

**Korean Severance Pay Reform:  
For Old-age Income Security or Coverage Expansion?**

Jai-Joon Hur

Korea Labor Institute, Seoul  
&  
World Bank, Washington DC

Email: hurjj@kli.re.kr, jhur@worldbank.org

October, 2003

Paper prepared for the International Workshop on *Severance Pay Reform: Toward Unemployment Savings and Retirement Accounts*, Laxenberg/Vienna, November 7-8, 2003.

## Abstract

According to the Severance Pay Reform Plan 2003, employers and employees *can* covert SP (Severance Pay) to RP (Retirement Pension). The benefit of RP will be payable from 55 in annuities for at least five years. Simple book-keeping will not be allowed, and financial regulations will be put on to guarantee benefit. Coverage limit will be minimal: every employee will be entitled to SP or RP from the very first month of employment relation.

As conversion to RP is entrusted to the employer and employees, Reform Plan 2003 does not seem to expand substantially the second tier of Korean old-age income security system, and correct substantially non-performance of SP unless incentive structure of both Corporate Tax Act and Revenue Tax Act are reformed so that many firms and employees will find incentives to adopt RP. However, the initiative of universal coverage will level up the low-coverage and contribute to protection of non-regular workers.

Once incentive structure of tax system is reformed, it will imply less *marge de manoeuvre* to employers in using SP reserves, and firms would not be able to simply book-keep SP and enjoy tax exemption, which will inevitably contract firms' investment as well as demand for labor, and thus aggregate performance of the economy.

Key Words: Severance Pay, Unemployment Insurance, Pension, Coverage, Korea,

---

### Acronyms used in this paper

DB: Defined Benefit

DC: Defined Contribution

IRA: Individual Retirement Account

RP: Retirement Pension

SP: Severance Pay

UI: Unemployment Insurance

UISA: Unemployment Insurance Savings Account

---

# **Korean Severance Pay Reform: For Old-age Income Security or Coverage Expansion?**

Jai-Joon Hur

## I. Introduction

The Korean Severance Pay scheme was first introduced in 1953, as a way of guaranteeing income for the retired (Art. 28 of Labor Standards Act 1953). The scheme was voluntary at first, and then became mandatory after 1961.<sup>1</sup> Its coverage has not been universal, limited to workers in establishments with at least thirty, sixteen, or ten workers. Since 1989, it applies to establishments with five or more employees covering around a half of the total salaried employment. Severance pay (SP in the following) is financed entirely by employers.<sup>2</sup> It is given only to those who worked at least one year in a firm. The benefit level is one month's salary per year's service.

In a certain sense, it is a mandatory deferred wage. As such it played a role as an incentive for long-term employment relation. Traditionally, however, it had multiple roles of social safety net when Korea did not have public welfare programs: an unemployment benefit, a saving for housing, a retirement benefit, etc. The base wage for the calculation of SP is an average of last three months wage before severance, which is doubtlessly a legacy of the past when payroll did not exist and it was difficult for employers, employees and labor inspectors to dispose exact information

---

<sup>1</sup> During the economic development plan period, many of employment protection clauses were introduced or strengthened in compensation for oppressing labor rights on collective bargaining. The mandatory SP and its generosity is one of those labor standards intensified in that historical context.

<sup>2</sup> It is also interesting to note that family allowance, negligible as it may be, and a considerable part of tuition fee of workers' children have been financed by employers in Korea.

bout the past wage level of individual workers.

When National Pension and Employment Insurance System were introduced in Korea in 1988 and 1995 respectively, the traditional role of SP was faced with challenges: *raison d'être*, benefit rule, funding system, etc. Concerns became ample in the second half of 1990s. As of 2003, however, the traditional aspects of SP remain virtually unchanged, putting it as nothing more than a deferred wage.

Korean SP scheme has been criticized by experts in Korean academia for being of little help to old-age income security, its low coverage, non-performance, and adverse selective trait in distributional aspect (Min 1992, Park 1992, Phang 1998, Hur 2001, Moon 2002). Since late 1980s, non-wage labor cost of Korean firms increased sharply. Employers claimed an appropriate reform of SP scheme (FKI 2001). With its population rapidly ageing and unsustainable structure of National Pension scheme, Korean old-age income security system seemed at crossroads (World Bank 2000).

Korea plans to raise the contribution rate of National Pension from 9.0 percent to 15.9 percent by 2030, and lower the replacement ratio of 40 year contribution from 60 percent to 50 percent (MOHW 2003). On September 29, 2003, the Korean Ministry of Labor opened its SP reform plan to the public, which, as well as the National Pension reform plan of Ministry of Health and Welfare, will be modified through hearings and then laid before the National Assembly (MOL 2003).

Does the recent SP reform initiative aim at amelioration of weak old-age income security system? Is this an effort to correct low-coverage, or a remedy for non-performance? Can it be a bridge to UISA?

The objective of this paper is to examine the recent reform initiative of SP scheme in Korea, as well as its implication. This paper is composed of four main parts. In Section II, it summarizes what the theory tells us about SP and describes a brief history of Korean SP, paying attention to its changing role in efficiency aspects around late 1980s. In Section III, it describes working of the current scheme, particularly focusing on protection aspects. In Section IV, it explains the background of recent reform plan, examines the contents of the reform plan proposed by Korean Ministry of Labor, and diagnoses the implication with elements of assessment. Concluding remarks are in Section IV.

## II. Severance Pay in Theory and Severance Pay in Korean Economy

### 1. What the theory tells us

From theoretical point of view, there are both positive and negative effects associated with SP.<sup>3</sup>

SP is an incentive to longer-term employment in a workplace on the part of employees, particularly under seniority-based wage profile. Employers may be interested in longer-term employment relation when skill formulation on the job is firm specific rather than general (or when on-the-job skill formulation is firm-specific to the extent that workers' tenures are too short for firms to fully take advantage of workers' firm-specific skill potential), when the firm is rapidly growing, and when technological change is not too fast so that the old technology does not become easily obsolete (Hur and Cheon 1997).

Long-term contract contributes to loyalty and trust between the employer and workers, which may contribute to higher productivity and reduce the resistance of workers to the

---

<sup>3</sup> Usual meaning of retirement in English is used to designate 'retirement from the labor market' in old age rather than 'severance from a firm'. In Korea, however, people have not clearly distinguished the word 'severance' from 'retirement' in usual life, which can be a side evidence that the life-time employment in a company was regarded as natural for Koreans (it does not necessarily mean that voluntary quit or turn-over was rare and tenure was long, and neither does it mean that it is still true). Till 1988, Korea did not have public old-age income security program except for three occupational pensions. Therefore, Koreans did not have to distinguish retirement allowance or old-age pension from severance pay. Consequently, literature on severance-pay-related Korean institutions used the word 'retirement' in the same meaning of 'severance'. For this reason, 'retirement allowance' has long been used as a translation of severance pay in English literature of Korean Severance Pay. As literature on 'retirement' from labor market proliferates, researchers begin to distinguish 'retirement' from 'severance'. To respect this, I use in this paper 'Severance Pay' rather than 'Retirement Allowance', 'Severance Pay Insurance' rather than 'Retirement Insurance', etc. Severance Pay Insurance was an option to Severance Pay provided to employers by SP reform 1997. Retirement Pension in this paper implies a corporate pension scheme of DB or DC type as well as IRA, which will become an option to traditional Severance Pay for firms and employees as a consequence of Severance Pay reform 2003.

decision of the employer (OECD 1999). Long-term employment relation makes it easier for workers to learn by doing, and promotes incentives of employers to provide training, thus increasing the innovation capacity as well as the aggregate productivity growth (Hur and Cheon 1997). Therefore, as far as the employers are interested in increasing workers' tenure, SP can be a good arbitrator for both the employer and workers, generating positive spill-over throughout the economy.<sup>4</sup> SP may have impact on the composition of employment. Reasonable SP can induce firms to create more high-wage jobs, increase average labor productivity, and may improve aggregate growth and thus welfare.

There are also negative effects of SP and the rationales can be found in numerous papers on employment protection. SP increases labor cost and hinders job creation. SP increases firing costs and reduces inflows to and outflows from unemployment. Higher firing costs slow down the pace of restructuring and reduce incentives of employers to introduce new technologies (Calmfors and Holmlund 2000). Reduced labor market flows may deteriorate human capital of unemployed people, resulting in "hysteresis" of unemployment (Hur 1996), and hinder more efficient allocation of jobs, thereby slowing down aggregate productivity growth. The presence of higher SP for older workers may bias employers' decision of separation against old workers, thereby letting prematurely experiences and acquired skills of older workers into disuse (Hur and Cheon 1997).

SP may have distributional aspects as well as efficiency effects. SP may contribute to the emergence or intensification of labor market segmentation. Higher labor costs resulting from SP induces motivations to detour regulations on the part of employers, and thereby prevents more of unskilled workers from accessing the primary market. SP may lead to higher unemployment of marginal worker groups or puts them in the trap of secondary market where employment contract is short and usually deprived of many of fringe benefits other than SP.

To be able to evaluate the net effect of SP on aggregate growth, one should therefore

---

<sup>4</sup> According to efficiency wage hypothesis of Lazear [1981] variant (the other variant is, of course, Shapiro and Stiglitz [1984]), known as work-life or delayed-payment incentives, deferred wage can induce worker's effort over time.

consider individual country's characteristics. Individual country may dictate different levels of labor market flows for different category of workers in different development stages. For example, firms may have more interest in long-term employment relation with highly educated workers when the economy is growing fast by reengineering and catching-up, productivity factor dominating cost factor. Similarly, SP may exert different impact on economic performance depending on whether other public welfare programs or payroll taxes exist or not. SP will have positive impact on firms' productivity when workers' tenures are too short for firms to take full advantage of workers' firm-specific skill potential, while it can be only cost-increasing without having any positive effect when workers tenures are sufficiently long.

## 2. Changing roles of Severance Pay and emerging challenges

Until the late 1980s, Korean economy grew at the rate of over 8 percent per annum. Firms could expand too at high growth rate and they preferred long-term employment relation with seniority-based wage system. They recruited periodically, usually two times a year, new labor market entrants on large scale and trained them to be equipped with firm specific as well as general skills. Workers accepted relatively low wage in their youth in exchange for relative high wage in their old age. The promotion ladder, which strongly depended on age and tenure, leveraged the effort of young workers, the deferred wage inducing worker's effort over time.

Rapidly expanding economy generated active workers' mobility. As a consequence, the distribution of workers' tenure was automatically controlled so that the workers' tenures are not quite long. Workers' tenures were relatively short and firms had an incentive to induce long tenure so that the firm specific skills did not fall short. The average tenure of Korean workers was 2.7 years in 1980 and it never exceeded 4.0 years all along the 1980s. SP was a strong incentive for inducing workers to long tenure.

Like other industrialized countries, Korean economy in 1990s was exposed to rapid technological change, fierce competition in the international market,<sup>5</sup> as well as the increase in payroll taxes with the introduction of National Pension and coverage

---

<sup>5</sup> Export-import dependency ratio of Korean economy is over 70 percent.

extension of social insurances (Hur 2003). Further more, overall wage level increased sharply since late 1980s, leading equivalently to the increase of not only potential debt of SP, but also firms' overall non-wage labor cost (Figure 1). What was worse, wage of regular workers increased in excess of overall productivity growth in late 1980s and early 1990s. Large firms, with more workers of long tenures, experienced the labor cost increase disproportionately (Table 1).

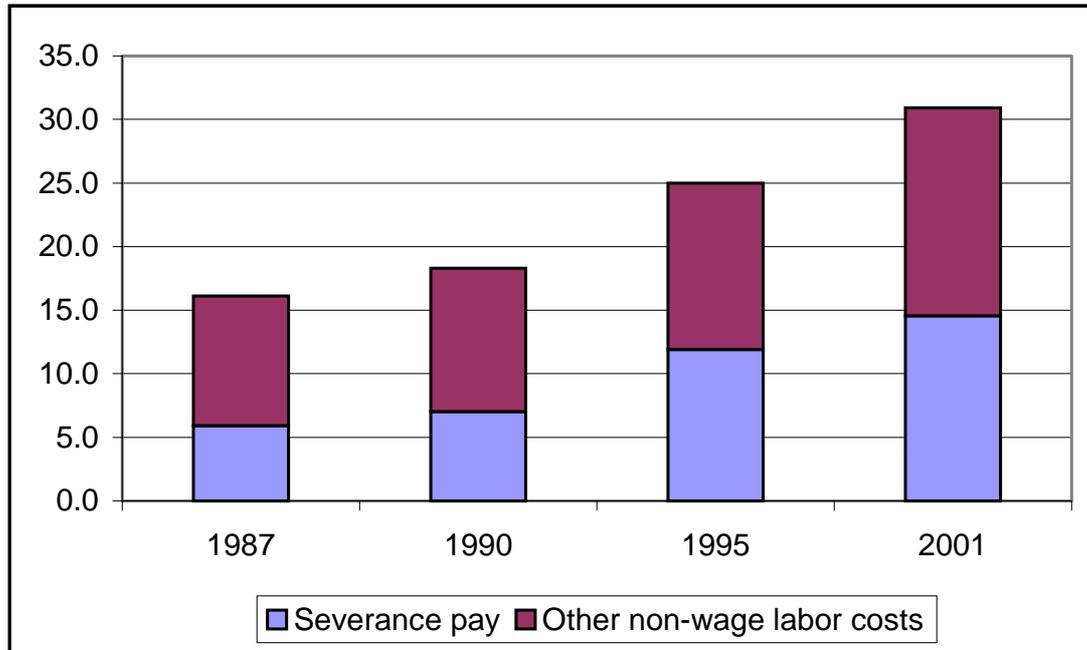
Workers' tenure increased rapidly (Figure 2). The average tenure of regular workers increased from 4.0 in 1989 to 5.0 years in 1992, and further to 6.0 years in 2002. Firms did not lack any more in firm-specific skills or its potential, with sufficient proportion of long tenure workers (Table 2).

Meanwhile, faced with new economic circumstances, firms began to demand more and more ready-to-use experienced workers rather than to recruit new labor market entrants and train them, and they preferred workers highly adaptable to rapidly changing market condition and technological change (Hur et al. 2003). Firms wanted to pay more to those workers with higher adaptability at the cost of low skilled workers. Under these circumstances, the existing SP scheme became burdensome for employers. More and more Korean firms found little interest in maintaining traditional SP scheme in the economic condition of 1990s. They simply regarded SP as a source of heavy labor cost or unreasonable constraint for rational management.

Firms began to adopt 'comprehensive annual contract wage [*Yeonbong*]' scheme, which clears up SP every year, particularly for non-production workers. It explosively increased after 1997 and about 40 percent of firms with over 100 employees adopt '*Yeonbong*' scheme as of 2002 (Kim 2003).

**Figure 1. Severance Pay and Other Non-wage Labor Costs**

(Unit : percentage of total labor costs)



Source: Ministry of Labor, *Survey Report on Labor Cost of Enterprises*.

**Table 1. Per Capita Labor Cost: Firms with more than 1000 employees**

(Unit : percent)

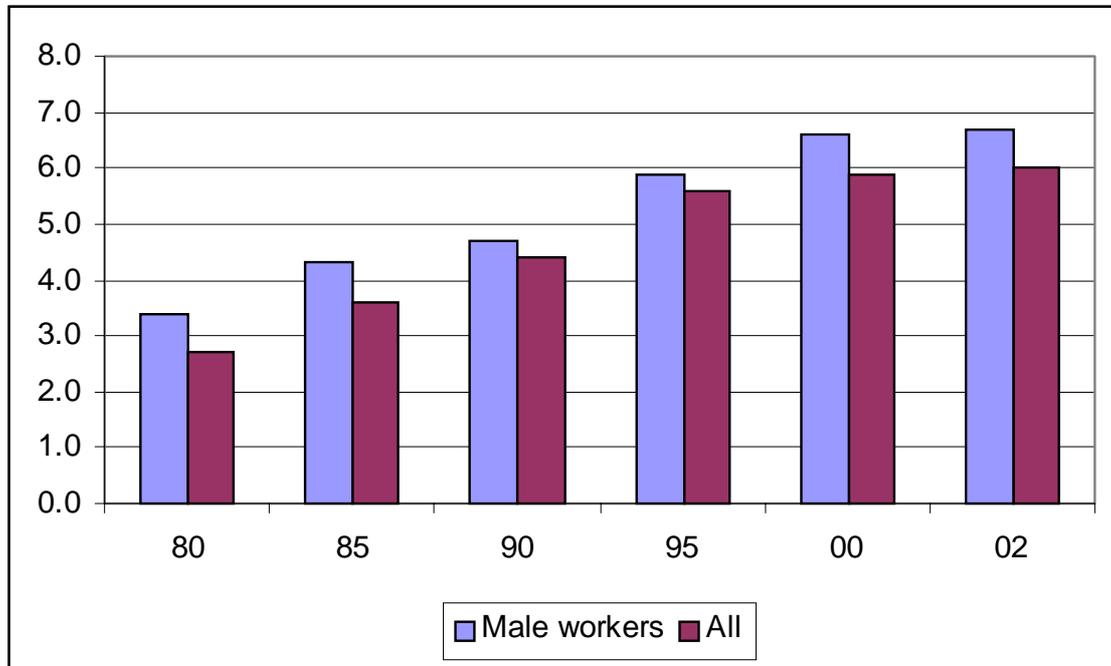
	Labor cost	Wages	Non-wage labor cost			
			Severance Pay, etc	Mandatory	Voluntary	
1986	103.7	99.4	127.8	113.0	67.4	163.6
1991	120.8	125.3	107.7	84.3	75.2	160.0
1996	157.4	153.4	173.0	153.4	137.2	172.5
2001	178.1	164.9	214.4	233.0	180.7	202.3

Note: Per capita labor cost of firms with 30~99 employees=100.

Source: Ministry of Labor, *Survey Report on Labor Cost of Enterprises*.

**Figure 2. Incidence of Average Tenure of Regular Workers**

(Unit: years)



Note: Those working in firms with at least 10 employees.

Source: Ministry of Labor, *Wage Structure Survey*.

**Table 2. Incidence of Workers' Tenure in Firms with  $\geq 500$  employees**

(Unit : percent)

Age	Year	< 5 yrs	5~9 yrs	10~14 yrs	$\geq 15$ yrs
All	1986	27.46	43.82	18.78	9.96
	1991	27.72	32.02	25.92	14.35
	1996	20.44	33.35	22.52	23.69
	2001	16.25	29.16	26.38	28.22
30~34	1986	39.07	53.07	6.92	0.94
	1991	40.90	46.03	12.03	1.04
	1996	33.92	54.00	10.71	1.36
	2001	28.54	56.94	13.31	1.21
35~39	1986	22.69	45.85	26.62	4.84
	1991	19.64	31.34	42.63	6.38
	1996	16.11	33.42	38.09	12.37
	2001	11.98	26.02	50.81	11.18
40~44	1986	18.73	33.69	29.66	17.91
	1991	17.99	18.17	36.24	27.60
	1996	12.52	15.74	26.03	45.71
	2001	8.95	10.97	28.84	51.24
45~49	1986	15.86	29.19	24.71	30.25
	1991	18.88	15.91	24.54	40.66
	1996	9.44	12.28	17.95	60.32
	2001	9.42	8.35	12.74	69.49
50~54	1986	14.76	25.05	21.21	38.98
	1991	21.93	15.53	18.48	44.05
	1996	10.41	11.31	14.53	63.75
	2001	11.52	8.62	10.21	69.64

Source: Ministry of Labor, *Wage Structure Survey*.

### III. Working of the Current Scheme

#### 1. Limited coverage

Coverage of the current Korean SP scheme is limited to workers in firms with at least five employees, covering less than a half of the total wage workers or 28.8 percent of total working population. SP is given only to those who worked at least one year at the same firm. Therefore, only regular workers can receive SP. According to the supplementary survey of *Economically Active Population Survey 2002*,<sup>6</sup> the number of employees who were entitled to SP was around 6.6 million, which falls far short of the half of the total salaried employment (Table 3).

**Table 3. Incidence of Workers Entitled to Severance Pay**

(Unit: thousands, percent)

Year	Number of entitled employees	Salaried employment	Labor force	Percentage covered among the salaried employment	Percentage covered among the labor force
1966	454	n.a.	9,074	n.a.	5.0
1975	1,448	n.a.	12,341	n.a.	11.7
1980	2,841	6,605	14,433	43.0	19.7
1985	3,583	8,104	15,592	44.2	23.0
1990	5,366	10,949	18,539	49.0	28.9
1995	6,168	12,899	20,844	47.8	29.6
2000	6,515	13,360	22,069	48.8	29.5
2002	6,584	14,181	22,877	46.4	28.8

Source: Ministry of Labor, *Survey Report on Establishment Labor Conditions*.

National Statistical Office, *Economically Active Population Survey*.

National Statistical Office, *Supplementary Surveys of Economically Active Population Survey 2000 and 2002*.

Min et al. [1992].

<sup>6</sup> A survey of over 32,000 households performed every month by *National Statistical Office* to produce labor market activity indicators.

## 2. Generous benefit level

The benefit level is *at least* one month's salary per year's service, which is mandatory by Labor Standards Law (Art. 34 of Labor Standards Act 1997). About 25 percent of firms (among those with more than 30 employees) have a progressive SP structure (Phang 1998 and Moon 2002). Therefore actual SP benefit is more than a month's salary on average.

Table 4 shows increasing-scale SP coefficients surveyed in 1983, 1992, 1997 respectively. Even if the progressive structure attenuated in 1996 compared to 1991, workers with thirty years' tenure received up to 47.9 months' salaries in privileged companies. Public sector workers enjoyed more generous SP scheme before 1998 (Table 5), which is doubtlessly a consequence of so-called principal-agent problem.<sup>7</sup> International evidences show that Korean SP of one month's pay per year of service is one of very generous schemes. With its progressive structure with increasing tenure, it seems extremely generous.

Limited coverage with benefit generosity implies 'strong protection' of regular workers and 'not weak, but absence of protection' for non-regular workers (Hur 2001). In fact, the inequality between primary market protected workers and secondary market precarious workers is not limited to SP.

---

<sup>7</sup> It was regarded as one of the representative moral hazards committed in public sectors and the progressive structure was abolished in most of all public corporations by the initiative of public sector restructuring plan during 1998-1999.

**Table 4. Level of Severance Pay by Tenure**

(Unit: months' salary)

Tenure years	All firms			Firms with progressive coefficients only		
	1982	1991	1996	1982	1991	1996
5	5.4	5.3	5.3	6.4	6.5	6.1
10	10.9	11.0	10.8	14.6	14.7	13.3
15	16.9	17.0	16.6	24.2	23.8	21.6
20	23.1	23.2	22.5	34.3	34.1	30.3
25	29.2	29.4	28.4	44.5	44.8	39.0
30	35.2	35.7	34.3	54.5	55.3	47.9

Source: Phang [1998] and Park [1992].

**Table 5. Progressive Structure of Severance Pay at Private and Public Corporations**

(Unit: months' salary)

Tenure years	Private corporations	Public corporations
10	13.3	15.5
20	30.3	33.0
30	47.9	52.5

Note: Average from a survey of 500 firms with at least 30 employees

Source: KLI, Survey on Severance Pay 1997

### 3. Imperfect performance

The rate of compliance shows gap depending on whether it is calculated from survey on firms or from survey on unemployed people. It proves that survey on running firms can give biased results about how SP of the unemployed is actually treated.

Compliance rate from a firm survey was as high as 98 percent in firms with at least 30 employees (Moon 2002). But according to the KLI survey conducted on 1,000 previously unemployed people in February 1998 who registered at local public employment service office, 23.7 percent of entitled workers could not receive SP, either because the business condition of their company deteriorated seriously to the extent that the company was incapable of pay SP, or the company went bankrupt or was closed

down (Table 6). About 13 percent of the respondents reported their employer's failure to compliance with the regulation, whether it is non-payment or deferral of payment (Phang 1998).

**Table 6. Compliance of Severance Pay Payment**

(Unit: percent)

Status	Ratio
Received	55.4
Will Receive Soon	20.9
Have Not Received	23.7
Sum	100.0

Source: KLI, Survey on Registered Unemployed 1998.

Current SP scheme is unfunded one and many firms simply book-keeps SP. Corporate Tax Act recognizes firms' in-house reserves as business expense up to 40 percent of estimated SP, whether or not the reserve is simply book-kept or actually accumulated (Art.33 of Corporate Tax Act). In contrast, when firms reserve it externally, up to 50 percent of estimated SP is regarded as business expense.

The generous regulation on in-house reserves given in Art.33 of Corporate Tax Act helps firms business by strengthening firms' cash flow, and by preferentially recognizing firms' expenses and thus exempting corporation taxes. But it deteriorates the benefit security of SP, because SP is not secured as much as book-kept in-house reserves when firms face insolvency.

According to KDI survey conducted in 1992, the average reserve for retirement allowances amounted to only 88 percent of the accumulated amount of mandatory contributions. And only 8 percent of these companies saved the total reserves externally (Moon 2002). In the survey of KLI 1997, the ratio of external reserve turned out 48 percent and in the survey of Financial Supervisory Service 2001, the ratio was found 60.5 percent (KLI 2001). It seems very natural that firms would not have any incentive to reserve more than 60 percent of SP externally when 40 percent of them are admitted as expenses just by book-keeping. In the survey of KLI 1997, the implicit SP debt was found to amount up to 34 percent of the capital stock and 3.2 percent of total asset (Phang 1998).

Actually this non-performing situation makes workers of small business disproportionately disfavored. Many small and medium-size enterprises went bankrupt in recessions of 1990s without being able to provide their employees with legally-required amount of wages and SP. Even large companies, with limited financial resources to pay SP, could not pursue effective restructuring, hindered by painstaking negotiations with their employees. To moderate such problems, “Pay Guarantee Fund” was established by Ministry of Labor in 1999. With the contributions as much as 0.2 percent of wage, totally financed by employers, Pay Guarantee Fund will guarantee final three months’ wage and SP of three year tenure, in case firms turn out to be insolvent. Still it guarantees only a very limited partial payment of wages and SP for workers, particularly for those with long tenure.

#### 4. Negligible role for old-age income security

Judging from the average tenure of workers, the average amount of Korean workers’ SP is about six months’ salary. In case of male workers, it is 6.7 months’ salary (see Figure 2 above). SP is paid in lump-sum upon every mid-career turnover. Therefore if it is not reinvested whenever workers turn over, SP can not play a substantial role as a tier of old-age income security system for the majority of workers. Furthermore, since 1997 Labor Standards Act allows mid-course payment of SP for incumbent workers, and many firms take advantage of this rule for pay contract on ‘comprehensive annual wage [*Yeonbong*]’ base. Therefore, it became even more difficult for SP reinvested until workers retire from the labor market. SP is frequently used by laid-off workers as living expenses during their job search periods (Table 7).

**Table 7. Where Severance Pay is Used**

(Unit: percent)

Purposes	Ratio
Basic Living Cost	53.1
Saving or Investment	20.9
Business Start-up	4.3
Vocational Training or Education	4.1
House Purchase/Moving/Rent	4.6
School or Marriage Cost for Children	3.5
Debts Repayment	7.6
Other	2.1

Source: KLI, Survey on Registered Unemployed 1998. Recited from Phang [1998]

## IV. Reform Initiative 2003 and Elements of Evaluation

### 1. Background

When National Pension was introduced in Korea in 1988, the traditional role of SP was faced with challenges. The *raison d'être*, benefit rule, funding system, etc. of Korean SP scheme became a target of hot social debate. But political economy of social partners did not change anything of the SP scheme. The way of calculating benefit level, eligibility, and financing rule remained virtually same as before.

In 1995 when Employment Insurance System was introduced in Korea, debates proliferated. Both trade unions and firms requested fiercely SP reform, focusing on different shortfalls of the existing SP scheme. Employers complained heavy burden on labor cost. Trade unions pointed out low-coverage and non-performance.

As a consequence, rule of payment for incumbent workers was newly introduced, allowing employees to claim their SP even his employment relation is lasting. Also Severance Pay Insurance was introduced so that firms could clear up their SP debt every year.

Meanwhile, Korea had entered 'aged society' in 2000, with the old age population explaining over 7.2percent of the total population. Total fertility rate had continued to fall sharply from 4.5 in 1970, to 2.8 in 1980, and then to 1.2 in 2002. Ageing speed would be so fast that Korea would join aged society group in 2019 and the old-age population will be more than 20 percent of total population in 2026. Once again, debates proliferated on old-age income security system, including the limit of SP's role in old-age income security system.

- Coverage is confined to businesses with at five employees and only less than 50 percent of salaried employment or around 30 percent of total employment are entitled.
- SP is paid in lump-sum upon every mid-career turnover, which makes it difficult to be reinvested until workers retire from the labor market.
- Effective institution of payment guarantee is missing, which lets workers of small

business in disproportionately unfavorable situation.

The shortfalls on issue were not much different from what were pointed out in late 1980s and early 1990s at the moment when the National Pension was launched. The difference was now that the issues were raised in more serious tone in a comparatively serious context.

Besides, firms requested SP reform demanding incentives equivalent to the amount of interest which will be funded instead of book-keeping, and lower contribution than 8.3 percent of wage (FKI 2001). And corporate pension was recommended by experts in financial sectors as a means of strengthening and stabilizing Korean financial market.

## 2. Contents of the reform plan

According to the reform plan,<sup>8</sup> employers and employees can, by mutual consensus, continue their SP, or introduce Retirement Pension, whether it is of DC or DB type. Retirement Pension (RP in the following) should be at least equivalent in value to the severance pay under the current SP scheme. Firms will have to fill up gap if the benefit of DB type RP falls short of the level defined by SP. It takes into consideration the vested rights of workers and does not mandate RP even for new labor market entrants.

It introduces IRA for frequently turning-over workers and workers in small or micro firms so that RP can be portable and contribute to old-age income security, It regulates annuities should be paid from 55. It defines responsibilities of employers and trust companies, together with further regulations on DC type RP to protect workers who are financially illiterate. However, tax incentives have not taken concrete shape yet, the design of tax incentives for RP being left to the Ministry of Finance and Economy. Other features are summarized in Table 8.

Once employers and employees agree to introduce RP, the benefit is payable from 55

---

<sup>8</sup> It will be premature to explain correctly the reform initiative 2003 now because it is fully liable to modification in the National Assembly. The description of features in the following is based on the reform initiatives announced September 29, 2003.

in annuities for at least 5 years. Simple book-keeping will not be allowed, and financial regulations will be put on to guarantee benefit. Coverage limit will be minimal: every employee will be entitled to SP or RP from the very first month of employment relation.

**Table 8. Comparison of Severance Pay Insurance and Retirement Pension**

	Severance Pay Insurance	Retirement Pension*
Main characteristics	- Voluntary, legally allowed to substitute SP - Managed by individual accounts	- Voluntary, legally allowed to substitute SP - Managed by individual accounts
Eligible companies and payment entitled to	- Firms with $\geq 5$ employees - Workers who have served at least one year	- All firms - Workers who have served at least one month
Links to loans	- Legally protected from being used as collateral or being transferred to other persons	- Legally protected from being used as collateral or being transferred to other persons
Management agencies	- Insurance companies, trust account in banks, investment and trust companies	- Insurance companies, trust account in banks
Return accrual	- Fixed (6.0%) or indexed interest rate	(- Plan dependent)*
Payment	- Lump-sum or annuities	- Lump-sum or annuities
Portability	- Practically not portable	- Portable
Insurance premium in accounting counted as	- Expense item in special account (separated from general account)	(- Expense item in special account)*
Legal base	- Labor Standards Act	- Retirement Pay Guarantee Act

Note: \* based on tentative plan and liable to changes after public discussions.

( ) \* “left to be specified” but “probable guessing by the author” as of Oct. 2003.

### 3. Elements of assessment

#### Amelioration of old-age income security?

In the reform plan 2003, SP is mandatory, but conversion to RP is voluntary. This consideration surely aims at a smooth transition from SP to RP, to be relieved from objections of both employers and employees.

Labor Standards Act amended in 1997 allowed employers to convert their SP schemes into Severance Pay Insurance. Although there have been continued efforts to promote Severance Pay Insurance in workplaces, the progress has been quite slow. Under the reform plan 2003, Severance Pay Insurance will be substituted by or integrated into DB type RP. The poor performance resulted mainly from favorable incentive structure to SP of both Corporate Tax Act and Revenue Tax Act.

Employers would frequently use the in-house reserve for SP as collateral for loans or working capital for business operation. But these practices were not possible with Severance Pay Insurance requiring externally-managed reserves. The favorable tax treatment for Severance Pay Insurance, compared to in-house reserve and lump-sum payment, was very limited in Corporate Tax Act. In fact, tax treatment for SP was already too favorable to the extent that Ministry of Finance and Economy could not invent any incentive for Severance Pay Insurance without reducing existing favorable incentive for SP, the latter being possible only gradually. As a result, employers tended to show little interest in Severance Pay Insurance.

Employees have not favored Severance Pay Insurance either. In a typical corporate pension program, employees have to wait a sufficiently long period before receiving annuities. Korean financial market has been dominated by strong volatility and uncertainty, while the rate of return on investment on house was empirically stable and produced high return. Despite the financial market volatility and high probability of firm bankruptcy, Korea did not dispose of effective mechanisms to protect pension benefits from such uncertainties (for example, an institution equivalent to Pension Benefit Guaranty Corporation of the US and related regulations). Besides Koreans have shown traditionally strong interest in purchasing their own house, which explains why

many of employee benefit plans allow mid-course withdrawal when workers want to purchase a house.

Revenue Tax Act did not provide appropriate incentives to Severance Pay Insurance either. An analysis of lump-sum SP vs. 10-year, 20-year, 30-year annuities scenarios under the current regulations of Revenue Tax Act shows that lump-sum receipt is more favorable than 10-year and 20-year annuities. Sensitivity analyses of lump-sum SP with other scenarios under three different discount rates gives the same results (KLI 2001). This also proves that Revenue Tax Act has already provided to SP very generous incentives.

The reform plan 2003 aims at transformation from unfunded system to funded one, and from lump-sum payment to annuities, allowing withdrawal of benefit after 55. Actual 'retirement process' of Korean employees begins around 55 (Hur and Cheon 1997), and entitlement for National Pension benefit is given at 60. Therefore, RP will support 55-60 year old span of Korean workers.

However, the speed of transition will be extremely slow because conversion to RP is voluntary, and its role as a second tier of old-age income security system will be as much limited unless incentive structure of both Corporate Tax Act and Revenue Tax Act are reformed.

#### Retirement Pension and National Pension: independent or opting-out?

However, one of the most conspicuous features of the reform plan 2003 is, none the less, the effort to consolidate the second tier of old-age income security system by introducing RP. Therefore, one important element in evaluating the SP reform plan is to assess its linkage with National Pension reform plan.

As a consequence of the SP reform 2003, apparently there will be three-pillars in the current old-age income security system: National Pension, Retirement Pension, and voluntary personal pension schemes. International comparison provides three alternative ways to link corporate pensions to the national pension scheme.

First, corporate pensions may be introduced independently from the national pension scheme and tax favors are provided to corporate pensions. An example of this model is corporate pensions of the US. Second, a 'contracting out' or 'opting out' from the

earnings-related part of the national pension scheme may be allowed for qualified corporate pensions. This model can be found in the UK and Japan. Third, public pensions may be totally privatized like in Chile, Argentina and other Latin American countries (Moon 2002).

RP neither opts out the earnings-related part of National Pension, which is practically impossible under the current National Pension scheme, nor does it totally replace National Pension. RP is independent from National Pension.

Introducing independent corporate pensions is the easiest way to convert existing lump-sum SP schemes into corporate pensions. But it is liable to a pitfall. If income replacement rate of National Pension benefit and other personal pension is already high, the high replacement rate may further rise to an even higher level with the introduction of independent corporate pensions. The contribution rates of employers may also rise.

On August 19, 2003, forty days before Ministry of Labor's SP reform plan was opened, Korean Ministry of Health and Welfare announced their pension reform plan to raise the contribution rate of National Pension from 9.0 percent to 15.9 percent by 2030, and lower the replacement ratio of 40 year contribution from 60.0 percent to 50.0 percent.

Assuming that both Ministry of Health and Welfare's and Ministry of Labor's reform plans become effective as they are, National Pension will provide in effect about 40 percent of replacement rate for standard Korean male workers. RP will provide around 22 percent of replacement rate. In total, a standard Korean male worker will receive approximately 62 percent of his lifetime income as his pension benefit.<sup>9</sup> According to Schmitt [1985], the appropriate post-retirement income is around 55-70 percent of pre-retirement income. Therefore, standard Korean male workers' replacement ratio will lie in the middle range of Schmitt's suggestion.

The current combined contribution rate of employers starts at 12.8 percent (4.5 percent for the NPS and 8.3 percent for the mandatory retirement allowance scheme) and is expected to rise up to around 16.3 percent by 2030. Given that total contribution

---

<sup>9</sup> These estimates were calculated under the assumption that standard Korean male workers work on average 33 years during his work life, and mandatory SP is converted into monthly contribution (8.3 percent of monthly wage) to National Pension.

of employers to social insurances is, as of 2003, around 16.5 percent (Table 9), it will rise up to 20.3 percent by 2030, with employees' contribution of 6.7 percent. Of course this forecasting is under the assumption that contribution rates of other social insurances will remain unchanged, which is very dubious because financial status of Health Insurance is unstable and that Work Injury Insurance has non-negligible latent debt.

**Table 9. Contribution Rates of Korean Social Insurance, as of 2003**

(Unit: percent)

	Employee	Employer	Total
Work Injury Insurance	-	0.4~31.9	1.49 (avg)
Health Insurance	1.815	1.815	3.63
National Pension	4.5	4.5	9.0
Employment Insurance	0.4	0.7~1.3	1.4 (avg)
Pay-Guarantee Fund	-	0.2	0.2
Severance Pay	-	8.3	8.3
Total	6.715	15.915~39.715	23.22 (avg)

#### Leveling up low-coverage?

The most reformatory part of the reform plan 2003 is its proposal of universal coverage and entitlement starting from the first month of employment, without depending upon whether or not workers served more than a year. Since the Employment Insurance System had taken the initiative of coverage expansion to all firms in 1998, other social insurances followed the same locus from one year to another (Table 10).

Even if it poses 7 or 10 year adjustment period before full contribution rate of 8.3% is enforced to small firms, this initiative is liable to objections of employers. As much, strong uncertainty dominates whether or not the implementation will begin next year. However, it is probable the debate among social partners result in a matter of how long adjustment period will be, rather than expansion or not. As long as coverage as well as entitlement range is expanded, it will doubtlessly level up low-coverage of the current SP, contributing to protection of employees in small firms and non-regular workers. Also it will correspond to an accomplishment of moving towards the protection of non-

regular employees, which was triggered by Employment Insurance System in 1998.

**Table 10. Year of Introduction and Full Expansion of Korean Social Insurance**

	Year Launched/Fully Expanded	Insured Persons
Work Injury Insurance	1964/2000	Employees**
Health Insurance	1977/1989(2002)	Employees + Self-employed
National Pension	1988/1999(2003)	Employees + Self-employed
Employment Insurance	1995/1998	Employees only
Pay Guarantee Fund	1999/2000	Employees only
Severance Pay	1961/2004*	Employees only

Note: Year in ( ) indicates the when employees in small firms were covered in the capacity of employee, not as independent worker.

\* “according to tentative plan”.

\*\* Employers of small firms can insure themselves

#### Performance enhancing?

As for SP, government has not disposed so far of substantial and procedural enforcement mechanism for the benefit. Therefore, if firms went bankrupt or faced insolvency, the benefit security was practically damaged.

Regarding RP, Ministry of Labor and Financial Supervisory Committee are likely to establish an institution equivalent to PBGC of the US. But it is quite probable that they will regulate only RP, SP being dominated by old rules. Therefore non-performance can not be substantially corrected as long as RP remains minor scheme. Small firms and new firms, which are liable to constraints in cash flow, will not prefer RP unless they find strong incentives in tax regulations or others. Fragile small firms can be more charmed by moral hazard: they will not have to pay any SP when bankrupt.

As was the case with in assessment of whether or not the reform plan 2003 will ameliorate the old-age income security system, the performance of SP will be enhanced very slowly unless incentive structure of both Corporate Tax Act and Revenue Tax Act are reformed so that many firms and employees adopt RP.

#### A bridge to UISA?

According to the reform plan 2003, workers are permitted to withdraw the saved severance pay, when they purchase a house, *when they are unemployed more than six months*, or when they need to support long-term care of family members. Apparently this is a kind of provident fund feature. However, the salient trait of RP account vis-à-vis unemployment is exactly reverse of prototype UISA idea of Feldstein and Altman [1998], Stiglitz and Yun [2003] or Yun [2003] which aims to internalize the cost of moral hazard of job searchers.

UI benefit will be given to the unemployed under the same rule as is regulated by the current UI scheme, and then they will be permitted to draw from his individual account, if they are unemployed more than six months. Therefore, there is no consideration of reducing moral hazard related with classical UI, but only discretion is allowed. Therefore it will be premature to expect that prototype UISA will be initiated or substitute the current UI scheme, or to regard the SP reform plan 2003 as an explicit bridging measure to UISA.

According to the reform plan, the right to withdraw is allowed only for DC type RP. Therefore even if RP become universal among workers, the SP reform initiative 2003 can not allow the discretion of 'unemployment savings and retirement account' to many unemployed people who are covered by DB type RP.

Besides, there are two other important politico-economical reasons that will hinder introduction of UISA. First, the contribution rate and expenditure of current UI is very moderate. Neither is it in deficit. On the contrary it recorded huge surplus only with the contribution rate of 1.0 percent and the rate was lowered to 0.8 percent from 2003. Second, Ministry of Labor has strong disincentive to reform present UI scheme to UISA, because it means reduction of its vested rights. All these considerations imply that the SP reform 2003 is independent from UISA initiative.

In the long-run perspective, however, it should be none the less emphasized that coverage extension of SP and individual accounting of RP are good stepping stones before Korean SP scheme moves towards UISA.

## V. Concluding Remarks

With growing needs of policy initiatives for Severance Pay reform, the Korean Ministry of Labor recently announced a reform plan. It aims at transforming Severance Pay (SP) into corporate pensions, called Retirement Pension (RP).

Clearly the reform initiative aims at expanding the underdeveloped second pillar of Korean old-age income security system and correction of non-performance. But the transition from SP to RP is totally entrusted to mutual consensus of employers and employees, and tax incentives have not taken any concrete form. Therefore, the role of RP as a second tier of old-age income security system will be as much limited, and performance of SP will not be improved in near future unless incentive structure of both Corporate Tax Act and Revenue Tax Act are reformed to help many firms and employees adopt RP.

The current SP scheme favors relatively high-income workers with a long history of service at one workplace. The most reformatory part of the reform plan 2003 would be its proposal of universal coverage and entitlement starting from the first month of employment, without depending upon whether or not workers served more than a year. As long as coverage as well as entitlement range is expanded, it will doubtlessly level up low-coverage of the current SP, contributing to protection of employees in small firms and non-regular workers. Also it will correspond to an accomplishment of moving towards the protection of non-regular employees, which was triggered by Employment Insurance System in 1998.

When tax incentives are reformed, employer and employees will be forced to find much incentive in externally reserved RP and annuities, but little incentive in lump-sum SP. Once such incentive structure of tax system is established, there will be further consequences. It will imply less *marge de manoeuvre* to employers in using SP reserves. Firms would not be able to simply book-keep SP and enjoy tax exemption. They will either book-keep and will not be able to enjoy tax favor, or reserve externally and enjoy tax favor. This will inevitably have impacts on firms' behavior and performance of the economy: it contract firms' investment as well as demand for labor, and thus aggregate

performance of the economy. It is the challenge that the recent SP reform plan is not reflecting much, or the subsequent tax reform should find an amicable settlement to.



## References

- Calmfors, Lars, and Bertil Holmlund (2000), "Unemployment and Economic Growth: a Partial Survey," *Swedish Economic Policy Review* 7(1): 109-153.
- Federation of Korean Industries (2001), "The Need and Direction of Reforming Retirement Allowance System," Seoul. (in Korean).
- Feldstein, Martin and Daniel Altman (1998), "Unemployment Insurance Savings Account," NBER. Working Paper No.6860.
- Hur, Jai-Joon (1996), "Hysteresis of the Labor Market," mimeo. (in Korean).
- Hur, Jai-Joon (2001), "Preconditions of Social Protection for Non-regular Employees", in Ahn et al., *Non-regular Employment in Korea*, Seoul: Korea Labor Institute. (in Korean).
- Hur, Jai-Joon (2003), "Labor Demand," in Wonduck Lee (ed.) *Labor in Korea 1987-2002*, Seoul: Korean Labor Institute. (in Korean).
- Hur, Jai-Joon and Byung-You Cheon (1997), *Old Workers' Labor Market*. Seoul: Korea Labor Institute. (in Korean).
- Hur, Jai-Joon, Hwan-Joo. Seo, Byung-You Cheon and Young Soo Lee. (2003), "ICT and Wage Inequality," Paper presented at the KLI-KEA joint seminar on *Labor in Knowledge-based Information Society*, Seoul, July 19.
- Kim, Dong-Bae (2003), "Human Resource Management of Korean Firms," in Wonduck Lee (ed.) *Labor in Korea 1987-2002*, Seoul: Korean Labor Institute. (in Korean).
- Korea Labor Institute (2001), *Proposals for Severance Pay Reform*, Seoul: Ministry of Labor. (in Korean).
- Lazear, Edward P. (1981), "Agency, Earnings Profiles, Productivity, and Hours Restrictions," *American Economic Review* 71(September): 606-620.
- Min, Jae-Sung., et al. (1992), *Policy Recommendation for Income Support Programs in Korea*, Seoul : Korea Development Institute. (in Korean).
- Ministry of Health and Welfare (2003), "Pension Reform Plan," Draft document. (in Korean).
- Ministry of Labor (2003), "Retirement Pension Plan," Draft document. (in Korean).
- Moon, Hyungpyo (2002), "The Korean Pension System: Current State and Tasks Ahead," Paper presented at OECD/INPRS/KOREA Conference on *Private Pensions in Asia*, Seoul, Korea. Oct. 24-25, 2002.
- National Statistical Office (2001), *Future Population Trend*, Seoul.
- OECD (1999), *Employment Outlook*. Paris: OECD.

- Park, Young-Beom (1992), *Retirement Allowance in Korean Firms*, Seoul: Korea Labor Institute.
- Phang, Ha-Nam (1998), *Korean Companies' Retirement Allowance System*, Seoul: Korea Labor Institute.
- Schmitt, D.G. (1985), "Today's Pension Plans: How Much Do They Pay?" *Monthly Labor Review*, 19-25.
- Shapiro, Carl. and Stiglitz, Joseph E. (1984), "Equilibrium Unemployment as a Worker Discipline Device," *American Economic Review*, 74(3): 433-444.
- Stiglitz, Joseph E. and Jongyoll Yun (2003), "Integration of Unemployment Insurance with Pension through Individual Account," Paper prepared for the International Workshop on *Severance Pay Reform: Toward Unemployment Savings and Retirement Accounts*, Laxenberg/Vienna, November 7-8, 2003.
- Yun, Jongyoll (2003), "An Empirical Simulation for the Relevance of Alternative Systems to Unemployment Insurance in Korea," Paper prepared for the International Workshop on *Severance Pay Reform: Toward Unemployment Savings and Retirement Accounts*, Laxenberg/Vienna, November 7-8, 2003.
- World Bank (2000), "Korean Pension System at the Crossroads, Report No.20404-KO.