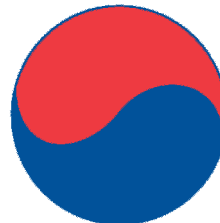


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# STRUCTURAL REFORM

## PROSPECTS FOR INCREASING LABOR MARKET FLEXIBILITY IN KOREA

By Kim Sung-teak

### Introduction

The importance of having an efficient labor market is growing because of recent trends such as globalization, the development of information-communication technology (ICT), and the increasing need for foreign direct investment and job creation. The innovations of ICT can produce higher economic growth with less labor. Under these economic circumstances, labor markets should respond quickly to rapidly changing product markets.

All these trends emphasize the importance of retaining the flexibility of the labor market in a country's economy. What is flexibility in the labor market? Bernard Brunhes in 1989 identified five main elements of labor market flexibility: external numerical flexibility, externalization, internal numerical flexibility, wage flexibility, and functional flexibility.<sup>1</sup>

Generally speaking, though, it is obvious that firms and an economy need to increase their labor market flexibility to compete in the current economic situation. An increase in labor market flexibility might imply a decrease in job security in terms of the typical concept of labor flexibility. If so, the next question would be how to amend laws and collective agreements to increase labor market flexibility without causing large-scale conflict between management and labor unions or workers.

The Korean labor market has been criticized for its lack of the elements of flexibility mentioned above. Some argue that labor market inflexibility is one of the major factors that is obstructing the steady growth of the Korean economy. However, the financial crisis in 1997 changed the structure of the Korean labor market dramatically. As a result, employment protection regulations were partially eased in 1998,<sup>2</sup> and firms tried to resolve all excessive labor and facilities disputes in order to survive and successfully carry out the restructuring process.

However, the increase in labor market flexibility has enlarged distinctions between regular and nonregular workers. Regular workers in unionized companies receive standard protection under the labor laws and the internal labor market practices of corporations. The turnover rate for nonregular workers is growing, however, and their wages are sensitive to current economic situations. In 1999, the turnover rate for nonregular workers was almost twice as high—40 percent—as it was for regular workers.<sup>3</sup> The average hourly wage of nonregular workers by 2005 had fallen to 70.5 percent of the average wage of regular workers; in 2002 it had been 80.7 percent of the wage of regular workers.<sup>4</sup> Therefore, criticism has been raised over the increasing labor market flexibility in Korea only in the area of the nonregular workers.

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1. Bernard Brunhes, "Labour Flexibility in Enterprises: A Comparison of Firms in Four European Countries," in *Labour Market Flexibility: Trends in Enterprises*, Bernard Brunhes, Jacques Rojot, Wolfram Wassermann, 11–36 (Paris: OECD Publishing, 1989).

2. For example, new legislation addressed collective dismissal and the worker dispatch system.

3. Lee Young-myun and Na In-gang, "A Study of Turnover and Tenure of Nonregular Workers" (panel study paper prepared for the seventh conference on Korean labor and income, 2005).

4. Nam Jae-ryang, "An Analysis of Wage Discrepancy between Nonregular Workers and Regular Workers" (paper prepared for the summer conference of the Korea Labor Economics Association, 2006).

To examine the present situation and the trends of labor market flexibility in Korea, the next section compares the labor market flexibility in Korea with that of other countries. This is followed by an analysis of the variables concerning labor market flexibility in Korea and the trends of the variables before and after the financial crisis in 1997. The final section suggests the direction in which to increase the labor market flexibility in Korea.

### **International Comparison of Labor Market Flexibility**

Korea has been categorized as a nation with a high level of employment regulation and employee protection.<sup>5</sup> An international comparison, however, does not indicate that the Korean labor market is highly inflexible among the industrialized countries. In the order of nations with low employment protection regulation, Korea ranked 14th in overall strictness of the regulation among the 27 Organization for Economic Cooperation and Development (OECD) member nations,<sup>6</sup> and Korea ranked 19th when only regular workers were accounted for in the late 1990s. However, in 2003, Korea ranked 13th overall and 16th when only regular workers were surveyed (*Table 1*).<sup>7</sup>

This finding implies that Korea preserves a medium level of strictness in terms of employment protection regulations among the OECD countries. In fact, the regulation change in 1998 eased the strictness. However, the difference between the level of employment

protection for regular workers and for nonstandard workers still exists because, in practice, a large number of nonregular workers are not protected by the regulation. Only one-third of nonregular workers are covered by major social insurance although almost 100 percent of regular workers are.<sup>8</sup>

*Table 2* shows the indices concerning the labor market flexibility from another viewpoint. According to IMD International, when legislation concerning hiring and firing practices, minimum wages, and other regulations is evaluated, Korea ranked 46th among 61 countries in 2005–06.<sup>9</sup> In terms of labor relations, Korea is evaluated as the most hostile.

In practice, however, Korea presents a totally different picture. When one considers hiring and firing practices only, Korea ranked 41st among 117 countries and 6th among 27 OECD countries in 2005–06; this was a large change from 73rd among 104 countries and from 14th among 27 OECD countries in 2004–05.

Thus, the Korean labor market has relatively strict overall regulations for the protection of workers. In Korea, hostile labor relations between management and labor unions make it difficult to ease the regulations toward a flexible labor market. But hiring and firing practices are not very strict in the real labor market because of the existence of large numbers of nonregular workers and small- and medium-sized companies.<sup>10</sup> The large number of nonstandard workers and workers in small and medium-sized compa-

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5. The employment protection legislation in Korea is considered to be strict because of the difficult dismissal procedure in the country. When a collective dismissal takes place, the employer is required to provide notice to the labor union or to an employee representative at least 60 days before the layoff. The severance payment system is also legally mandated. Moreover the difference in severance payments for voluntary and involuntary dismissal is larger than Japan requires. In addition, the grounds for collective dismissal are strict. Dismissal is possible only when there is a fair and urgent managerial reason to do so.

6. *Employment Outlook 2004* (Paris: Organization for Economic Cooperation and Development, 2004). The comparison used the overall index 2, which is the weighted average of indicators for regular contracts, temporary contracts, and collective dismissals.

7. The 1999 OECD analysis has limitations: the rankings of the countries are based exclusively on formal regulations and legislation. The degree to which regulations are applied in reality is different in different nations, but this was considered by the OECD.

8. Kim Sun-teak, "Income Discrepancy and Social Safety Net in Korea," unpublished paper, 2006.

9. *World Competitiveness Yearbook* (Lausanne, Switzerland: IMD International, 2005, 2006).

10. Small and medium-sized enterprises make up 99.7 percent of firms in Korea and about 86 percent in terms of the number of workers in Korea.

**Table 1: Indicators of Employment Protection Legislation, 2004**

Selected areas of the world	Regular employment			Temporary employment			Collective dismissals		Strictness of employment protection legislation				
	Late 1980s	Late 1990s	2003	Late 1980s	Late 1990s	2003	Late 1990s	2003	Overall index 1 <sup>a</sup>			Overall index 2 <sup>b</sup>	
	Late 1980s	Late 1990s	2003	Late 1980s	Late 1990s	2003	Late 1990s	2003	Late 1980s	Late 1990s	2003	Late 1990s	2003
<b>Western Europe</b>													
France	2.3	2.3	2.5	3.1	3.6	3.6	2.1	2.1	2.7	3.0	3.0	2.8	2.9
Germany	2.6	2.7	2.7	3.8	2.3	1.8	3.5	3.8	3.2	2.5	2.2	2.6	2.5
Switzerland	1.2	1.2	1.2	1.1	1.1	1.1	3.9	3.9	1.1	1.1	1.1	1.6	1.6
<b>Southern Europe</b>													
Greece	2.5	2.3	2.4	4.8	4.8	3.3	3.3	3.3	3.6	3.5	2.8	3.5	2.9
Italy	1.8	1.8	1.8	5.4	3.6	2.1	4.9	4.9	3.6	2.7	1.9	3.1	2.4
Portugal	4.8	4.3	4.3	3.4	3.0	2.8	3.6	3.6	4.1	3.7	3.5	3.7	3.5
<b>Northern Europe</b>													
Denmark	1.5	1.5	1.5	3.1	1.4	1.4	3.9	3.9	2.3	1.4	1.4	1.8	1.8
Finland	2.8	2.3	2.2	1.9	1.9	1.9	2.6	2.6	2.3	1.4	1.4	1.8	1.8
Norway	2.3	2.3	2.3	3.5	3.1	2.9	2.9	2.9	2.9	2.7	2.6	2.7	2.6
<b>Eastern Europe</b>													
Czech Republic	n.a.	3.3	3.3	n.a.	0.5	0.5	2.1	2.1	n.a.	1.9	1.9	1.9	1.9
Hungary	n.a.	1.9	1.9	n.a.	0.6	1.1	2.9	2.9	n.a.	1.3	1.5	1.5	1.7
Poland	n.a.	2.2	2.2	n.a.	0.8	1.3	4.1	4.1	n.a.	1.5	1.7	1.9	2.1
<b>North America</b>													
Canada	1.3	1.3	1.3	0.3	0.3	0.3	2.9	2.9	0.8	0.8	0.8	1.1	1.1
Mexico	n.a.	2.3	2.3	n.a.	4.0	4.0	3.8	3.8	n.a.	3.1	3.1	3.2	3.2
United States	0.2	0.2	0.2	0.3	0.3	0.3	2.9	2.9	0.2	0.2	0.2	0.7	0.7
<b>Asia and Oceania</b>													
Australia	1.0	1.5	1.5	0.9	0.9	0.9	2.9	2.9	0.9	1.2	1.2	1.5	1.5
Japan	2.4	2.4	2.4	1.8	1.6	1.3	1.5	1.5	2.1	2.0	1.8	1.9	1.8
Korea	n.a.	2.4	2.4	n.a.	1.7	1.7	1.9	1.9	n.a.	2.0	2.0	2.0	2.0

Source: *Employment Outlook 2004* (Paris: Organization for Economic Cooperation and Development, 2004).

a. Overall index 1 is the average of regular workers and contract workers.

b. Overall index 2 is the weighted average of indicators for regular contracts, temporary contracts, and collective dismissals.

Notes: n.a. = not available. Higher values represent stricter regulations.

nies do not receive protection that the labor laws provide.

Hence, in the Korean labor market there is a segmentation between the regular and the nonregular workers and between the workers in large companies with strong labor unions and those in small- and medium-sized companies. This becomes a serious matter in terms of employment protection as well as gaps in working conditions.<sup>11</sup>

### Trends of Flexibility in Korea's Labor Market

Since the 1997 financial crisis, reforms have been undertaken in labor legislation and in practice to increase the flexibility in Korea's labor market. We now examine important changes in labor market flexibility in Korea after 1997 and compare the current situation with conditions before 1997.

#### Employment Restructuring

After the 1997 financial crisis, Korean companies such as the 30 largest conglomerates, public com-

panies, and financial institutions underwent major restructuring; the number of employees decreased in companies that underwent restructuring. Numbers of workers in these companies decreased from 1,559,000 in October 1997 to 1,221,000 in October 2002.<sup>12</sup> This indicates that the workforce in these companies was reduced by 20 percent and that 332,000 jobs were lost. In other words, during the five years after the financial crisis, the workforce of the largest companies in Korea that went through restructuring decreased by 20 percent.

At companies that underwent restructuring, job accession and separation have occurred more frequently since 1998. The labor mobility rate, which is the accession rate (number of hires/number of employees) plus the separation rate (number of separations/number of employees), rose greatly from 31.3 percent in 1995–96 to 64.5 percent in 1998–99. It then fell slightly to 40.9 percent in 2000–01 and to 39 percent in 2001–02.

Adjusting employment through methods such as rearranging factories within a company also increased. Changes in the workplace indicate labor turnover that

**Table 2. International Comparisons for Labor Market Flexibility, 2004–06**

Country	Year <sup>1</sup>	Labor regulations <sup>2</sup>	Labor relations <sup>3</sup>	Hiring and firing practices <sup>4</sup>
Korea	2005–2006	3.12 (46/61)	3.97 (61/61)	4.1 (41/117)
	2004–2005	3.28 (44/60)	4.00 (60/60)	3.3 (73/104)
France	2005–2006	2.73 (54/61)	4.86 (57/61)	2.4 (112/117)
	2004–2005	2.34 (58/60)	4.82 (54/60)	2.2 (103/104)
Japan	2005–2006	6.09 (16/61)	7.93 (8/61)	3.6 (64/117)
	2004–2005	5.78 (16/60)	7.85 (6/60)	3.2 (75/104)
United States	2005–2006	6.76 (6/61)	7.13 (19/61)	5.3 (7/117)
	2004–2005	6.55 (8/60)	6.86 (25/60)	5.3 (6/104)

Sources: *World Competitiveness Yearbook* (Lausanne, Switzerland: IMD International, 2005, 2006).

1. Year when statistics were published.

2. 0 = hinder business activities, 10 = do not hinder business activities; refers to hiring and firing practices, minimum wages, etc.

3. 0 = hostile, 10 = productive.

4. 1 = impeded by regulations, 7 = flexibly determined by employers.

11. Even though a bill to remedy the problems of nonregular workers passed in November 2006, it is uncertain whether the protections in the bill vis-à-vis nonregular workers and workers in small- and medium-sized companies will be effective in practice.

12. Data cited in this section on employment restructuring are from Ministry of Labor, Employment insurance database, Seoul, Korea, various years.

is caused by business realignment within a corporation. This can be seen as an attempt to increase functional flexibility in the process of corporate restructuring by using methods such as changing the jobs and locations of workers. The rate of hiring through change of workplace increased from 4–5 percent before 1998 to 11 percent in 1998–99. This rate then slightly fell to 6.7 percent in 1999–2000. Through such trends, we witness the increased flexibility of the major Korean companies, which have adjusted their workforce by reassignment.

During the five years after the financial crisis, about 28 percent of employees underwent involuntary job separation, which was led by the aggressive employment adjustment of employers. Among involuntary job separations, recommended resignation with a consolation retirement allowance accounted for 16.5 percent,<sup>13</sup> contract terminations accounted for 7.9 percent, and collective dismissal accounted for 3.4 percent. The figure was slightly higher if there was no labor union and if the company was relatively small.

Because the financial crisis hit financial firms the hardest, the financial sector led the involuntary separations, with 34.4 percent of workers downsized. It is estimated that, for five years, between one-fourth and one-third of the entire workforce in companies in the financial sector underwent restructuring. The involuntary job separation rate was less than 1 percent annually before the financial crisis; however, it surged to 7–9 percent after the crisis. Such a trend could be witnessed at workplaces both with and without labor unions.

### ***Changes in Hiring Methods***

Before the financial crisis, major companies in Korea focused on the “internal labor market hiring method.”

Through this method, companies employed graduating students through a yearly recruitment program and trained them within the firm to meet the specific needs of the company. New trends indicate that, since the financial restructuring, companies have shifted their focus to the external labor market hiring method, that is, they hire experienced people only when they need them.<sup>14</sup> This trend facilitated the need for an externally flexible labor market and a new skill-training system.

### ***Job Duration***

Even though Korea has had rigid employment protection regulations, Korea has not had a long-tenure employment structure. According to the Ministry of Labor’s Basic Survey on Wage Structure in 2000, at workplaces with more than five employees, the average tenure of employees was 6.4 years, and the percentage of workers who held their jobs for less than one year was 19.5 percent.

The proportion of workers with long tenures in Korea is smaller than that of the United States, a nation with the most flexible labor market.<sup>15</sup> In 2000, the percentage of workers with a tenure of more than 15 years in the United States was 18.5 percent, but in Korea it was only 12.5 percent. In Korea, the percentage of workers who held their jobs for less than one year was 34.1 percent, a figure that was only 21.7 percent in the United States.<sup>16</sup>

### ***Changes in Wage Flexibility***

Since the financial crisis, the wages of Korean workers have responded very sensitively to economic conditions (*Figure 1*). In particular, compared with regular pay, overtime pay and bonuses responded more sensitively to economic fluctuations. This was espe-

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13. In Korea, the recommended resignation is preferred over collective dismissal because of the strict management regulations for collective dismissal.

14. Conclusions are drawn from Ministry of Labor, Employment insurance database, Seoul, Korea, various years.

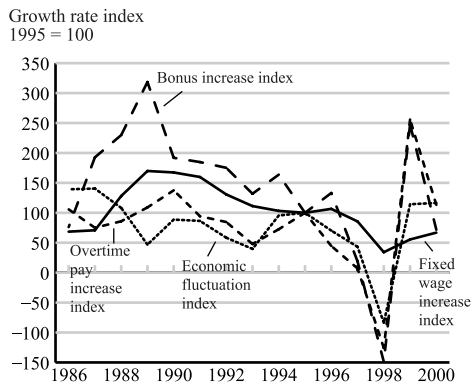
15. “Secondary Survey of the Economically Active Population” (Seoul: Korea National Statistical Office, 2001); “Current Population Survey” (Washington, D.C.: U.S. Census Bureau, 2000).

16. Some people claim that the tenure of employees decreased in Korea because the proportion of temporary and daily workers increased in Korea’s workforce. However, given that the Ministry of Labor’s Basic Survey on Wage Structure was conducted mostly on regular workers, it is unlikely that the reduction in the average tenure of employees occurred exclusively because of an increase of temporary and daily workers.

cially true in the case of bonuses, which tended to be static before the financial crisis. Since the financial crisis, however, bonuses have fluctuated closely with economic fluctuations.

The wage system has also become more flexible. The percentage of workers receiving wages based on an annual salary system surged from 1.3 percent in 1996, to 3.7 percent in 1998, to 12.0 percent in 2000, and then to 19.4 percent in 2002.<sup>17</sup>

**Figure 1: Changes in Labor Indices in Korea, 1986–2000**



Source: Korea National Statistical Office, various years, <http://www.nso.go.kr/eng2006/emain/index.html>.

## Conclusion

To enhance labor market flexibility, the Korean government initiated a series of reforms in labor regulation beginning in 1998, just after the Asian financial crisis. The international evaluation of the flexibility of Korea's labor market is now rating it more highly. The regulations in the labor market, such as requirements for firing, requirements for collective dismissal, and use of dispatched workers, are not changing greatly, but in practice the country seems to be finding its way toward a flexible labor market.<sup>18</sup> For ex-

ample, the proportion of nonregular workers, who are easy to dismiss and reemploy, is increasing, and the application of recommended resignation is growing as a method used to increase the external numerical flexibility. Also, functional flexibility is improving as business realignment within a corporation has increased. The wage system is becoming more flexible. The proportion of employees receiving wages based on an annual salary system has increased rapidly regardless of the size of companies, and the wage system is tending toward change from a seniority-based to a performance-based system.

These general trends that force the Korean labor market to acquire more flexibility also produce additional problems, such as exploitation of nonregular workers, deterioration of workers' skill levels and workers' loyalty to firms, and declines in workers' opportunity to get a decent job.

Therefore the solution to improving labor market flexibility in Korea is twofold. First, the strict protections for regular workers should be eased toward the international standard in order for Korea to compete with global companies. But such a change should accompany a policy of protecting nonregular workers in order to avoid the spread of dualism and polarization. In November 2006, the National Assembly in Korea passed a protection bill for nonregular workers; it was aimed at stopping discrimination and preventing overwork on the part of the workers by the firms. To accomplish this objective, however, the legislation needs to be obeyed in practice by the large number of small- and medium-sized businesses. Employment protection for regular workers needs to be relaxed to make this reform effective.

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17. "Annual Survey on Wage Structure" (Seoul: Ministry of Labor, various years).

18. In fact, the Supreme Court of Korea ruled that companies that want to dismiss employees are not required to fulfill all the conditions in the labor law if the companies' goal is to prevent a future crisis.



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