the government to step back from individual labor disputes, narrow the divide between regular and other workers, and make labor relations less confrontational. In order to increase labor market flexibility, the employment protection framework would be reformed by shortening the notification period for dismissals and easing conditions of dismissal for companies undertaking bankruptcy proceedings. It also includes measures to improve the social safety net, including by expanding the social insurance systems, and to increase protection for nonregular workers.

4. **This paper analyzes the causes and macroeconomic consequences of Korea's dual labor market and discusses the government's reform proposals.** The paper is organized as follows: Section B describes the main features of the labor market and the social safety net.

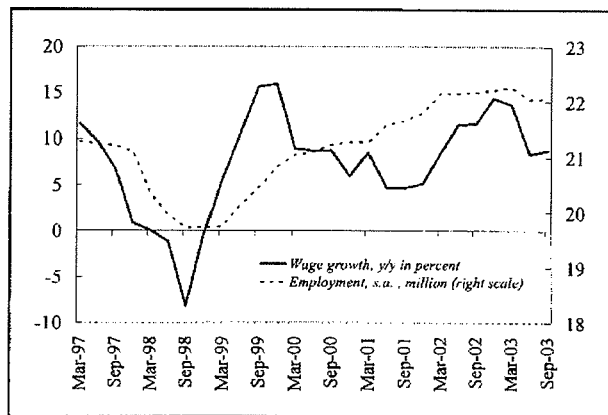
¹ This paper was prepared by Dong He and Thierry Tressel (APD).

Section C analyzes the causes and consequences of labor market duality. Section D discusses the major elements of the government's reform proposals and Section E reviews relevant experiences of labor market reforms in other OECD countries. Section F concludes.

B. Labor Market Structure and Institutions

Market structure

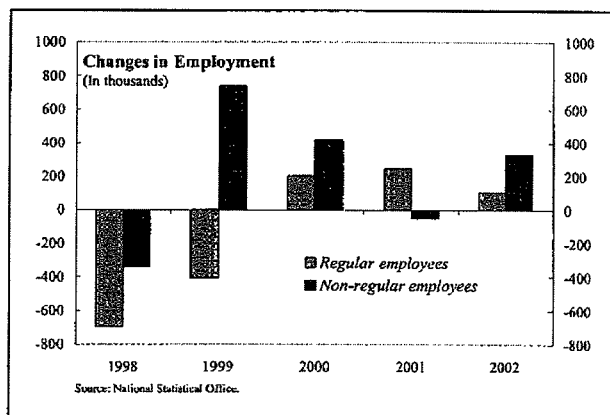
5. **The 1997–98 financial crisis had significant impact on the labor market.** Unemployment rose sharply, from 2.6 percent in November 1997 to a peak of 8.6 percent in February 1999, while labor force participation fell by 1.5 percentage points between 1997 and 1999. Unskilled workers and young workers were the most affected. Wages responded flexibly, falling by 5.9 percent in nominal terms and 12.5 percent in real terms between July 1997 and July 1998, cushioning the impact on employment. Unemployment soon returned to pre-crisis levels, while wages partly recovered their pre-crisis levels in 1999. Nevertheless, labor force participation rates remain low, at 65.4 percent, about 5 percentage points below the OECD average, partly because female participation is still low, at 53.4 percent. Younger workers experience structurally higher rates of unemployment, associated with both longer job search and less stable jobs.



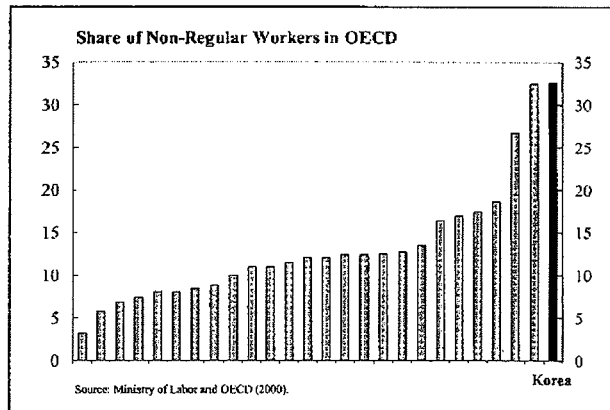
| | 2001 | 2002 | 2003 |
|--------------------------------|------|------|-----------|
| | | | Jan-Sept. |
| Total | 3.8 | 3.1 | 3.4 |
| High School Graduates or Lower | 3.7 | 3.0 | 3.3 |
| Junior College Graduates | 5.4 | 4.7 | 5.0 |
| Youth (15-29 years old) | 7.5 | 6.7 | 7.6 |
| High School Graduates or Lower | 8.0 | 7.0 | 8.0 |
| Junior College Graduates | 7.2 | 5.9 | 7.1 |

Source: Jeong (2003)

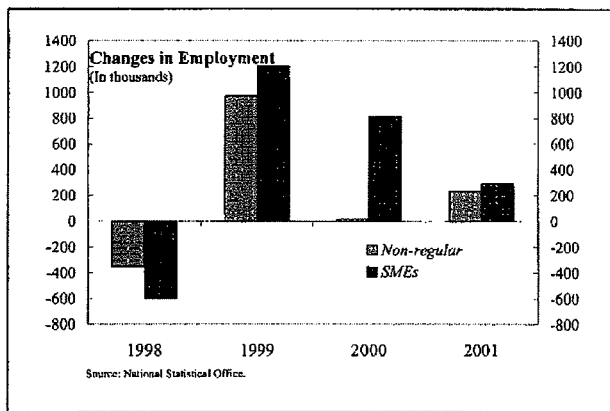
6. **The crisis also reinforced the shift away from regular employment.** The share of regular employment had started to decline before the crisis; however, temporary and daily employment rose sharply as the economy was recovering, accounting for about 90 percent of the increase in wage contracts between 1998 and 2002. Thus, overall labor market flexibility has been achieved through an increasing degree of duality of the labor market. The core of regular workers with a high level of employment protection is supplemented by



a large group of temporary and daily workers, whose numbers can be easily adjusted in line with changing economic conditions. According to the Ministry of Labor, the proportion of nonregular employees stood at 32.6 percent as of August 2003. Measurement problems notwithstanding, this figure is among the highest in the OECD area (Box III.1). The increase in the share of nonregular workers contributed to a decline in the average job tenure. After reaching a peak of 6.1 years in 1998, workers' average tenure in Korea has declined to 5.6 years in 2002. This contrasts with average job tenure of 11.3 years in Japan, 9.8 years in the EU, and 7.4 years in the U.S. in the 1990s.



7. The shift away from regular employment does not simply reflect the expansion of small or medium size enterprises. Employment at SMEs did grow very fast in the wake of the 1997–98 crisis, raising its share in total employment from 74.4 percent in 1997 to 85.6 percent in 2001.² However, a significant share of annual changes in nonregular employment could not be accounted for by employment changes at SMEs.³ For instance, in 1998, at least half of the jobs destroyed at SMEs were regular jobs.⁴ Conversely, employment growth at SMEs was strong in 2000, although the number of nonregular jobs barely changed.



² SMEs in Korea are generally defined as companies employing fewer than 300 employees. More specific definitions are stipulated for agriculture and services, with an employment threshold varying between 200 and 30 employees.

³ From an international perspective, a large and active SME sector is not inconsistent with a dominance of regular jobs: Japan and Germany, for instance, have about 70 percent of wage earners employed in SMEs, even though only 12 percent of employees have nonregular contracts. Another case in point is Ireland, where 72 percent of employees work in SMEs, and less than 10 percent of employees are nonregular workers.

⁴ This is the lower bound estimate, obtained by assuming that all nonregular jobs destroyed in 1998 were at SMEs.

Box III.1. Labor Market Duality in Korea: How Big a Concern?

Labor market duality can be assessed by quantifying the incidence of precarious jobs. In principle, precarious jobs are found among employees and among non-employees (i.e., self-employed and unpaid family workers). However, non-employees account for a negligible share of employment in most OECD countries. Therefore, the OECD focused on temporary jobs among employees to count and analyze precarious jobs. The OECD defined temporary jobs (or nonregular jobs) as “those forms of dependent employment which, by their nature, do not offer workers the prospect of a long lasting employment relationship” (OECD, 2002). This definition includes fixed-term contracts, temporary agency workers, daily workers, contracts for a specific task, replacement contracts, etc.

Data published by the Korean National Statistical Office (NSO) suggest that Korea has the highest share of nonregular employees among OECD countries. According to the NSO, the share of regular employees in total employment stood at 32.6 percent in the third quarter of 2003, less than the share of non-employees (35.6 percent) and about the same as the share of nonregular employees (31.8 percent). Hence, the share of regular employees in total employment is much lower than in all OECD countries: regular jobs accounted for more than 60 percent of total employment in most OECD countries in 1998 (Martin and Torres, 2000). Only Spain had a similarly high level of nonregular jobs (about 25 percent of total employment). Self-employment is also very high in Korea, and unpaid family workers were about 8 percent of total employment in the third quarter of 2003, while they account for less than 3 percent of employment in most OECD countries.

| | |
|-------------------------------------|------|
| Total | 100 |
| Employees | 64.4 |
| Regular | 32.6 |
| Nonregular | 31.8 |
| <i>Of which</i> : Temporary workers | 22.4 |
| Daily workers | 9.4 |
| Non-Employees | 35.6 |
| Self-Employed | 27.7 |
| Unpaid Family Workers | 7.9 |

Source: National Statistical Office

The distinction between regular and nonregular workers is reflected in a number of dimensions. Nonregular workers are paid lower wages, are entitled to fewer benefits, and are not well covered by the social safety net. Nonregular workers earn 20 percent less than regular workers, after controlling for various factors (OECD, 2003). In addition, they are excluded from certain benefits such as severance pay (which is also a “retirement allowance”) and childcare and maternity leave. Finally, they are not well covered by the social safety net either because they are not eligible (as a result of the short duration of contracts), or because employers do not comply with mandated social contributions. Thus, less than 8 percent of nonregular workers are covered by unemployment insurance, medical insurance, or the national pension (Cho, 2003).

The actual number of nonregular employees—according to the OECD definition—is likely to be significantly lower, however, than reported by the NSO. The NSO defines nonregular workers as those who have contracts of less than a year, and those who are not entitled to several fringe benefits. Hence, a large number of employees are classified as nonregular because they have no written work contract or are not entitled to certain allowances, even though they remain with their employer on a longer-term basis. Excluding such workers, the Ministry of Labor estimates that 32.6 percent of employees (equivalent to 21 percent of total employment) had nonregular jobs in August 2003, instead of the 49.4 percent as estimated by the NSO. Meanwhile, the OECD has calculated that only about 17–18 percent of employees are temporary workers, by reclassifying certain categories (such as contractors) into self-employment. Even in this case, the proportion of temporary employees in Korea remains high by OECD standards; it is well below the proportion of temporary employees in Spain (31.5 percent), but about the same as in Mexico and Portugal. Moreover, adding non-employees with precarious jobs (such as unpaid family workers) to temporary employees would reinforce the perception of a dual labor market.

8. **Wages for regular workers have been growing much faster than those for nonregular workers.** While wages for regular workers have been growing at close to double digits in recent years, nonregular workers have seen their wages stagnate. Wage differentials by size of enterprises are also substantial: after controlling for workers' observable characteristics such as gender, education, tenure, age, and jobs' characteristics, such as industry and unionization, firms with over 500 employees were found to have paid wages about 20 percent higher than firms with less than 30 employees (Jeong, 2003). Another factor contributing to the wage differentials between regular and nonregular workers is the seniority-based wage system in Korean firms. As regular workers typically stay employed with the same employer for a long period of time, their wages grow automatically with seniority.

| Wage Differentials (In percent) | | | |
|------------------------------------|-------|-------|-------|
| | 2000 | 2001 | 2002 |
| Large firms to small firms | 122.5 | 124.3 | 119.5 |
| Regular to nonregular workers | 125.3 | ... | ... |

Source: Jeong (2003).

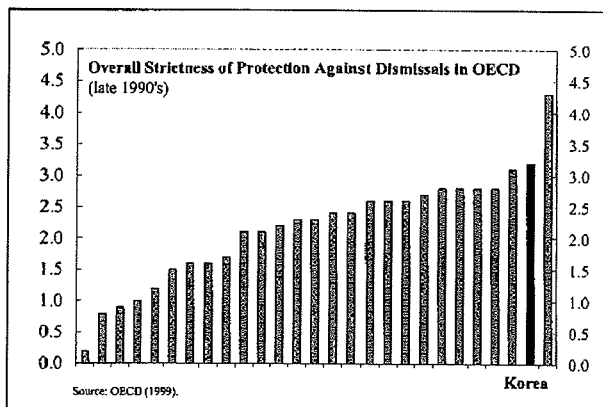
9. **Income inequality has widened since the crisis.** Between 1995 and 1999, the Gini coefficient increased from 0.28 to 0.32, and remained stable since then. The ratio of the income of the richest 10 percent of households to the poorest 10 percent rose from about 3.8 in 1997 to more than 4.2 in 2002 (Choi, 2003). While such changes in income distribution might reflect complex economic and social forces at work, such as the structural rise in the demand for skilled labor and direct consequences of the 1997–98 financial crisis, one additional explanation is that the growth of nonregular jobs in smaller firms widened wage inequality toward the bottom of the distribution (Choi and Kim, forthcoming).

Employment protection

10. **Korean regular workers enjoy some of the strongest employment protection in the OECD.** The strict preconditions for terminating an employment relationship (at least in firms with five or more employees) led the OECD to rank Korea 2nd out of 27 countries in a comparison of the strictness of employment protection for regular workers (OECD, 1999a). According to the Labor Standards Act (LSA), an employer cannot dismiss, suspend, or take other discipline action against an employee without “just cause.” The LSA does not specifically state what reasons will constitute just cause; however, precedent has set a high standard for what constitutes “just cause.” An employer who has committed an unjust termination may be subject to criminal sanctions and/or civil remedies, including imprisonment for up to five years or a criminal fine of up to W 30 million.

11. **The LSA introduced in 1998 the concept of redundancy dismissal and employment adjustment for “managerial reasons”, which were further defined by a reference to “transfers, mergers and acquisitions.”** The LSA revision also defined preconditions for collective dismissal, in other words, those involving large number of employees. Layoffs, including for “urgent managerial reasons,” have to follow stringent criteria and procedures. These include: (i) the employer must make every effort to avoid dismissals, in other words,

dismissals should be used only as the last resort in adjusting the workforce; (ii) the selection of employees to be dismissed must be based on fair and reasonable criteria; (iii) the employer must consult sincerely (in good faith) with trade unions as to the measures to avoid dismissals and selection of dismissed workers; and (iv) employee representatives or unions must be notified at least 60 days in advance of layoffs.



Industrial relations

12. **The characteristics of industrial relations system and the role of unions in Korea have been affected by legal provisions as well as by economic conditions.** Labor rights were restricted under the authoritarian political regimes in the past. Since the late 1980s, the emphasis of reforms has shifted from ensuring smooth industrialization and economic development to strengthening labor rights by guaranteeing the autonomy of the bargaining system and bringing labor legislation in line with internationally-accepted standards. Nevertheless, the lack of mutual trust between labor and management remains deep-rooted, often leading to hostile confrontations and destructive strikes.

13. **Despite the low penetration rate of 11 percent, labor unions in Korea have been influential because of the high unionization rate among large firms.** Economic troubles experienced by large downstream firms can be spilled over quickly to small upstream firms through the web of subcontracting. Prolonged work stoppages in large downstream firms place small upstream firms at risk because work stoppages often result in delayed payments to the upstream firms which do not have easy access to external finance.⁵

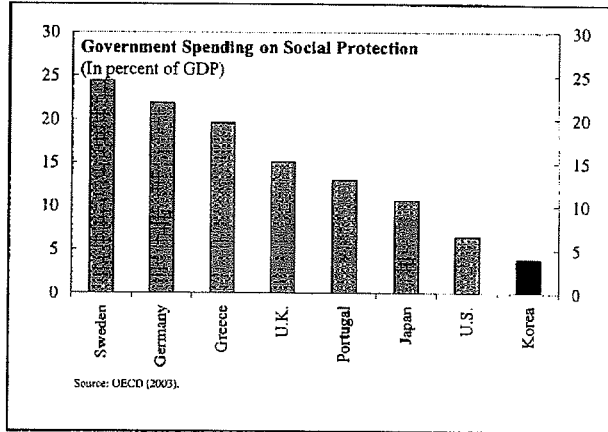
| | 2001 | 2002 | 2003 |
|--------------------------------------|---------|---------|---------|
| Number of strikes | 235 | 322 | 320 |
| Workers involved (persons) | 88,500 | 93,809 | 137,241 |
| Lost working days (000s) | 1,083 | 1,580 | 1,299 |
| Production loss (in billions of won) | 2,126.9 | 1,717.7 | ... |

Source: Ministry of Labor.

⁵ 75 percent of SMEs in the manufacturing sector supplied more than 95 percent of their output to downstream firms (Kim, 2002).

Social safety net

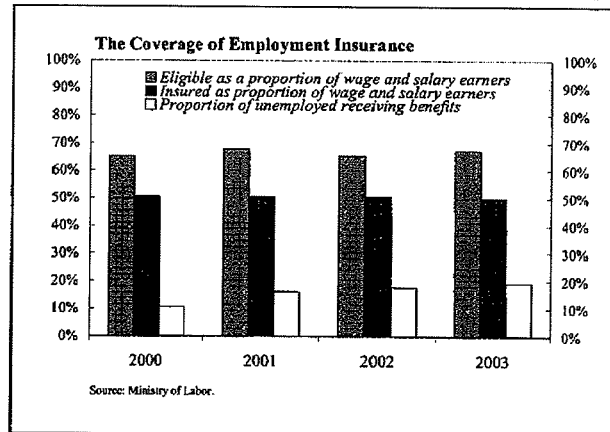
14. **The social safety net has developed relatively recently.** While in the past the extended family has provided a source of income support for those falling in poverty, its role has declined as family ties have weakened as a result of modernization. Budgetary allocation for welfare spending has increased following the crisis, rising at 18 percent on average since 2000. However, government spending remains low as compared to other OECD countries, reflecting the late development of social insurance and pension systems.



15. **The coverage of the Employment Insurance System (EIS) remains low, despite major steps taken.** After the crisis, the coverage of the EIS was expanded to all firms, and the length of the employment period required for eligibility was shortened. Moreover, the benefit duration and the minimum amount of benefit have been increased. As a result, unemployment benefits are now comparable to other OECD countries. However, the coverage of the EIS remains limited. While 67 percent of wage and salary workers are now eligible, only 50 percent are insured.⁶ Moreover, only about 19 percent of the unemployed receive benefits, mainly because uninsured workers are more likely to become unemployed. The main reason for the limited coverage of the EIS is the non-compliance of employers with social contributions, especially in small businesses. A recent study of the EIS estimates that the average compliance rate stood at 53 percent in 2000, with noncompliance being concentrated among SMEs (Cho, 2003).

| | Payment Rate | Minimum Benefit Annual (US\$) | Maximum Benefit Annual (US\$) | Duration Months |
|---------------|--------------|-------------------------------|-------------------------------|-----------------|
| Germany | 60% | ... | 30,890 | 12 |
| United States | 50% | 4,524 | 15,600 | 6 |
| Japan | 80% | ... | 20,209 | 10 |
| Korea | flat rate | 4,348 | 6,798 | 9 |

Sources: OECD (2002), and Ministry of Labor.
Note: 1999 purchasing power parities are used to compute US\$ amounts.



⁶ Daily workers, with less than one month of employment, and part-time workers who work less than 18 hours weekly, could not participate in the EIS before January 2004.

16. **The traditional social assistance program has been modernized with the introduction of the National Basic Livelihood Security Act.** The NBLA, in effect since 2000, provides cash benefits for those earning less than the official poverty line. Benefits have been raised, and are now close to the minimum cost of living (OECD, 2000). However, only about half of the poor receive benefits because the eligibility criteria are unusually strict. For example, eligibility depends on the capacity to earn (not the actual income) of the extended family (not of the household).

17. **Various active labor market programs were introduced during the crisis to supplement the EIS.** Some of them, including job subsidies and public works, have been gradually phased out as the economy recovered. The impact and performance of these programs were considered poor, because of lack of targeting, and perverse incentives created by the relatively high cash benefits provided by the public work program (OECD, 2000). Training programs for the unemployed were also expanded. While their performance was weak initially, they appear to have improved over the past years, as the employment rate of training graduates rose from 21.8 percent in 1998, to 41.9 percent in 2002.⁷ Various steps have been taken to improve programs, including better targeting, financial incentives of training institutes based on performance, and closer links to the local labor markets.

C. The Causes and Consequences of Labor Market Duality

What causes the increase in nonregular employment?

18. **In OECD countries, there appears to be a close association between the strictness of employment protection for regular workers and the share of nonregular employment.** Countries that have stricter employment protection legislation for regular workers also tend to have higher nonregular employment (Booth *et al.*, 2002). In contrast, Ireland, the U.K, and the U.S., countries that have low levels of employment protection, have very low rates of temporary employment despite having no regulations against the use of such contracts. Cross-country analysis suggests that temporary contracts are typically used as substitute for regular contracts, as there does not appear to be any relationship between employment growth and the change in the share of temporary employment (Garibaldi and Mauro, 2002).

19. **In Korea, several factors explain the increasing duality of the labor market after the crisis.** More reliance on nonregular jobs reflects firms' attempts to cut labor costs and increase their capacity to adjust their labor force in line with economic conditions, as regular workers are more expensive to hire and fire, in both monetary and administrative terms. Structural shifts in labor demand, including declining demand for less skilled workers, and the need to reallocate

⁷ A robust analysis of the performance of those programs controlling for trainees' characteristics is not available. Thus, the conclusion is only tentative.

production after the crisis, may have also made employers reluctant to offer regular contracts to such workers.⁸

20. **The changes to dismissal standards introduced in 1998 have not made it easier for viable firms to adjust regular employment.** In fact, most job losses in 1998 were due to bankruptcies, especially among SMEs. Moreover, redundancy for “managerial needs” accounted for only a tiny proportion of job losses (6.3 percent in 1998, and 1.2 percent in 2001), and only 32 collective dismissal cases, involving 2,390 employees, were reported to the authorities in 2000.⁹ Indeed, it has been argued that the new regulations have made it more difficult to lay off workers (Kim, 2002). Before the crisis, redundancy layoffs were not banned as the Supreme Court had acknowledged managerial needs for layoffs in previous rulings. Arguably, by introducing strict procedural requirements, the new legal provisions, intended to suppress excessive and unnecessary layoffs, imposed severe constraints on firms’ ability to lay off workers. For instance, the necessary “sincere” consultation with unions could turn confrontational, and prevent adjustments in the labor force whenever there were divergent views regarding economic conditions.¹⁰ Similarly, the requirement to “exhaust all means” to avoid layoffs could, in practice, make lay-offs almost impossible.

Does labor market duality reinforce confrontational industrial relations?

21. **Labor market duality reinforces the bargaining power of unions because workforce adjustments are likely to be borne first by nonregular, non-unionized workers.** Moreover, given the lack of a secondary market for regular jobs, and the high risk of being downgraded into nonregular and unstable jobs, workers oppose flexibility even if they would not remain unemployed for long periods. In addition, the underdeveloped social safety net leaves Koreans little means of making ends meet once they are out of a job, increasing workers’ resistance to increased flexibility.

22. **Confrontational industrial relations in Korea also reflect the “insider-outsider” problem.** First, there is the tension between workers in large unionized firms and workers in small, unorganized firms. High wage growth as a result of union bargaining in large firms limits growth of jobs in those firms. Workers unable to find jobs in large firms because of the high wage growth look for jobs in smaller firms, effectively increasing labor supply to smaller firms. This widens the wage gap between workers in small and large firms. Moreover, the monopsony power of large downstream firms implies that wages at upstream SMEs cannot compete with

⁸ The rising demand for skilled workers relative to unskilled workers is illustrated by the observation that the college premium rose from 47 percent in 1995 to 52 percent in 2001 (Jeong, 2003).

⁹ As reported by the Ministry of Labor.

¹⁰ A case in point is Hyundai Motor Co. which was able to lay off only 277 employees in 1998 (instead of the 8,000 originally planned), despite a 40 percent capacity utilization rate in March 1998 (Choi and Kim, forthcoming).

those at large firms. Second, there is the tension between the employed and the unemployed. As union members lose membership when becoming unemployed, the jobless population's interests are not internalized by unions when negotiating over wages and employment conditions.

23. **Legal restrictions on union activity may also have contributed to union militancy.** The OECD has pointed out that, as a result of the broad definition of "unlawful acts" and the wide definition of "essential services" where strike action is severely restricted, police action against strikers in Korea has in the past been triggered by a lower level of disruptive action than in many other countries, hindering efforts to foster a stable industrial relations climate (OECD, 2000).

Is labor market duality bad for equity and efficiency?

24. **Labor market duality raises concerns for the welfare of nonregular workers.** Wage differentials between nonregular and regular jobs do not reflect observable components of productivity: the average wage penalty associated with a temporary contract is significant, and oscillates between 10 percent and 27 percent in most OECD countries, after accounting for workers' and jobs' characteristics (OECD, 2002). In addition, the short duration of temporary jobs—usually less than a year—often disqualifies nonregular workers from benefits. In Korea, less than 8 percent of nonregular workers are covered by the unemployment insurance, the national pension or the medical insurance (Cho, 2003). This is a source of concern because nonregular workers are likely to disproportionately bear the unemployment costs of labor demand shocks.

25. **Labor market duality has negative consequences for efficiency.** Empirical evidence shows that nonregular workers receive less formal training by their employers than regular workers, after accounting for workers' and jobs' characteristics (OECD, 2002). This is a concern for human capital accumulation if mobility into regular employment is limited. Moreover, a large share of nonregular employment is likely to reinforce the bargaining power of insiders who feel more insulated from labor demand shocks. As insiders are able to obtain higher wages, firms' incentives to invest in new technologies diminish.¹¹

26. **An adequate level of mobility of the core segment of the labor force is important to the growth of total factor productivity.** High firing costs may reduce the economy's average productivity by maintaining a fraction of the workforce working with technologies that are not up-to-date (Saint Paul, 1999). Even if on-the-job training could promote learning-by-doing, it is questionable that it will be sufficient to adapt to major technological shocks. Recent growth theory indeed considers that the essence of the growth process is a continuous inflow of new firms making old firms obsolete, with the associated waves of job destruction and job creation (Aghion and Howitt, 1998). The entry of new firms increases productivity indirectly as well, by forcing incumbent firms to be more efficient, in particular in innovative industries (Aghion *et al.*,

¹¹ For instance, Bentolina and Dolado (1994) show that, in Spain, an increase of one percentage point in the temporary employment share raised the growth rate of permanent workers' wages by about 0.3 percent.

2003). In particular, a conducive business environment and adequate job opportunities in younger firms will permit new entrants to challenge the market power of large incumbents by allowing the former to attract talented workers. In such a world, an adequate level of labor mobility is crucial to promote economic growth.

D. The Government's Reform Proposals

27. **The new government of President Roh has recognized the critical importance of improving industrial relations and enhancing the efficiency of the labor market in Korea.** The government believes that the lack of flexibility of the core segment of the labor market presents a major impediment to achieving the strategic goal of making Korea a business hub for northeast Asia. Accordingly, the Ministry of Labor set up in May 2003 a "Research Committee on Industrial Relations System Development", comprised of 15 academic specialists, with a view to developing proposals. Based on the report of the research committee, the Ministry of Labor issued its own "Reform Proposal for Sound Industrial Relations," laying out an action plan to take policy measures to improve industrial relations, increase labor market flexibility, and strengthen social protection for vulnerable workers.

28. **The Tripartite Commission is discussing the proposals of the research committee with a view to developing consensus among the social partners.** The government plans to submit legislation to the National Assembly on issues that have been thoroughly discussed by the Tripartite Commission. It will gradually promote the issues that are raised for the first time in the proposal after discussions by the Tripartite Commission. The government has also pledged to enforce laws dealing with illegal strikes, as well as combating unfair labor practices by employers, and strengthening the social safety net.

29. **The first objective of the reform proposals is to minimize social costs associated with industrial conflicts.** The government aims to prevent excessive industrial action by helping labor and management maintain a balance of power. To this end, both workers' basic rights and employers' counter-rights will be strengthened by revising relevant labor law provisions, taking into account recommendations by the ILO and the OECD. The rights of association will be strengthened by, among others, allowing the unemployed to join non-enterprise level trade unions, and legalizing payment of wages to full-time union workers. While easing institutional restrictions on industrial action (for example, by abolishing the concept of "essential public services" where strike action is prohibited or severely restricted), employers will be allowed to have lockouts regardless of the legitimacy of industrial actions. Employers will also be allowed to use replacement workers through new recruitment and subcontracts in cases of legal strikes in public services.

30. **The second objective of the reform proposals is to increase labor market flexibility while ensuring job stability.** Dismissal standards will be relaxed by shortening the notification period and easing conditions of dismissal for companies undertaking bankruptcy proceedings. The advance notice period for dismissal will vary depending on the scale of dismissal, with a 60-day upper limit. Criminal punishment for unfair dismissal will only be imposed on repeated unfair dismissals. Labor laws will also be amended so that there will be greater clarity in the

terms of labor contracts in cases of ownership change such as mergers and acquisitions. It is proposed that employment rules and collective agreements should be honored by the new employers for certain specified periods of time (for example, one year).

31. **The third objective of the reform proposals is to strengthen social protection for vulnerable workers.** The government aims to reduce income gaps between workers of large companies and SMEs, and between regular and nonregular workers, and to strengthen mechanisms for redressing discrimination against nonregular workers. To increase job security for fixed-term workers, those working for the same employer for over two years through multiple contract renewals will be entitled to the same rights as regular workers and thus enjoy the same standards of dismissals. The government also plans to expand the coverage of the employment insurance and industrial accident compensation systems over nonregular workers. A major obstacle to expanding the coverage of social insurance programs has been the failure of reporting and making contributions by employers at small enterprises. To tackle this problem, the government is planning to upgrade legal enforcement, including by allowing workers to register themselves with the Employment Insurance System. Labor market programs for long-term unemployed and aged workers will also be strengthened.

32. **The reform proposals of the Ministry of Labor offer more flexibility to management in exchange for greater support of union activities.** If the reforms are implemented, they will be an important step contributing to more harmonious industrial relations and more efficient labor market outcomes in Korea. However, additional reforms would be needed to increase flexibility significantly. The procedure and requirements in case of lay offs for managerial reasons would remain stringent, and the requirement of using dismissals as last resort will continue to keep employment adjustment costs high.

E. Lessons from International Experience

33. **To fight rising structural unemployment, many OECD countries implemented labor market reforms in the 1980s and 1990s.** Countries that have been the most successful in reducing structural unemployment are those that have been the most determined in implementing a comprehensive range of labor market reforms.¹² Countries have eased the stringency of employment protection, either by easing employment protection for permanent workers (Spain and Finland), or by deregulating the use of temporary contracts.¹³

¹² The OECD (1999) found that the United Kingdom, Denmark, Ireland, the Netherlands, New Zealand, as well as Canada and Australia, had been the best in terms of improving labor market performance.

¹³ Italy, Greece, Korea, Spain and Sweden have allowed the use of temporary work agencies. Restrictions on fixed-term contracts were eased in Germany, Italy, Austria, Belgium, Finland, France, the Netherlands, Portugal, and Sweden among others (OECD, 2002).

34. **There appears to be some degree of substitutability between employment protection and unemployment benefits in OECD countries.** The countries that adopt stronger dismissal restrictions tend to have smaller unemployment insurance programs, and vice versa. This tradeoff reflects political economy considerations: there is more demand for employment protection if unemployment benefits are low. Such observations notwithstanding, stronger competitive pressures, such as those arising in the context of globalization, are shifting the balance of the two institutions in favor of mobility-friendly unemployment benefits. Job-security oriented labor market institutions, which are focused on protection of primary breadwinners' labor income, are proving to be ill-suited to accommodate new demands for mobility, and more broadly, microeconomic adjustment (Boeri and others, 2003). In the context of globalization and fast technological progress, a strategy for Korea would be to strengthen the social safety net while easing employment protection for regular workers.

35. **In order to reduce labor market duality and narrow the divide between regular and nonregular workers, some countries are searching for a middle ground.** Some countries have sought to reduce the job precariousness of nonregular workers by restricting the use of nonregular contracts, but this does not seem to have worked. The Spanish experience in the 1990s is a case in point (Box III.2). Temporary employment in Spain had been rising since the mid-eighties, with no effect on the high rate of unemployment. A first reform in 1994 aimed at restricting the use of temporary contracts was not successful, because such administrative restriction did not address the incentive problems facing the employers.

36. **A more effective approach has been to create incentives for employers to hire regular workers by lowering the costs of such hires, for example, by offering a new type of regular contract with lower labor adjustment costs.** Such a contract is more attractive to employers than the existing permanent contract while at the same time it offers better job security than enjoyed by the current nonregular workers. Again, the Spanish experience is pertinent. A second reform in 1997 led to the introduction of a new permanent contract with lower severance payments for unfair dismissals. This reform appears to have been successful in stimulating growth of regular jobs in the private sector. Between 1997 and 2000, 1.5 million jobs were created in Spain, almost three-quarters of which were hired under the new permanent contracts. As a result, the proportion of temporary employment in the private sector fell markedly.

F. Concluding Remarks

37. **The structure of the Korean labor market is evolving.** Many high-paying and stable jobs were lost during the financial crisis, and they have been largely replaced by low-paying and unstable jobs when the economy recovered. The increasing scarcity of regular jobs reflects their high cost. Strict employment protection for regular workers and union power in large firms reinforce each other, reducing employers' incentives to hire regular workers. In the face of fierce product market competition, employers are likely to continue the trend to hire more nonregular workers in order to contain labor costs. On the other hand, new entrants to the labor market such as college graduates tend to view such temporary jobs as traps and prefer to wait for opportunities to get regular jobs. This imbalance in supply and demand is being reflected in higher unemployment rate and longer job search among the youth.

Box III.2. The 1997 Spanish Labor Market Reform

The Spanish labor market is characterized by strict employment protection for permanent workers, and it has become segmented over the past two decades. Strict employment protection for permanent workers combined with a deregulation of temporary employment in 1984 fueled a sharp rise in the share of temporary employment from about 15 percent in 1987 to more than 35 percent in 1995. Meanwhile, the unemployment rate remained high. In 1994, the government passed a law to restrict the use of temporary contracts, and broaden the definition of dismissals for economic reasons. However, temporary employment continued to rise and effective firing costs did not fall significantly, as courts interpreted the law in favor of workers (Mauro, 1998).

In 1997, the employers' associations and the main labor unions reached an agreement on a reform package to reduce effective dismissal costs and promote employment stability. The intersectoral agreement led to the promulgation of two Decree-Laws which were ratified as Acts by Parliament in June 1997. The main element of the reform was the creation of a new permanent contract, available to groups of workers who had difficulties finding permanent jobs (Mauro, 1998). The new permanent contract differed from the existing one on severance payments. Specifically, the compensation in case of unfair dismissals was reduced to 33 days per year of service (with a ceiling of 24 months pay) from 45 days per year of service (with a ceiling of 42 months pay) for the existing permanent contracts. The existing permanent contracts were not affected by the reform. The new permanent contract was available to certain categories of workers, including certain categories of unemployed workers—long-term unemployed people, unemployed people between the ages of 18 and 29, or above 45—and workers under a temporary contract. To encourage employers to hire under this new permanent contract, social contributions were reduced by 40–60 percent for the first two years of the contract. The agreement was initially valid for four years, after which the performance of the measures had to be evaluated in order to decide whether to abolish or adopt them as permanent.

The 1997 reform was followed by a rise in permanent employment, and contributed in reducing unemployment. Between 1997 and 2000, 1.5 million jobs were created in Spain, 76 percent under permanent contracts (Dolado *et al.*, 2002), as unemployment fell to 13.6 percent in 2000 from 21.4 percent in 1997. Moreover, in 1998, two-thirds of permanent contracts signed were of the new type, and more than 2.5 million new-type permanent contracts were signed between 1997 and 2000 (OECD, 2000 and 2001).

The reform was seen as a success, and the new permanent contract was prolonged in 2001. According to the OECD, the “remarkable” labor market performance in the late 1990s was partly due to the labor market reforms of the 1990s to reduce employment rigidities, even though additional reforms remained necessary to increase flexibility. The proportion of temporary workers fell only slightly, however, to 31 percent in September 2002 from 33 percent in 1997, because the rise of permanent employment in the private sector was offset by higher temporary employment in the public sector (OECD, 2001, and Dolado *et al.*, 2002). The introduction of the new permanent contract contributed significantly in ending the rising trend of the share of temporary employment, as this did not simply reflect the cyclical increase in the demand for labor (Dolado *et al.*, 2002). In 2001, when the new permanent contract was prolonged, the coverage was extended, as only male workers between 30 and 45 years remained on the old contract.

38. **For more efficient labor market outcomes, it would be desirable to both lower the hiring and firing costs of regular workers and expand the coverage of the social safety net.** To be sure, increasing labor market flexibility requires not only reforms of labor laws and institutions. For example, it would also require reforming the seniority-based wage system so that wage flexibility can be improved. Still, further reduction in the costs of labor adjustment, particularly administrative and judicial steps that are seen by firms as the major cost of employment protection legislation, are the key steps necessary for significantly enhancing the flexibility of the labor market, to make it better adapted to Korea's rapid economic development. In the meantime, strengthening the social safety net will help regular workers adjust to a more mobile labor market and promote social cohesion.

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