

## ADVANCING ECONOMIC FREEDOM: KEY TO ENSURING SOUTH KOREA'S GREATER ECONOMIC FUTURE

By Anthony B. Kim

### Abstract

Despite a considerable level of uncertainty caused by the global economic slowdown since late 2008, South Korea has outperformed many other advanced economies in terms of installing a path of solid economic recovery. Nevertheless, South Korea has confronted its own economic and political challenges as the country attempts to weather uncertain times ahead and to chart a new chapter of advancement. In 2012, the intensity of the debate on how to further reform and reshape South Korea's economy for the future, particularly the role of government in free markets, was greater than ever before. Sound development and progress of a market economy requires a fair and transparent competitive environment as well as the security of economic freedom. The South Korean economy needs greater transparency and market competition fostered by economic freedom, not a new kind of government meddling or the policy pursuit of big government in the name of "economic democratization." In fact, "economic democratization" needs to be discussed in the frame of enhancing economic freedom, not limiting it. Economic freedom, cultivated by the rule of law, limited government, regulatory efficiency, and open markets, is critical to generating the broader-based economic dynamism. Undeniably, many of the positive changes South Korea has achieved over the past decades can be attributed to discarding the old way of thinking. In upgrading its economic system, a truly dynamic Korea should embrace greater economic freedom.

### Introduction

With global economic recovery far from secure, many major economies continue to be at a critical juncture and face decisive policy choices. Political and economic developments since the economic and financial turmoil in late 2008 have inspired a fundamental rethinking of the social contract between citizens and governments in many parts of the world. Indeed, South Korea, one of the world's top 35 free economies according to the Heritage Foundation's *Index of Economic Freedom*, has confronted its own economic and political challenges as the country attempts to weather uncertain times ahead and to chart a new chapter of advancement.

Both economically and politically, the year 2012 was an important milestone for the South Korean economy. In the midst of the ongoing global economic slowdown and weak recovery, it marked the fifteenth year after the 1997 Asian financial crisis that South Korea successfully upgraded its economy. With earlier market reforms triggered by the crisis relatively well institutionalized and other macroeconomic policies to sustain economic expansion in place, the South Korean economy grew at a respectable pace of over three percent in 2012. Also notably, for the first time in twenty years, South Korea held both parliamentary and presidential elections in the same year. The intensity of the debate on how to further reform and reshape South Korea's economy for the future, particularly the role of government in free markets, was greater than ever before.

**Anthony Kim** is Senior Policy Analyst for Economic Freedom in the Center for International Trade and Economics at the Heritage Foundation. Mr. Kim's paper is the fifty-fifth in KEI's Academic Paper Series. Note: The findings, interpretations, and conclusions expressed in this paper are entirely those of the author. They do not represent the views of the Heritage Foundation.

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Korea Economic Institute  
1800 K Street, NW Suite 1010  
Washington, DC 20006  
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This paper will take a brief look back at South Korea's economic transformation since the 1997 financial crisis and argue that advancing economic freedom through more committed institutional reforms is critical to meaningfully realizing the country's pursuit of so-called "economic democratization" as well as installing broad-based economic expansion for the future. Undoubtedly, the South Korean economy has the fundamentals—such as its large supplies of capital, highly educated labor forces, modern infrastructure, and stable legal system—all in place. The extent of South Korea's long-term economic vigor and competitiveness, however, will be critically determined by both the outcome of ongoing debates about the proper scope of government and the country's progress toward greater economic freedom. One of the most effective welfare policies, after all, would be to sustain a vibrant entrepreneurial environment that creates dynamic employment and investment opportunities for a greater number of South Koreans.

### South Korea's Economic Transformation since the 1997 Asian Financial Crisis

The 1997 Asian financial crisis triggered extensive economic and political unrest in emerging Asian markets, sending many countries from Thailand to South Korea into recession. Unlike previous economic crises in Mexico and Latin America, the Asian crisis was not caused by excessive government spending or unmanageable public debt, but instead was mainly rooted in the private sector.<sup>1</sup> At the time, one common interpretation was that the crisis debunked the "Asian Miracle." Capitalism and globalization were repudiated and blamed for the bursting of currency and property bubbles and the resultant economic difficulties.

Some observers even argued that "the Asian miracle was always a sham" and predicted "a decade of lost growth in East Asia," like the one that Latin America went through after its debt crisis in the early 1980s.<sup>2</sup> Yet the economic recovery after the crisis has proven that reports of the Asian Miracle's demise were premature. In hindsight, the 1997 crisis was just a temporary setback.<sup>3</sup> The late Milton Friedman stated that the "Asian Miracle is real" and observed, the thought that "one crisis discredits three decades of growth is allowing the headlines to overwhelm history."<sup>4</sup> As the recovery has shown, Friedman was correct in predicting that the Asian economies would fix their problems and get back on track.<sup>5</sup>

Indeed, for the South Korean economy, the temporary setback provided much-needed momentum to adjust its economic system

to the constantly changing global economy. The fifteen years since the crisis have validated that point. South Korea continues to be one of the most dynamic economies. As painful as the 1997 financial crisis was, it has provided South Korea a strong incentive to make its economic system more open and transparent. To their credit, successive governments have taken steps to address economic problems by reforming financial sectors, increasing regulatory transparency, strengthening corporate governance, and opening the market to greater competition. In addition, they have continued to promote South Korean competitiveness by embracing foreign trade and further integrating into the global trading system.

Although it took time for post-crisis reforms to restore investor confidence, the subsequent recovery was stronger and swifter than recoveries in other emerging market countries.<sup>6</sup> Fifteen years after the financial crisis, the South Korean economy has firmly rebounded, with real per capita GDP passing the pre-crisis level (See Chart 1). With greater economic resilience in place, South Korea has been able to bounce back and resume the soaring growth rates that have enabled its per capita GDP to double since 1998, catapulting South Korea into the ranks of the world's wealthiest nations.

It is notable that almost ten years after the Asian financial crisis, the South Korean economy confronted yet again a larger-scale economic turmoil that originated in the United States – namely, the global financial meltdown in late 2008. Compared to the Asian crisis, however, South Korea has fared quite better through the immediate months of the crisis and the current global economic slowdown. As a matter of fact, South Korea's renewed economic upturn began within months of the financial panic of late 2008 and has largely continued since then.

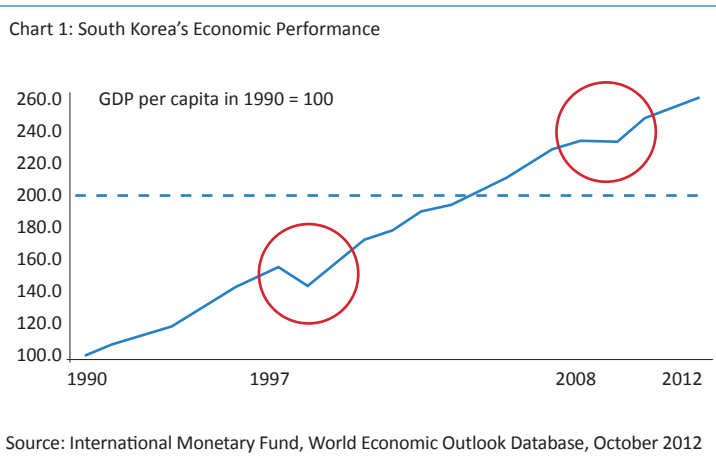
South Korea's capacity to emerge from not one but two debilitating economic and financial turmoil without prolonged stagnation has drawn attention in a world that suddenly needs economic role models. As Barry Eichengreen, a professor of economic history at the University of California, Berkeley, observed, "Korea has many differences with the United States, but they certainly did financial reform right. Korea under the I.M.F. did radical surgery."<sup>7</sup>

Indeed, despite a considerable level of uncertainty caused by the economic and financial crisis since late 2008, South Korea has outperformed many other advanced economies in terms of installing a path of solid economic recovery. The South Korean economy has recovered faster and more vigorously from the 2008

global crisis than most members of the Organisation for Economic Cooperation and Development (OECD), and has enjoyed low unemployment and low government debt.

To be certain, as an export-oriented open economy, South Korea initially experienced moribund economic growth along with the rest of the world. However, net exports remained remarkably robust through the current global economic slowdown, and GDP per capita fell markedly less than in the aftermath of the 1997 crisis (see Chart 1). What is remarkable is that the relatively strong economic performance of South Korea in years since late 2008 has occurred in an environment of very weak global demand. In large part, such impressive export performance has been facilitated by South Korea's strategic and steadfast pursuit of various free trade agreements with key economic partners around the world, which was culminated by the long-awaited implementation of the Korea-U.S. FTA in March 2012. These trade agreements have all contributed to South Korea's remarkable achievement of trading over \$1 trillion on the global market over the past two years.<sup>8</sup>

In fact, as pointed out by a November 2012 Foreign Policy special report, South Korea is rightly considered as one of the seven countries that won the great recession. South Korea "was the first wealthy country to emerge from recession in 2009, and household income has grown for the last 11 quarters."<sup>9</sup>



Reflecting such impressive performance of the South Korean economy, all three major rating agencies—Moody's, Fitch, and Standard and Poor's—upgraded South Korea's sovereign credit rating in 2012.<sup>10</sup>

It is also notable that during the past decade, South Korea has been one of the fastest-growing OECD countries, with real GDP expanding by over 4 percent per annum. Such growth has narrowed the per capita income gap with the United States from 62 percent in 1991 to around 35 percent in recent years.<sup>11</sup>

## The South Korean Economy at the Crossroads

Beyond further solidifying its ongoing economic recovery, South Korea should focus on building its economic potential by strengthening its commitment to reforms that enhance economic freedom and, therefore, competitiveness in its economic system and greater opportunities for many.

Today's economic growth and prosperity depend on maintaining and improving an environment in which entrepreneurial activities and innovation can flourish. Investment capital and entrepreneurial talent flow toward economies with low taxes, secure property rights, sound money, sensible regulatory policies, and greater transparency. Countries with higher degrees of openness and flexibility benefit from the free exchange of commerce and thereby enjoy long-term and broad-based economic growth and prosperity.

The global economic and financial turmoil of the past four years has emboldened critics of the capitalist, free enterprise system and raised questions about the best policy framework for supporting economic growth, employment, and overall prosperity. Questions relating to the role and size of government have been front and center, both in national debates and in international discussions. For example, with countries from Europe to China facing the demographic challenges of aging populations, problems of funding pensions on a sustainable basis are becoming acute. Also notably, the global recession has strained social safety nets almost everywhere; increased spending in some countries has turned what was previously a debate about long-term funding solutions into an acute crisis demanding immediate decisions about austerity measures to restrain national debt.

When dealing with democracies, of course, battles are fought not just among countries, but also within them through the political system and the electoral process. In Europe, decades of high social welfare spending and stifling regulation have combined to reduce economic and social dynamism and flexibility. As electorates were clamoring for action during the financial crisis and recession, governments' scope for effective response proved



surprisingly small. For governments increasingly constrained by budget deficits and rising debt, the disconnect between their past political promises and their economic capability to fulfill them, and between their financial assets and liabilities, became difficult to ignore. A fundamental rethinking of the social contract, the basic relationship between government and citizen, became, for some countries like Greece or France, not just an academic exercise but a political debate that spilled into the streets.

“The extent of South Korea’s long-term economic vigor and competitiveness will be surely determined by the outcome of ongoing debates about the proper scope of government, the existing social contract, and welfare policies.”

South Korea has confronted its own economic and political challenges as the economy attempts to weather uncertain times ahead. Particularly in 2012 when for the first time in twenty years, South Korea held both parliamentary and presidential elections in the same year, the intensity of the debate on how to reform and reshape its dynamic economy for the future had centered on social welfare issues and the role of the government in the economy.

In other words, keen observations made in 2005 by a long time Korea watcher, Marcus Noland of the Peter G. Peterson Institute for International Economics, remained quite relevant to South Korea’s political scenes in 2012:

Today South Korea is an awkward interstice as the country tries to work out the appropriate role of the state. While there is a consensus that the country cannot return to the ways of the past, there appears to be less of a consensus about the way forward. This difficulty is compounded by what appear to be—at least in the context of comparative data—institutional weaknesses in the political system. South Korea’s economic development has, in effect, outstripped its political development. A strengthening of those political institutions and a clear redefinition of the role of the state vis-à-vis the economy would appear to be a central challenge looking forward.<sup>12</sup>

The extent of South Korea’s long-term economic vigor and competitiveness will be surely determined by the outcome of ongoing debates about the proper scope of government, the existing social contract, and welfare policies.

### Promoting Economic Freedom, Not Big Government, is to Key to “Economic Democratization”

During the last presidential race, the campaign buzz word was so-called “economic democratization.” Both the opposition candidate, Moon Jae-in, and the ruling, conservative Saenuri Party’s Park Geun-hye, endorsed the notion of “economic democratization” as the key economic and political goal. The elusive concept’s two main aims focused on reducing economic inequality—notably in the context of controlling and regulating *chaebol*—and expanding South Korea’s welfare system. The two contenders’ specific approach towards the concept had quite differed in scope and detail, and still, how the notion of “economic democratization” will eventually translate into real policies in coming years remains largely uncertain.

In fact, any possible translation of “economic democratization” into specific policies would be inevitably shaped by how to define the role and scope of government in the South Korean economy. In other words, considering that any discussion of economic freedom is essentially about defining the relationship between individuals and governments, “economic democratization” needs to be discussed in the frame of enhancing economic freedom, not limiting it.

As various countries’ successful democratic developments have vindicated, political democratization is about advancing and ensuring lasting political freedom. Democracy is fundamentally rooted in the proposition that political sovereignty originates with citizens. Enduring democratic systems are often characterized by protection basic human rights as well as promotion of opportunities to engage in meaningful political participation and competition under the rule of law.

By the same token, “economic democratization” should be about ensuring that everyone has equal opportunities to compete to succeed in the free market system.

As discussed in the *Index of Economic Freedom*, a comprehensive annual country-by-country analysis on economic freedom by the Heritage Foundation:



Economic freedom is a condition or state of being in which individuals can act with autonomy while in the pursuit of livelihood...In general, state action or government control that interferes with individual autonomy limits economic freedom...The goal of economic freedom is not simply an absence of government coercion or constraint, but the creation and maintenance of a mutual sense of liberty for all. As individuals enjoy the blessings of economic freedom, they in turn have a responsibility to respect the economic rights and freedoms of others. Governments are instituted to ensure basic protections against the ravages of nature or the predations of one citizen over another so that positive economic rights such as property and contracts are given societal as well as individual defense against the destructive tendencies of others.<sup>13</sup>

As the definition of “economic democratization” remains largely elusive, the political and academic debates over the value and policy direction of the concept will continue in coming months and years. Nonetheless, particularly in the context of defining the appropriate role of government in forming related policies, it needs to be noted that “economic democratization” should not mean to guarantee equal outcomes in competitions, justifying government interference in the free market system.

A free market system that provides for economic freedom allows for greater diversity, promoting creativity and innovation. It is true that government can play an important role in ensuring economic stability and vibrant growth while sensibly overseeing markets. However, the role of government is neither to create and distribute wealth nor to ensure equal outcomes. Given the diversity of individual efforts, not all will succeed. Unequal results are a natural outcome of equal opportunity. Government’s role is to clear the way for people to create their own wealth. It must uphold the rule of law, secure property rights, and thus sustain transparency of the market system.

During South Korea’s past presidential campaign, “*chaebol*-bashing” had been quite often employed, and how to reform the *chaebol* took the center stage of the economic policy debates. Under the slogan of “economic democratization,” presidential candidates on both political sides had proposed various forms of regulating the *chaebol*, whether through restrictions on cross-shareholdings or higher taxes.

The *chaebols* have been important pillars of South Korea’s economic development over the past decades. Nonetheless, it is undeniable

that the *chaebol*’s over-dominance of the economy as well as their untidy corporate governance has gradually undermined South Korea’s free market system, especially in the context of crony capitalism—the symbiotic nexus between business and government that undermines the rule of law in the free market. Having seen the *chaebol*’s historically close ties with politicians and government officials that have distorted competition in the free market, many ordinary South Koreans are right to be critical about the *chaebol*, “up to a point.”<sup>14</sup>

As a matter of fact, however, South Korea’s bigger problem is more fundamental than the *chaebol*. For the past six decades, the country’s government-led economic strategy has been mainly to encourage large, exporting firms to grow larger and export more. A greater number of South Koreans have noticed that this outdated approach and its lingering legacy, which runs the risk of systematically perpetuating crony capitalism in South Korea, has become increasingly detrimental for an advanced and open economy like today’s South Korea.

Sound development and progress of a market economy requires a fair and transparent competitive environment as well as the security of economic freedom. South Korea needs greater competition fostered by greater economic freedom, not a new kind of government meddling or big government in the name of “economic democratization.”

## Economic Freedom Matters to South Korea’s Economic Future

Reviewing the economic performance of over 100 countries over the past thirty years, a 2011 World Bank study revealed new empirical evidence supporting the idea that economic freedom and civil and political liberties are the root causes of why some countries achieve and sustain better economic outcomes.<sup>15</sup> According to the World Bank’s research, a one unit change in the initial level of economic freedom between two countries is associated with an almost one percentage point differential in their average long-run economic growth rates. In the case of civil and political liberties, the long-term effect is also positive and significant with a differential of 0.3 percentage point.<sup>16</sup>

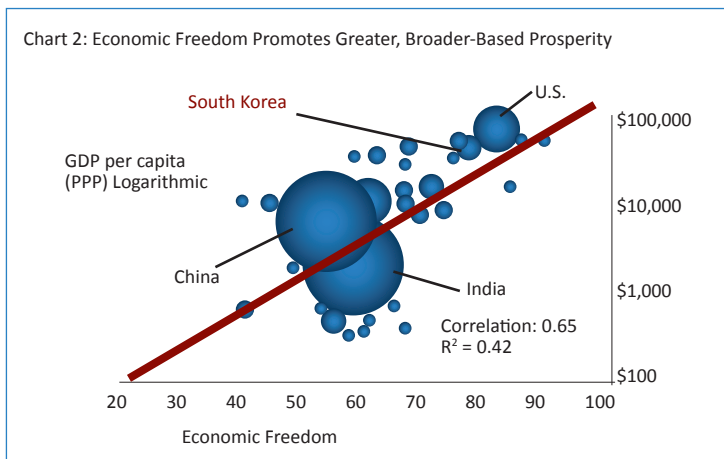
Furthermore, the study found that the expansion of freedom conditions over time also positively influences long-run economic growth. As noted by the study:



No evidence was found that the initial level of entitlement rights or their change over time had any significant effects on long-term per capita income, except for a negative effect in some specifications of the model. These results tend to support earlier findings that beyond core functions of government responsibility—including the protection of liberty itself—the expansion of the state to provide for various entitlements, including so-called economic, social, and cultural rights, may not make people richer in the long run and may even make them poorer.<sup>17</sup>

Economic freedom, cultivated by the rule of law, limited government, regulatory efficiency, and open markets, is critical to generating the broader-based economic dynamism that brings more opportunities for people to work, produce, and save.

This multidimensional relationship between economic freedom and development has been empirically documented in cross-country research, the annual *Index of Economic Freedom*, and in many other academic studies.<sup>18</sup> Not only does a high level of economic freedom clearly induce a greater level of prosperity (see Chart 2),<sup>19</sup> but it also facilitates progress in overall human development including better health, longer lives, greater education, and cleaner environments. And freer countries have a much better record at reducing poverty and promoting capacity for innovation.<sup>20</sup>



Numerous other studies have also shown that the entrepreneurship encouraged by greater economic freedom leads to innovation, economic expansion, and overall human development.<sup>21</sup>

In pursuing sustainable prosperity, both the direction of policy and commitment to economic freedom are also important. Indeed, over the last decade, the countries with greater improvements in economic freedom achieved higher rates of economic expansion, as shown in the *Index*.

As indicated by the findings of the *Index*, sustaining dynamic and inclusive economic expansion is in fact about putting into practice three fundamental principles of economic freedom: empowerment of the individual, non-discrimination, and open competition. This is not a dogmatic ideology. In fact, it represents the rejection of dogmatism, allowing individuals the freedom and flexibility to embrace diverse and even competing strategies for economic advancement.

### Time for South Korea to Free Its Economy

The Heritage Foundation’s *Index of Economic Freedom* provides a framework for measuring economic freedom by identifying the most important components of economic freedom and determining how each country measures up, factor by factor.

Today, according to the 2012 *Index*, South Korea’s economy ranks 31st among 179 countries rated. Its score of 69.9 (on a 0-100 scale, with 100 being best) ranks ahead of both the global and Asia-Pacific regional averages. As one of the “moderately free” economies (countries with economic freedom scores of 60 through 60.9) in the *Index*, South Korea’s economy has the fundamentals—such as its large supplies of capital, highly educated labor forces, modern infrastructure, and stable legal system—all in place. Since 2000, as Chart 3 depicts, the South Korean economy has fluctuated within the boundary of “moderately free.”





Unfortunately, however, a closer look reveals that South Korea's level of economic freedom is neither as comprehensive nor as concrete as it should be. The economy of South Korea, the fifth largest economic power in Asia-Pacific, shows favorable but conflicting indicators. Current performance reflects a solid track of economic recovery, but long-term challenges caused by inconsistent economic policies, lingering systemic deficiencies, and increasingly competitive rivals threaten to sap its momentum.

For example, although its regulatory process has improved, bureaucracy and lack of transparency still hinders entrepreneurial activities. Interventionist government policies still linger. Perhaps more critically, corruption and weak political institutions have continued to damage government integrity and undermine the foundations of economic freedom, keeping South Korea from becoming a "free" economy. According to the 2012 Corruption Perception Index by the Transparency International that measures "how corrupt a country's public sector is," South Korea's ranking has slipped for two years in a row, placing the country 45th among 176 countries.<sup>22</sup>

It might not be surprising that frustration has been building up among people, in particular among young people whose unemployment rate stands at a high level. South Korea's youth unemployment rate has hovered at around nine percent, more than twice the national average.<sup>23</sup> Anti-business sentiment and populist attacks on the free market system become more frequent as well. These developments, in turn, make it even harder to achieve the necessary reforms.

How should South Korea respond? Rather than just talking, seriousness about enhancing South Korea's economic freedom should mean matching rhetoric with more concrete actions in modernizing and upgrading its economic system. More importantly, South Korea must start with a bigger change—a change in mindset. Globalization is a fact of life in Korea. It is happening in the economy, but it should also happen in the way of thinking. Indeed, many of the positive changes South Korea has achieved over the past decades can be attributed to discarding the old way of thinking. A truly dynamic Korea should embrace more economic freedom in order to adapt its social and economic model to global realities.

A failure to carry through on necessary economic reform with strong leadership and commitment to advancing economic freedom may add to growing concerns over South Korea's

competitiveness. The danger isn't that the South Korean economy will collapse but that it will become less attractive to investors who will increasingly bypass South Korea to invest elsewhere.

## Conclusion

Economic freedom leads to prosperity because free economies allow for competition, which is the best proven method by which the daily activity of a great number of people can be coordinated without coercion. Competition, at the same time, requires the organization of institutions, such as stable money, minimal and transparent regulation, minimal participation of the state in economic activity, and a strong enforcement of property rights and regulations.

South Korea possesses enviable economic strengths. It enjoys a stable political system, a strong cultural work ethic, a highly educated workforce, and a history of technological innovation. But the country is fast approaching a critical juncture. Insufficient transparency and lingering cronyism have undermined the integrity of the government, prevented the creation of dynamic small and medium-size enterprises, and discouraged investment by domestic firms.

As Friedrich A. Hayek foresaw decades ago, "The guiding principle in any attempt to create a world of free men must be this: a policy of freedom for the individual is the only truly progressive policy."<sup>24</sup> Thus, the battle of ideas must also be a battle for the meaning of the very words with which we debate. Is it "progressive" to utilize the coercive power of the state to redistribute and level incomes within a society? Is it "liberal" to build a massive state apparatus to regulate conditions of employment, usage of energy, and access to capital? The answers to such questions in the context of translating the concept of "economic democratization" into practical policies will determine how South Korea enhances its economic dynamism and sails through the 21st century.

Neither South Korea nor any other country can turn back the clock. Globalization is a fact of life – both economically and socially. As real time examples around the globe have been clearly showing, welfare-statism based on populist big government policies is the road to bankruptcy. In rejecting that path, South Korea must not shy away from the challenge of pursuing greater economic freedom that will empower South Korea's coming generation with more opportunities.



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