

## An Economic Perspective of Kaesong Industrial Complex in North Korea

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**Abstract:** Constructing of Kaesong industrial complex in North Korea is led by private enterprises such as Hyundai group, under the agreement of two Korean governments. So far the constructing of Kaesong industrial complex operates well with the agreement of 'Inter-Korean Economic Cooperation Promotion Committee'. There are some grounds that should be preceded for Kaesong industrial complex in North Korea to get the political safety and economic prosperity as follow; First, South Korea should improve a system and provide supportive policies to simplify investment processes and to strengthen that of stability. Second, the North should make an effort to ease political and military tensions in Korea in order to give freedom of economic activities in Kaesong industrial complex.

**Keywords:** Economic Effect, Industrial Complex, North Korea Economic Cooperation

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### INTRODUCTION

Inter-Korean economic cooperation, which came to have legal effects by "the Law of Inter-Korean Exchanges and Cooperation" enacted in 1990, started at first, as trading business such as the simple commodities trade and processing in commission trade. It developed into the cooperation business that directly invests on the North Korea.

So far Inter-Korean trade volume increased by 38 times, from \$19 million in 1999 to about \$720 million in 2003. Trading items also considerably increased from 25 to 588 pieces.<sup>[1]</sup> Thanks to these increases, it became possible to take 'the First Inter-Korean Economic Cooperation Activation Measure'; to expand investment scope in the North; and to simplify the approval process for Inter-Korean economic cooperation activation (1995-1999).

Gradually, it became argued that the business on Kaesong industrial complex. Hyundai Asan Co., has participated in developing Kaesong industrial complex since the beginning stage of arguing, and it has acquired an exclusive right for managing businesses in the industrial complex at the time. As Hyundai Asan Co., had financial problems in South Korea, North Korea appointed Kaesong district as a zone guaranteeing preferential economic activities in the Supreme People's Assembly Committee; and enacted<sup>[2]</sup> "Law for Kaesong Industrial District" in November, 2002.

'Kaesong industrial complex business operation agreement' was signed with the Korea Land Corporation in December, 2002. With this agreement,

the first-step of construction business 1 million Pyeong (1 Pyeong = 3.3  $m^2$ ) was launched. Kaesong industrial complex is considered as an opportunity for promoting Inter-Korean economic cooperation and helping the rebound of economy of North Korea.<sup>[3]</sup>

North and South Korea recently held the 11th 'Inter-Korean Economic Cooperation Promotion committee'; and announced basic agreement (Oct., 2005) regarding economic cooperation.<sup>[4]</sup> It was agreed that investment would be guaranteed, double taxation would be prevented, the committee to prevent commercial dispute would be organized; and liquidation would be paid. An agreement on the overall economic cooperation such as Inter-Korean railroad and road connection business, Kaesong industrial complex construction business and business on Mt. Geumgang, was adopted.

Specific things are agreed so as to solve problems in economic cooperation and to expand institutional mechanism on economic cooperation such as completion of Kaesong industrial complex site development in June, 2004; organization of Kaesong industrial complex business support team in October, 2004; providing electricity in March, 2005 and providing telecommunication in December, 2005. Therefore, the purpose of this paper is to examine the current situation and problems of Kaesong industrial complex construction and its economic effects. It also aims to present conditions of successful construction of Kaesong industrial complex construction and ways to make up for institutional weaknesses.

## CURRENT SITUATION OF KAESONG INDUSTRIAL COMPLEX CONSTRUCTION AND ITS OBSTACLES

**Background of Kaesong Industrial Complex Construction:** The argument on Kaesong industrial complex construction began as North Korea accepted the proposal. It was shaped well in the west coast industrial park project of Hyundai Asan Co. There were different views on the candidate sites of the industrial complex, but Kaesong was chosen as the site in the end. Main reasons of this agreement are as follows.<sup>[5]</sup>

First, it is because of the economic crisis that North Korea has suffered for about 10 years since late 1990s. The economic growth rate of North Korea continued to be negative from 1990 to 1998. Therefore North Korea tried to recover its economics by the name of 'power country' construction. It is well shown that General Secretary Kim, Jong-il, remarkably increased his support for economic area.

Second, it is because of the engagement policy of former president Kim, Dae-jung; and reconciling and cooperating atmosphere of North and South Korea since the summit. Kim, Dae-Jung government consistently sustained the engagement policy; and pursued the peace of the Korean Peninsula and its reconciliation and cooperation.

North Korea also realized that improving relationship with South Korea and expanding economic cooperation were essential for overcoming critical economic crisis under understanding the purpose of the *Sunshine Policy* (The sunshine policy means various economic policies executed by Kim, Dae Jung Government for supporting the North Korea).

Therefore the agreement on the Kaesong industrial complex was based on the realistic recognition. There is no other country that would support North Korea as South Korea does, and companies in South Korea are willing to invest in North Korea.

### The Promotion Process of Kaesong Industrial Complex

Kaesong industrial complex construction business is one of the businesses that the late honorary chairman of Hyundai group Chung, Ju-yung had in mind. He visited North Korea in December 1998 and in February 1999. This project made rapid progress as he presented west coast industrial complex project of 8 million Pyeong scale to North Korea and North Korea accepted it. In the next step, Chung, Mong-Hun, the chairman of Hyundai group, and Kim, Yoon-Kyu, the president of Hyundai Asan Co., visited North Korea. They had a meeting with the North Korean leader Kim, Jong-il and the complex construction business took a concrete shape in August, 2000.

Afterwards the agreement on the construction

business of Kaesong industrial complex was officially made on August, 2000. In order to support it institutionally, North Korea announced "the Law for Kaesong Industrial District" on November, 2002. Pursuant to the law, the Korea Land Corporation finally achieved right for the real business which includes raising funds to secure 1 million Pyeong construction sites, designing, supervising, and selling in lots.

Table 1: The promotion process of Kaesong industrial complex

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- Aug 22 2000	Made an agreement on 20million Pyeong construction between Hyundai Group and North Asia Pacific
- Nov 27 2002	North Korea announced "the Law of the Kaesong Industrial District" and its regulations
- Dec 27 2002	Ministry of Unification approved Hyundai- Korea Land Corporation as 'an economic joint venture'
- June 30 2003	Held the ground-breaking ceremony of Kaesong industrial complex
- Dec 12 2003	Established the construction office of the Kaesong industrial complex
- Jan 29 2004	Made an agreement on coming and goings, and stays in Kaesong industrial complex and Mt. Geumgang district (so-called 'an agreement on traffic')
- June 30 2004	Constructed Kaesong industrial complex pilot park (28 thousand Pyeong) held the completion ceremony
- Dec 15 2004	Ceremony of making the first product in Kaesong industrial complex (Pilot park in operation)
- Dec 5 2005	Companies inaugurated plant construction

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Source: The Ministry of Unification (<http://www.unikorea.go.kr>).<sup>[6]</sup>

Afterwards, the progress has been made on the talks and arguments on the Kaesong industrial complex construction. The completion ceremony of its pilot zone was recently held on June, 2004 and 15 companies were selected as participating in this business.<sup>[7]</sup> Products made in Kaesong industrial complex exported for the first time in April, 2005. The amount of exportation reached \$14,900,000 in December, 2005.

### Business Conditions of Kaesong Industrial Complex

Kaesong industrial complex has an advantage that it's near South Korea so that enterprises of South Korea may dispatch their employees and land price of North Korea is relatively low. First, it's 60 kilometers away from Seoul and 170 kilometers away

Pyongyang which enables to get power supply from South Korea; and delivering lots of materials and people easily by railways, roads, and sea routes.

Second, South Korea may take control of Kaesong industrial complex by selecting a chief director and members of 'the administrative agency for industrial park' from Hyundai Asan Co. and Korea Land Corporation.

Third, the minimum salary of North Korean labors can meet at \$57.5 (minimum wage \$50+social insurance fee 15%) and the rate of annual salary raise may be limited by 5%. Then the salary is considerably lower than that of China (\$100~\$200) and even lower than that of Vietnam (\$60). The productivity also can be raised by directly giving salaries to employees and by giving out bonuses. Working hours in North Korea is 48 hours per week which is more profitable than those of China (44 hours per week). Refer to Table 2.

Fourth, companies in Kaesong industrial complex supply raw materials, selling products and commission by making a contract with agencies, corporations and organizations of North Korea.

Fifth, companies in social overhead capital, light industries, science and high technology fields of Kaesong industrial complex pay 10% of their profit as corporate income taxes to North Korea. Companies in other fields of Kaesong industrial complex pay 14% of their profit as corporate income taxes to North Korea. It is lower than corporate income taxes that companies have to pay to Chinese special economic zone (SEZ) (15%). Companies that continue to be in promotion and production area (non -service area) for more than 15 years will be fully exempted from corporate income tax for five years; and after that 50% of income tax will be reduced for the next 3 years. Companies that continue to be in service area for more than 10 years will be fully exempted from corporate tax income for 2 years beginning from the profit generation year; and 50% of income tax will be reduced for the next year. Therefore running a business in North Korea is more favorable to companies than those in China in terms of corporate income tax (Corporate income taxes are exempt for two years from the profit generation year and 50 % of income taxes are reduced for the next three years in China. So, Gaeseong industrial complex is better working place than China).

Sixth, parceling-out price of industrial park is about \150,000 per Pyeong, which is higher than that of Dandong district in China, \50,000 per Pyeong.

**Obstacles of the Kaesong Industrial Complex project:** Kaesong industrial complex project has been well mutual understandings. It has been only 6 years since the South and the North agreed on this development. South Korea is also involved in Mt. Geumgang tourism business, and constructing of railways and roads for establishing social overhead capital. The South completed the construction of the pilot zone of Kaesong industrial complex. North Korea

supports economic activities institutionally by enacting "the Law for Kaesong Industrial District."

Despite these efforts, it is difficult to carry out producing facilities and secure export markets unless North Korea nuclear problems is solved, and its relationship with U.S., is improved. It is one of the biggest obstacles in the success of the business. Besides it has institutional obstacles which need to be adjusted step by step.<sup>[8]</sup>

First, there's a control system which places a restriction in exporting strategic goods. Pursuant to Wassenaar Arrangement, an outflow restriction regulation of strategic goods exports, it is difficult to get production facilities and parts outflow into Kaesong industrial complex. Wassenaar Arrangement is established in order to replace Coordinating Committee for Export control (COCOM) of cold war era. It is an international regulation which prevents cutting-edge strategic products and technologies from inflowing into troubled areas, particularly countries considered as supporters of terrorist groups. So, it specifies the export control of conventional weapons, and dual uses items and technologies. It means there's a considerable restriction against outflow of electron and precision parts in North Korea and it inevitably will delay the progress of the related business.

Second, custom tariff rate is high. The products manufactured in North Korea are applied by the very high tariff rate Column□ that is dozens of times higher than those of other countries so that it is not easy to export these products to Western countries. For example, in U.S., 65.0% custom tariff is imposed on ties made in North Korea, whereas 7.6% custom tariff is imposed on ties made in other countries. Therefore products manufactured in North Korea are considerably inferior to those made in other countries in their price.

Third, laws and institutional devices are insufficient. On the whole, Inter-Korean economic cooperation written agreement should be come into effect shortly and processes of 3C (Come-and-go, Communications, Customs) and an inspection sector should be simplified, since South Korea selects companies working in Kaesong industrial complex. Above all, additional agreement and complementary measures should be made first since the regulations of the Law for Kaesong industrial district are yet to be made; and concrete practice conference is delayed.

Fourth, the Inter-Korean cooperation fund is short of money. The demands of Inter-Korean cooperation fund are gradually increasing as the North and the South expand its economic cooperation whereas governmental donations tend to decrease. Therefore government donation is more needed for this shortage excluding light-water reactor.

Table 2: Comparison of industry park business conditions in Kaesong, China and South Korea

Classification	Unit	Kaesong (A)	China (B)	South Korea (C)	Compared to China (A/B)	Compared to South Korea (A/C)
Monthly Wage	\$	57.5	100-200	423	0.29-0.58	0.12
	\ <sup>1)</sup>	69,000	120,000-240,000	567,260 <sup>2)</sup>		
Legal Working hour per week	hour	48	44	44	1.1	1.1
Corporate Income Tax	%	10-14	15	23-28	-	-
parceling-out price per Pyeong	\	150,000	50,000 <sup>3)</sup>	407,550 <sup>4)</sup>	3	0.37

Notes: 1) \$ 1=\ 1,200 Won 2) Minimum Wage by Law 3) Based on Dandong district 4) Parceling-out price of national industrial complex in Sep., 2002 (excluding foreigners exclusive zone) ranged \ 194,700-620,400  
Source: Requoted from Park, Seok Sam (August, 2004)

Table 3: Economic Effects in Two Koreas (Direct Effects)

Section	unit	year						
		Yr 1-3	4 years	7 years	8 years	9 years	17 years later	
Total cost of industrial park construction	hundred million dollar				1.87			
	Annual amount of production	hundred million dollar	-	940	2170	2170	8390	8190
	Annual value-added	hundred million dollar	-	270	610	610	2440	2240
	Compared to GNI in 2003	[%]	[-]	[0.4]	[0.8]	[0.8]	[3.4]	[3.1]
	Number of jobs	thousand	-	13	30	30	104	104
	Compared to economically active population in 2002	[%]	[-]	[0.06]	[0.13]	[0.13]	[0.46]	[0.46]
Industrial park rent total revenue	hundred million dollar				1.36			
	Total Revenue (A+B)	hundred million dollar	-	0.6	1.3	1.3	6.0	22.8
	[Compared to GNI in 2003]	[%]	[-]	[0.3]	[0.7]	[0.7]	[3.3]	[12.4]
	Salary Revenue (A)	hundred million dollar	-	0.6	1.3	1.3	5.0	5.0
	Corporate Income Tax Revenue (B)	hundred million dollar	-	0.0	0.0	0.0	1.0	17.8
	Number of jobs	thousand	-	84	194	194	725	725
[Compared to economically active population in 2002]	[%]	[-]	[0.71]	[1.64]	[1.64]	[6.14]	[6.14]	

Source: The Bank of Korea (Aug., 2004)<sup>[13]</sup>

Table 4: Economic effects in the North (unit: \$100 million)

Classification			1 step	2 step	3 step	after completion (annual)	the total (for 9 years)	
Direct foreign currency earning effects	labor cost	complex construction	0.07	0.21	0.35	-	7.04	
		complex operation	-	1.13	3.56	1.73		
	raw and subsidiary materials	complex construction	0.37	0.74	1.85	-	25.29	
		complex operation	-	2.73	12.60	7.00		
	financial revenue	freight rates	-	0.71	3.26	1.81	13.88	
		land rent	0.10	0.20	0.50	-		
		corporate income tax	-	0.74	3.40	1.89		
		others	-	0.16	0.72	0.40		
	subtotal			0.54	6.61	26.24	12.84	46.21
	Industrial park construction	complex site construction		1.25	2.50	6.25	-	10.00
infrastructure construction		0.52	1.04	2.60	-	4.16		
landscaping of project		0.15	0.29	0.73	-	1.17		
subtotal			1.92	3.83	9.58	-	15.33	
Plant building construction			4.25	8.50	21.25	-	34.00	
Total			6.71	18.94	57.07	12.82	95.54	

Source: Hong, Soon Jick (April, 2004)

Table 5: Economic effects in the South Korea (unit: \$100 million)

Classification		step 1	step 2	step 3	after completion (annual)	the total (for 9 yrs.)
Labor cost reduction	constructing a complex <sup>a</sup>	13.90	9.13	22.82	-	45.85
	constructing a complex <sup>b</sup>	2.06	6.17	10.29	-	18.52
Sales effect of raw and subsidiary material	operating a complex	-	33.64	106.19	51.45	191.28
	constructing a complex <sup>a</sup>	6.86	1.71	7.26	-	15.84
Production inducement effect	operating a complex	-	32.76	151.20	84.00	267.96
	building a new town <sup>a</sup>	91.92	58.91	196.12	-	346.94
Value-	not building a new town <sup>b</sup>	20.53	41.06	120.62	-	182.21
	building a new town <sup>a</sup>	39.13	25.08	83.50	-	147.71

added inducement effect	not building a new town <sup>b</sup>	8.74	17.48	51.35	-	77.57
Total <sup>a</sup> (building a new town)		151.81	161.23	567.09	135.45	1015.59
Total <sup>b</sup> (not building a new town)		31.33	131.11	439.66	135.45	737.55

Notes: 1) <sup>a</sup> is a case of building a new town requested by the North, whereas <sup>b</sup> is a case of not building a new town. The difference of <sup>a</sup> and <sup>b</sup> in construction expenses are caused by the building of a new town. Therefore raw and subsidiary material sales revenue of industrial park construction <sup>a</sup> has nothing to do with the new town construction. It's the effect of new town construction. 2) The monthly average labor cost in North is \$57.5 and, in South \2,127,000 (\$1,772.5), here.

Source: Hong, Soon Jick (April, 2004)

### ECONOMIC EFFECTS OF KAESONG INDUSTRIAL COMPLEX PROJECT

**Meaning of Kaesong Industrial Complex Project:** Kaesong industrial complex project does not just mean an improvement of Inter-Korean bond. It is a large scale national policy business where the two Koreas pursue mutual interests by combining capital and technologies of the South with land and manpower of the North.

Kaesong industrial complex project provides geographical conditions that enable the South and the North to utilize their strong points, such as capital and technologies of South Korea and competitive manpower and resources of North Korea. Using these conditions, it can take 'the Inter-Korean economic cooperation stronghold' role, leading Inter-Korean economic community construction, by making less competitive small and medium sized enterprises work in this complex, creating rational division of labor structure of inter-Korea and developing the South and the North into a physical distribution center.<sup>[9]</sup>

Besides, it symbolizes confidence in the improvement of Inter-Korean relations such as connecting railways and roads between two. It has potentials to become a key place of human and material exchanges in Northeast Asia which may be a hub even to Europe. It is a business that will contribute to balanced improving relations in the Inter-Korean.

**Economic Effects in Two Koreas:** Inter-Korean economic effects of Kaesong industrial complex project is shown in Table 3. First, economic effects in the South are as follows. Annual amount of production will be reached at \84 billion; value-added amount of production will amount to \24.4 trillion which is 3.4% of gross national income (GNI) in 2003, considering 9 years from the development. Besides over 10 thousand job positions will be created which corresponds to 0.46% of economically active population in 2002.

Second, economic effects on the North are as

follows. The annual gross income is \$0.6 billion that corresponds to 3.3% of GNI of North Korean in 2003. More than 720 thousand job positions will be created, which amount corresponds to 6.14% of economically active population of the North in 2002.

**1. Economic effects in the North:** Economic effects of the Kaesong industrial complex project in the North are as follows. First, it helps North Korea to overcome financial difficulties. Direct foreign currency earning effects such as labor cost revenue, raw and subsidiary material sales revenue, and freight revenue will be acquired during its construction operation process. Summing it up with foreign currency from building industrial park and infrastructure will be reached around \$96 billion. It is 4 times of the amount of annual budget of North Korea and its trade amount.<sup>[10]</sup> Refer to Table 4.

Second, North Korea may show its public open-door image by pursuing this project. A remarkable progress hasn't been made although North Korea continues to amend regulations and institutions for attracting foreign investments since 1990s. It is well shown in Sinuiju special economic zone (SEZ) in 2002. However, Kaesong industrial complex project is different from that it is an economic joint venture through a direct agreement by two Koreas. Therefore the North may outgrow its closed image by this project.<sup>[11]</sup>

Third, it is possible to acquire technology and management know-how for economic development. Technology and manufacturing facilities of the South will bring about intra-industry relation effect such as constructing infrastructure around the industrial park like railroads and roads; and developing industries related to the industrial park. It is expected that respectively \3.3 trillion of production effect and \1.1trillion of value-added inducement effect. Besides about 39 thousand job positions will also be made.<sup>[12]</sup>

**2. Economic Effects in the South:** Economic effects of the Kaesong industrial complex project in the South

may be divided into three.<sup>[11]</sup> First, it will revitalize domestic economy. It will be less competitive small and medium sized enterprises because of high-cost structure with new opportunities. We may become more competitive in the world by expanding our productivity and developing industries which can be done by concentrating on high value-added business and production process.

Economic effects of the project in the South can be seen in Table 5 which shows labor cost reduction, sales effects of raw and subsidiary materials, production and value-added inducement effects. When the first step of Kaesong industrial complex project is completed, total \$3.1 billion effects will be revealed. By the time all the three steps of the projects are completed in 9 years later, the total effect will be summed to approximately \$73.7 billion.

Second, South Korea may secure a production base. South Korea may become more competitive in the manufacturing industry from the labor-intensive industries, such as the textile industry to the high-tech industries, by securing a production base where technology may be transferred easily and management skills may be taught with ease.

Third, South Korea may establish a bridgehead to the northern direction. Although there were diplomatic relationships with China and Russia, they have had barely economic exchanges. By doing this project, human and material network of North Korea become connected to companies in South Korea so that companies in South Korea may play a bridgehead role to the northern direction.

## **CONCLUSIONS AND POLICY IMPLICATIONS**

Kaesong industrial complex project pursued as an Inter-Korean economic cooperation business is promoted to revive North Korean economy in an early stage and to get new growth power of Korean economy. It is considered as a win-win joint venture that guarantees economic prosperity and political peace to both Koreas by securing a base to become a center of Northeast Asian economies.

Each Korea has various tasks that should be resolved, and policies in both Koreas should be amended for the Kaesong industrial complex project to be recognized as a successful economic joint venture.

First, South Korea must resolve tasks such as improving institution related to Inter-Korean economic cooperation and outflow deregulation of strategic

materials. Overall supporting policies from the government also need to be accompanied. It is necessary to reform “the Law for Inter-Korean Exchanges and Cooperation” and “the Law for Inter-Korean Cooperation Funds” to simplify procedures of going North Korea, to simplify approval procedures of Inter-Korean economic joint venture, and to operate loss support systems which guarantee stability of investment in North Korea and reduce investors’ taking risks.

Second, North Korea should amend regulations on Kaesong industrial complex such as regulations for real estate and controlling foreign currency. It should be improved finance and foreign currency systems regardless of the political environment change of Kaesong industrial complex. Finance and foreign currency systems should be improved to specify base currency; to specify whether won currency may be used or not; to allow autonomies of companies in the Kaesong industrial complex for autonomic employment and dismissal of manpower in North Korea; to establish banks for a safety of financial transactions.

Third, both Koreas should provide systems to guarantee traffics communications, and transportation as well as personal security. It is essential to effectuate ‘an investment guarantee accord’ as a mechanism to guarantee investment safety. Systematic mechanisms also are needed to prevent North Korea from reducing or suspending the projects for political reasons. Finally, it is imperative to guarantee the freedom of economic operations in order to succeed the Kaesong industrial complex project in the long term. Military tensions on the Korean Peninsula should be eased both in political and military point of view. Kaesong industrial complex project is also meaningful, as it will perform a special economic zone from the point of view of the third country. Therefore, the success of economic policy of North Korea through reform and open-door policy depends on the success of this project.

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