

## Could a Pan-Korea Development Corporation Promote Economic Cooperation between South and North Korea?

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With the possibility of a North-South peace treaty between the two Koreas becoming a real possibility at some time in the future, considerable discussion has arisen as to be the best way in which the more prosperous South could assist the North toward an economic recovery which would both promote unification and be a necessary condition of unification. The author here seeks to examine the various possibilities and discuss relative merits.

**Key Words:** Korea, unification, economic aid, privatization.

Recently, South Korea offered large-scale economic assistance to North Korea if the North would agree to a dialogue leading to a peace treaty. As expected, the North did not respond. Yet, its dwindling economy,<sup>1</sup> hampered by significant reductions in economic aid from Russia and China, may leave North Korea little choice but to accept the offer in the near future. Alternatively, a sudden or gradual unification of the two Koreas under South Korean tutelage will require the South to provide important economic assistance to the North. It is imperative, therefore, to start contemplating the most efficient method of economic cooperation between the two Koreas.

North Korea, with badly dilapidated economic structures, offers abundant and highly profitable investment opportunities, especially in its infrastructure.<sup>2</sup> However, these opportunities have been created and preserved by the enormous sacrifices of ordinary people in the North in terms of perpetual sub-standard living conditions. To a lesser degree, sacrifices were also imposed upon the ordinary

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<sup>1</sup> For the current economic condition in North Korea, see for example, Sungwoo Kim, "North Korea's Economy Analyzed Through Its Foreign Trade," *Vantage Point*, Vol. XX, No.8, August 1997, pp. 27-39.

<sup>2</sup> See, Marcus Noland, "Why North Korea Will Muddle Through," *Foreign Affairs*, Vol. 76, No. 4, July/August 1997, pp. 105-118.

people in the South either directly by the devastation of the Korean War or indirectly through welfare losses resulting from the unavailability of half of Korea. Therefore, we posit that the fundamental objective of economic cooperation between the two Koreas should be to maximize economic benefits for all, especially for the ordinary people of both North and South Korea, rather than a small subset of the population fortunate enough to have funds for investment in the North. With this tenet, we will evaluate the relative efficiencies of six conventional forms of economic cooperation. Finding that none of them satisfies our basic objective, we propose a new vehicle for economic cooperation.

### **North Korea's Current Economic Malady**

A search for the efficient method of economic cooperation requires a basic knowledge of the major defects in North Korea's economy so that the proposed cooperation will be able to eliminate these defects.<sup>3</sup> We discuss only several obvious major defects.

First, the prevalence of *Juche*, or the self-sufficiency policy, has mandated the maximum use of indigenous materials and technology. Coupled with the constant emphasis on speed of accomplishment, this mandate compelled a widespread improvisation with a crude common sense, rather than a scientific technology, even on major projects. Such crude technology has an absolute limit and may work for a short run, but it is totally inadequate and inefficient for a long run. Factories built and operated with improvised technology ran for a while with an ad hoc system of repairs and replacement. Eventually they reached a point of non-rehabilitation, and most production came to a standstill.

Second, North Korea's rigid central planning assigns annual production quotas to individual factories, without detailed analysis of direct and indirect demands for their products by the rest of the

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<sup>3</sup> For further discussion on this point, see Sungwoo Kim, "Agricultural Policy and Grain Production in North Korea," *Journal of Social, Political and Economic Studies*, Vol. 22, No. 1, Spring 1997, pp.23-38.

economy.<sup>4</sup> Quotas specify only the quantity, not the quality, of products. To meet an assigned quota on time, quality was seriously compromised, with the result that the amount of usable products was much smaller than the amount delivered. Consequently, the total output of certain sectors was grossly inadequate to support the rest of the economy, and production halted due to the lack of raw materials. Practically in every multi-year economic plan for North Korea, projected target years had to be postponed by several years, which the North has referred to as adjustment periods, due to the serious imbalance in output between individual sectors of the economy.

Third, due to a strict pyramid chain of command, there is no accountability for policy failures. All major economic policies are dictated by the leadership at the top, often in the form of instant decisions during field trips. Those below the top simply implement the assigned policy devoid of accountability; the leadership at the top can never be presumed to make a mistake, and therefore, nobody ultimately is to be held responsible for a policy failure. Worse yet, since the failure of a leader's policy can never be acknowledged and rectified, new policies and projects must envelop the existing defects of previous policies, with the result that flaws magnify and multiply over time.

Fourth, the existing system significantly discourages economic incentives for individual workers. All workers in North Korea are considered government employees with fixed salaries and assigned production quotas. The quota is determined annually on the basis of the previous year's performance. On the one hand, over-fulfillment of the assigned quota produces temporary benefits, often in the form of meaningless badges or titles; on the other, it engenders the serious cost of inviting a higher future quota, the failure of which imposes a severe penalty. Thus, workers are content with fulfilling the current quota, and plant managers actively lobby for a lower annual quota.

Finally, potential economic paralysis due to these system failures has been so far mitigated by an infusion of massive economic aid

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<sup>4</sup> Under central planning, vested interests of individual departments to ensure the accomplishment of assigned production quotas tend to result in a much higher capital-output ratio than the optimum, and perpetuate enormous production inefficiency. United Nations, *World Economic and Social Survey 1996*, New York, 1996, Ch.VI.

from the former U.S.S.R. and China. However, this aid was in fact a curse in disguise. Like an infant industry syndrome, economic aid continued or increased as long as North Korea's economy remained underdeveloped; and, consequently, the aid has prolonged the economic inefficiency of the North.<sup>5</sup>

The sudden collapse of the socialist world with a significant reduction in aid dealt a serious blow to North Korea's economy. The immediate and visible impact of this predicament was famine due to grain shortage, which the North attributed to natural calamity, yet in reality was caused by chronic failure of the system that was hidden so far by foreign aid. For all practical purposes, North Korea's economic structure has deteriorated beyond a point of rehabilitation through piecemeal patch-works. The only solution is to revamp the current structure with a modern system based on rational economic principles. This will be the second major objective of the proposed economic cooperation between the two Koreas.

#### **The Relative Efficiency of Alternative Forms of Possible Economic Cooperation**

We reiterate the basic objective, other than the obvious desirability of reducing the potential military threat of war between the two Koreas, of any proposed economic cooperation is to ensure that maximum benefits accrue to the ordinary people of both North and South Korea, and maximum revamping of the current economic structure of North Korea with a modern economic system. With these tenets, we evaluate, in ascending order, the relative efficiencies of six conventional forms of economic cooperation.

The first form can be direct aid in goods and services from the South to the North. As mentioned, this type of aid from the former U.S.S.R. and China has prolonged the mismanagement of the North Korean economy. This form of direct aid should be used only for a temporary and specific purpose, such as grain assistance based on purely humanitarian considerations, and should never be used for the

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<sup>5</sup> Many empirical studies find either no or a negative correlation between the amounts of economic aid and economic growth of the recipient countries. See Carol Graham and Michael O'Hanlon, "Making Foreign Aid Work," *Foreign Affairs*, Vol. 76, No.4, July/August, 1997, pp.96-104.

purpose of economic development. If this form of aid is intended to encourage North Korea's superficial participation, without its sincere desire, in a peace dialogue, then as North Korea's economy regresses in the future the required amount of aid would have to increase correspondingly. The moment the South discontinued such aid for lack of progress in the peace talks, tension in the Korean peninsular would revert to the original state of belligerence without any tangible benefits deriving from the past aid. In addition, such assistance benefits only a small segment of the population in the North, mainly the highly visible and easily verifiable urban dwellers. In the North, a choice of occupation as well as residency is strictly controlled by the government.<sup>6</sup> Urban dwellers with cultural and educational amenities are in fact the privileged class of the society. Benefitting mainly urbanites at the sacrifice of less visible rural dwellers does not satisfy our stated tenet of economic cooperation. An additional technical difficulty is North Korea's extreme sensitivity about the identity of donor countries, especially South Korea. In the past, the North insisted that all identifying labels be removed, with the South steadfastly refusing compliance. This contention may seriously complicate the intended aid in goods and services.

The second form of economic cooperation could be that the South provide an investment fund, to be managed by the North for the improvement of its civilian economy – similar to South Korea's economic aid to the former Soviet Union.<sup>7</sup> This form would be politically acceptable to the North, but has two major inherent problems. In the totally government-controlled economy of the North, it is impossible to delineate between the military and the civilian sectors, except the obvious ones such as armament production. For example, such seemingly innocuous products as clothes, shoes or bicycles destined to the civilian sector can be quickly transferred by

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<sup>6</sup> In North Korea, occupation and residency of an individual is strictly controlled by the government. For details, see Philo Kim, *Two Koreas in Development*, New Brunswick, N.J.: Transaction Publishers, 1992.

<sup>7</sup> For a fascinating account on how South Korea and Russia opened a formal diplomatic relationship with \$4 billion in economic aid from South Korea to the Soviet Union, see Kim Hakjoon, "The Process Leading to the Establishment of Diplomatic Relations Between South Korea and the Soviet Union," *Asian Survey*, Vol. XXXVII, No. 7, July 1997, pp. 637-651.

the government to the military.<sup>8</sup> To a certain degree, such transfer can also be effected in South Korea. Yet, this action requires a congressional approval after lengthy public debate. Unless the nature of proposed investment projects is known and can be monitored in great detail, a measure which the North will strenuously object to, any economic assistance from the South in order to mitigate the military threat from the North may in fact enhance that threat at a future date. Next, letting the North manage the new investments with its current managerial expertise and system almost guarantees the failure of the new investment and a total waste of funds, as evidenced by the current debacle of North Korea's economy. North Korean leadership, completely indoctrinated into its *Juche* policy and rigid central planning, is not willing to adapt to the rational decision making of a modern economy.

The third form of economic cooperation could be that South Korea, with the advice of North Korea, unilaterally decide and supervise chosen investment projects in the North. This kind of subservient relationship may not be acceptable to the North. Even with certain modifications palatable to the North, government's direct involvement in the civilian economy is the least efficient method of management, as evidenced by the current trend of deregulation in many industrialized countries.<sup>9</sup> The success of investment in a totally untested area such as North Korea requires vision and risk-taking entrepreneurship with potentially very high personal consequences.

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<sup>8</sup> One estimate places North Korea's defense budget up to 27% of its Gross Domestic Product. Compared to 4% of the defense budget of South Korea out of its GDP, the military expenses of North Korea enjoy a huge part of its economy, and it will not be easy to delineate between military and civilian expenditures in North Korea. See, Park Jin, "North Korea's Fiscal Problems: Are there any solutions?" in *North Korea: Uneasy, Shaky Kim Jong-il Regime*, Seoul, Korea: Naewoe Press, 1997, pp. 197-249.

It may be informative to have a glimpse of defense budget of the former U.S.S.R. Its defense budget is top secret information known to only three people in the country. According to its former president, the true defense budget was 40%, rather than the publicly alleged 16%, of the total state budget. Also 20 billion out of 25 billion rubles earmarked for scientific research was spent for military purpose. See Mikhail Gorbachev, *Memoirs*, New York: Doubleday, 1995, p. 215

<sup>9</sup> In addition, corruption by government workers tends to be rampant in a developing market-oriented economy such as China. Hilton Root, "Corruption in China, Has It Become Systematic?", *Asian Survey*, Vol. XXXVI, No. 8, August 1996, pp. 741-757.

Government employees lack vested personal interests in the success of an investment project. To them, failure of the project brings a much more severe personal penalty than the reward associated with success, and they tend to act very cautiously. This behavior is totally unsuitable to pioneering investment projects in North Korea.

The fourth form of cooperation could be the creation of a new agency staffed by an equal number of representatives from the South and the North, with each side having equal voting as well as veto power on investment decisions. This form might be politically amenable to the North, yet is potentially as absurd as a ship with two captains with significantly different destinations yet with equal authority of command. In fact, North Korea has always favored this type of unification under the proposed name Kyo Republic in which a new government would be formed with an equal number of representatives and voting rights from the South and the North. South Korea, with a population twice as large and its economy far stronger than that of North Korea, rejected this suggestion of equal representation in government.

In the fifth form of cooperation, economic experts from neutral countries might be invited to initiate and manage investment projects in North Korea mainly funded by South Korea. This proposal contains two serious problems. First, due to rapid globalization of the world economy, it is almost impossible to find countries or individuals totally neutral to the Korean economy. South Korea's successes in ship building and steel production had a seriously adverse impact upon the corresponding industries in Italy and Poland. In a recent Tumen River development proposal by the supposedly neutral United Nations, the discord over vested interests by directly affected nations, namely North Korea, China, and Russia, almost ruined the project. Actual project being undertaken is much smaller in scope and imagination than the one originally envisioned.<sup>10</sup> Second, the suggested form is a direct insult to South Korea's entrepreneurship. Under its tutelage, South Korea was able to accomplish one of the highest economic growth rates in the world. The suggested form is tantamount to substituting these entrepreneurs

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<sup>10</sup> See, Daniel Adrich, "If you build it, they will come: a cautionary tale about the Tumen River Projects," *Journal of East Asian Affairs*, Vol. 11, No.1, Winter 1997, pp. 299-326.

with economists and managers from other countries with less vested interests and competence.

In order to maximize the participation of South Korean entrepreneurs, the sixth form of economic cooperation could take the form of joint ventures between conglomerates of South Korea and the government of North Korea under tax incentives or guaranteed loss reimbursement by the South Korean government. In fact, on a small scale such joint ventures have already been undertaken with substantial success. This form is superior to the other forms discussed so far; yet it does not maximize our basic objective of economic cooperation between the South and the North. The principle of a market economy dictates that the South Korean conglomerates would concentrate their investments in North Korea into the most profitable, though perfectly legal and morally justifiable, projects with short term horizons.<sup>11</sup> They would likely shy away from investments in basic infrastructure with significant externalities and a long-run horizon. In addition, benefits from investments, which could be enormous, would accrue only to a small segment of the population in the South fortunate enough to own shares in the participating conglomerates, as well as to people in the North directly involved in the projects. This form of cooperation would not maximize the benefits for ordinary people in the North and the South, in addition to maximizing investments in the infrastructure of the North.

### **The Creation of a Pan-Korea Development Corporation**

So far we have assumed that economic cooperation would be carried out by the two independent countries of South and North Korea. We also have to consider a remote possibility that the two Koreas would be unified under the tutelage of South Korea. In this case, the proposed economic assistance will have to assume an additional role of preventing a highly disruptive occurrence after the unification. In South Korea, speculation on real estate had been one of the most profitable investments. At the moment of unification, the Southerners with means will attempt to purchase practically every

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<sup>11</sup> Kelley K. Hwang, "South Korea's bureaucracy and the informal politics of economic development," *Asian Survey*, Vol.XXXVI, No. 3, March 1996, pp. 306-319.



inch of the Northern land even with its site unseen. Eventual commercial development of the land will require a massive relocation of current residents on the land or worse, denudation of ancestral burial sites, with the resulting enmity of Northerners against the South. To avoid this, initial pivotal investments in the North after unification must be carried out by a single entity under the mandate of the stated fundamental objectives of economic cooperation.

While any form of aid to North Korea would inevitably be subject to the terms of a unification treaty, we would propose the establishment of a quasi-public agency tentatively called the Pan-Korea Development Corporation, with sole jurisdiction for the generation of funds for and investment decisions in the North in the early stage of unification. The total population of Korea is composed of 45 million in the South and 24 million in the North. The corporation would create 69 million of its shares, which would be offered on a voluntary basis one share each to every citizen in the South at \$100 per share and to every citizen in the North without charge *if* the Northerners agree to remain in the North. To insure full participation by every citizen of the South, the central bank of the South will lend, with the proposed share as collateral, up to \$100 to anyone who needs the money to purchase the share. This will generate an initial fund of at least \$4 billion for exclusive investments in the North, mainly in new infrastructure, with employment priority given to people in the North.<sup>12</sup> Profits accruing from user fees, especially from commercial users, charged on the new infrastructure will be equally distributed to all holders of the shares both in the South and the North. The remuneration for directors of the proposed corporation will be determined solely by the economic success of new investments in the infrastructure of the North.

At this point, one can legitimately argue that the proposed investment of \$4 billion by the PKDC would be trivial in comparison with the several hundred billion dollars of investment that were purported to be required by the South for North Korea after

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<sup>12</sup> See, Marcus Noland, Sherman Robinson, and Monica Scataska, "Modeling Economic Reform in North Korea," *Journal of Asian Economics*, Vol. 8, No. 1, Spring 1997, pp. 15-38. In addition, a unified Korea should seek various international funds for economic development. See, Robert A. Manning, "The United States and the Endgame in Korea," *Asian Survey*, Vol. XXXVII, No. 7, July 1997, pp. 597-608.

unification.<sup>13</sup> Lest this allegation of the enormous investment requirement dispirits the aspiration of the PKDC, the validity of the allegation needs to be examined carefully.

First of all, the PKDC is designed to provide only the nucleus of future investments in the North, concentrating mainly on its infrastructure and continuously being re-invested in new projects. The PKDC will be complemented by parallel investments with funds from world financial institutions for economic development as well as from private sources for purely commercial enterprises.

Secondly, the allegation of an enormous investment requirement is based on three unfounded assumptions. First, implicit in this allegation is a fear that without a significant and expeditious reduction in the income gap between the two Koreas after unification, there would be a detrimental mass labor migration from the North to the South. That this can be prevented is revealed by the recent experience of the German unification in which the expected mass exodus of people from east to west was avoided due to governmental policies.<sup>14</sup> No doubt, there will be a certain amount of non-economic migration in either direction immediately after unification. However, for long term economic migration, a mere difference in incomes between any two places does not provide sufficient incentive. Economic migrants evaluate potential incomes, i.e., actual income discounted by the probability of acquiring it, of places of origin and destination, and only when the difference in the potential income is greater than actual cost of migration, including economic as well as psychic costs of separation from family, friends, and familiar surrounding, is migration likely to ensue.<sup>15</sup> To wit, even in South Korea itself, there are substantial income differentials between industrial urban centers and agrarian rural areas. Yet, rural-

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<sup>13</sup> One study suggests that South Korea may need to invest between \$600 and \$857 billion worth of new investments in North Korea after unification. Noland, Robinson, and Scatista, *op. cit.*

<sup>14</sup> After German unification, the feared mass migration from East to West Germany did not materialize. See Gerlinde Sinn and Hans-Werner Sinn, *Jumpstart; The Economic Unification of Germany*, Cambridge, Mass: The MIT Press, 1992, p. 8.

<sup>15</sup> For further discussion on this point, see Sungwoo Kim, "Interregional Economic Migration: Some Theoretical Considerations, Part I and II: Comment," *Journal of Regional Science*, Vol.17, No.1, April 1977, pp. 117-123.

urban labor migration ceased to be a major economic problem. After unification, if the people in the North are accorded employment priority in new investments, their potential incomes will hopefully be significantly bolstered and economic migration to the South would then be greatly curtailed.

Second, it is unrealistic to expect to significantly reduce income gaps between regions within a short period of time. Even in the richest countries in the world, such as United States and Japan, there exist substantial regional income gaps without serious detrimental effects. Especially in Korea where North and South have maintained totally opposite economic systems for more than a half century, it will require at least a decade to achieve an appropriate integration of the two systems without seriously negative side effects. What is important is not that an income gap will exist during this transitional period, but that the gap be narrowed by sincere efforts of the unified Korea on behalf of the people in the North.

Third, the notion that on unification the South will have to bear all responsibility for rejuvenating the Northern economy is somewhat condescending to the people in the North. As Hirshman convincingly demonstrates in his analysis of economic development, every country underestimates its true economic potential. Only those countries, including South Korea, which were willing to take seemingly insurmountable risks were able to develop their economies.<sup>16</sup> The North Koreans are a well-educated and highly-motivated people, and should not need to be treated like welfare recipients in the unified Korea. Given the economic freedom then with the aid of the initial investment fund, as well as economic guidance and cooperation from the South, the North should be able to develop its economy on its own momentum.<sup>17</sup> Especially if the South will guarantee markets, either domestic or overseas, for products from the North, we may

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<sup>16</sup> Albert O. Hirschman, *Development Projects Observed*, Washington, D.C.:Brookings Institution, 1967. For the "hiding hand" in action, see, Elliot Marseille, "Intraocular Lenses, Blindness Control, and the Hiding Hand," in Lloyd Rodwin and Donald A. Schon, (eds.), *Rethinking The Development Experiences*, Washington, D.C.:Brookings Institution, 1994, pp. 147-175.

<sup>17</sup> A unified Korea could greatly benefit from the experience of German unification. For example, right after unification, Germany established the Treuhandanstalt to facilitate the transfer of state owned firms in East Germany into civilian management. For further discussion, see Sinn and Sinn, *op. cit.*

expect enough entrepreneurs to emerge in the North to create a sustained growth through a ripple effects.

Therefore, a proposed investment of \$4 billion, which may not be sufficient to radically transform the Northern economy overnight, in a Pan-Korea Development Corporation of the kind I have described would provide a powerful initial thrust for gradual and sustainable development of the North after unification.

## The Ambiguous Status of the U.S. Insular Territories

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The author surveys the anachronistic constitutional status of the diverse U.S. insular "territories" and finds that these vary widely, many of them having been granted extra-Constitutional privileges superior to those possessed by the states of the Union.

Key Words: U.S. Territories, U.S. Constitution, U.S. Nationality, International Treaties

Historically, a U.S. territory was a land with a population too small and scattered to govern itself as a state and therefore was administered by the federal government. But most importantly, a U.S. territory was considered to be, above all else, a temporary status. Based upon the principles of the Northwest Ordinance of 1787 – principles implemented by the federal administrations of George Washington, John Adams, Thomas Jefferson and James Madison – States were to be carved out of existing territories and admitted to the Union on the basis of equality with existing states. This was the case with the Old Northwest Territory, the Old Southwest Territory, Louisiana Territory, Oregon Territory, and Mexican Cession.

Since a territorial status was temporary, territories which did not become States either became independent countries – Cuba in 1903 and the Philippines in 1946 – or were transferred, in whole or in part, to a foreign power. For example, the northwest portion of the Louisiana Territory (1818),<sup>2</sup> the northeast portion of the State of Maine (1842),<sup>3</sup> the northern half of the Oregon Territory (1846),<sup>4</sup> and one-third of the Alaskan panhandle (1903)<sup>5</sup> were transferred to the United Kingdom; Okinawa (1972) was transferred to Japan,<sup>6</sup> and

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<sup>1</sup> Mr. Fallon is the author of *Deconstructing the United States*, published in 1998 as Monograph Number 27 in the *Journal of Social, Political and Economic Studies Monograph Series*.

<sup>2</sup> Convention of October 20, 1818.

<sup>3</sup> The Webster-Ashburn Treaty of August 9, 1842.

<sup>4</sup> The Buchanan-Pakenham Treaty of June 15, 1846.

<sup>5</sup> The Alaska Boundary Tribunal Award of October 20, 1903.

<sup>6</sup> U.S.-Japan Treaty of May 15, 1972.