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Opinions

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Comparative Review of Social Policy Indicators in OECD and Implications for Korea

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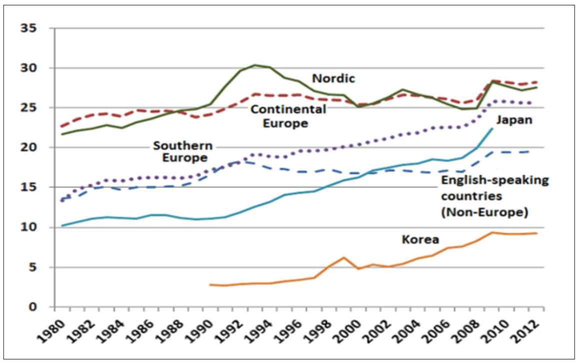
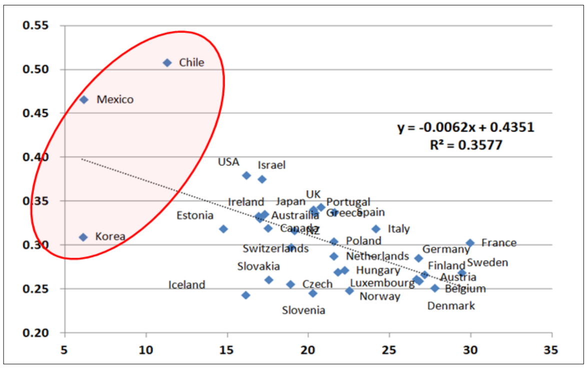
The worries about fiscal sustainability in developed countries have created a controversy regarding welfare policy in Korea, which has managed to achieve a relatively sound fiscal position. Increasing welfare expenditure, which is still far from the average level of other OECD countries as shown in <Figure 1>, has become a key economic issue that attracts much public attention. Fiscal conservatives call for tighter controls on welfare spending, because once spending starts growing, it tends to become hard to reduce and reverse from that point. On the other hand, some call for greater welfare spending in order to temper the effects of economic polarization, social unrest, unemployment, and an aging population. As illustrated in <Figure 2>, the level of welfare expenditure is negatively correlated to the level of inequality measured by the Gini coefficient.

Figure 1. Change in welfare spending (% of GDP)



Source: OECD.

Figure 2. Correlation between welfare spending (% of GDP) and the Gini coefficient

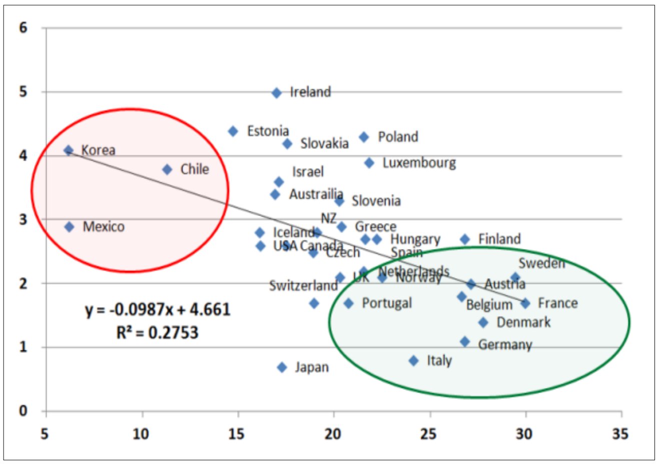


Note: Average welfare spending in 1995-2010 (horizontal axe) and Gini coefficient in 2009 and 2010 (vertical axe).
Source: OECD.

The discussion over the proper size of welfare spending is based on the argument that large governments tend to be inefficient. It is often said that a large government distorts resource allocation and economic activities and that big welfare expenditure decreases incentives to work, leading to chronic low growth and high unemployment. However, there are also opinions that cite the positive effects of welfare expenditure on economic growth. First, welfare expenditure can make up for capital and labor market failure. As income inequality may inhibit investment in human and physical capital, redistribution policies can remedy this capital market failure and promote growth. Second, welfare spending can contribute to social integration, allowing for stable growth. Widening income gaps aggravate discord and conflict between classes, becoming a factor for social unrest that leads to a negative impact on economic growth. If we accept this view, it is important for policymakers to create a mechanism in which welfare policy supports sustainable economic growth, while minimizing a distortion effect that stems from excessive public intervention.

Many empirical studies have shown a negative correlation between welfare expenditure (or government size) and economic growth rates, which is easily found in <Figure 3>. However, the impact of welfare expenditure on economic growth rates varies depending on its characteristics. For instance, it is well known that countries with higher education and R & D spending displays high economic growth rates despite large welfare expenditure as a percentage of GDP. A high level of investment in human capital and R & D can offset, to some extent, economic inefficiency that derives from big government expenditure.

Figure 3. Correlation between welfare spending (in % of GDP) and economic growth



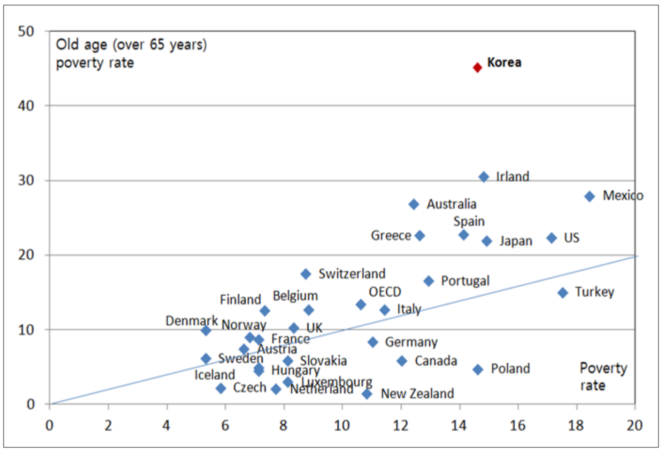
Note: Average welfare spending in 1995-2010 (horizontal axe) and real GDP growth rate during the same period (vertical axe).

Source: OECD.

Welfare state models face numerous challenges. Many developed countries in Europe are experiencing worsening fiscal sustainability with narrow room for economic stimulus, and have a more sluggish economic growth. Austerity measures were put in place to recover fiscal stability, but making cuts in large spending budgets has proven difficult and painstaking. Raising tax rates, which represents an alternative, is difficult because of the possibility of its negative impact on economic activity.

Situations in Korea are different from what European countries face now and it is difficult to apply European examples directly to Korean context. It is noteworthy to point out what Korea is confronted with. First, economic inequalities have been increasing. Korea had been successful in achieving high GDP growth rate, while keeping its economic inequality level low until the financial crisis in the late 1990s. Despite the weak level of welfare spending compared to developed countries, fast economic growth led to an increase in employment and consequent good performances to reduce the poverty problem in Korea. However, the structural adjustment, including layoff and increasing flexibility, in the labor market produced unwanted side effects, such as rising unemployment numbers and increasing share of temporary workers. Second, Korea has been facing the problem of low fertility rate. Korea's fertility rate went down below 2.1 (called replacement rate) in 1983 and recorded 1.15 in 2009, which is the lowest level among OECD countries. With its population rapidly aging, Korea's old age population reached 7% in 2000 and is expected to reach 14% in 2018 and 20% in 2026. Increasing old age population causes poverty problem particularly in the Korean context in which the social welfare system is not well established. Korea's old age poverty rate is 30% higher than OECD average as shown in <Figure 4>, while general poverty rate is only 4% higher.

Figure 4. Overall poverty rate and old age poverty rate



Note: Overall poverty rate (horizontal axe) and old age poverty rate (vertical axe).
Source: OECD.

Given record-low birth rates and the aging population, it is likely that Korea will be obliged to spend more on welfare policy. The important question is how to create a sustainable welfare model that reflects Korea's particular economic and social development. In this regard, the following issues should be discussed in near future. First, it is necessary to maximize the existing welfare policy, but also develop ways to raise taxes in a growth-friendly manner. In addition, in the coming years, it is necessary to decide on the time to increase tax rates. Second, we have to create an atmosphere conducive to policy innovation. Given that high tax rates, an essential feature of welfare regimes, may place a burden on business activities and employment, it would be necessary to ease unnecessary regulations and reform the business environment in order to encourage economic activity. Third and last, we must establish growth-oriented welfare regimes with a special focus on strengthening human capital and employment rates. KIEP