

# Expansion of North Korea's Second Economy and Change in Governance Structure

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## Introduction

There has been a dearth of theories explaining the transition in the communist bloc after the fall of communism or the radical changes in North Korea, a country that had lived under a Stalinist system for half a century. While external variables helped cause the rapid systemic changes in the former communist bloc, few theories posit more fundamental reasons such as the changes in the socialist planned economy and the transition process to a market economy. However, analyzing the changes in the socialist system by focusing on the shift from a centrally planned economy and the characteristics of the socialist regime will bring useful insights into the intimate relationship between the country's current economic crisis and its political changes.<sup>1</sup>

This paper looks at the North Korean system's unofficial rather than official relations. In particular, the paper focuses on the emer-

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<sup>1</sup> Analyzing the institutional qualities that maintained the stability of the socialist system is a way to perceive the North Korean system's characteristics and changes. Studies need to analyze the possibility that the social basis maintaining the governance relations of the "Executive" or "Singular" system will change, as well as study of the socioeconomic foundations of the "ideology" or "traditional factors". This research would allow us to see whether North Korea's socialist governance relations are static or in a state of change. It would also allow us to examine the issue of qualitative change to a new system.

gence of the second economy,<sup>2</sup> which exists outside the planned economy and is a typical occurrence in socialist countries, and looks at the weakening of socialist ruling institutions. The main point will be the changes in the institutional ruling basis for socialist relations of rule and subordination. This paper will analyze the systemic dependency relations of subordinates to the central authority within the centralized planned economy and the party apparatus, the dependence of party cadres to their superiors, and that of citizens to the state or party cadres.

### **Erosion of the "Executive" Governance Mechanism**

In theory, the expansion of a second economy in a socialist system leads to the de facto decentralization of the socialist planned economy.<sup>3</sup> In the North Korean system, loosening of the planned economy's institutional framework and the interrelated development of the second economy, including the black market, were the natural outcome of economic troubles in the 1990's. In the former socialist economies, the second economy or market economy usually coexisted with the official planned economy, and gradually expanded as voluntary and partial reform measures were introduced. In North Korea however, the 1990's saw an overall "economy of scarcity" and a weakening of planning capacity which included the collapse of the material distribution system, and paralyzed distribution in the production system. This led the second economy to go beyond its supplementary role to the planned economy and rapidly expand to become a considerable substitute for many of the planned economy's functions.<sup>4</sup>

The development of North Korea's second economy was an important socio-economic change that came from below, and con-

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<sup>2</sup> In this paper, the "second economy" refers to all private economic activity (whether legal or not). The second economy includes all economic activity outside of the planned economy's regulations. This concept is more than the mere expansion of individual corruption and is not simply an economic phenomenon. It is rather an outcome of the socialist system's political and economic contradictions, and is a main factor in systemic change.

<sup>4</sup> Grossman, Gregory, (September-October 1977), "The 'Second Economy' of USSR," *Problems of Communism*, vol. 26, p.40.

tradicted the prevailing idea that a thorough distribution system and strict social control would prevent a second economy from emerging. In the future, with non-planned economic activity becoming regular and routine, both legal and illegal second economy activity are expected to increase continually. As the experiences of other developing countries or former socialist countries have shown, the new economic activities, by introducing private incentives, may become the main engine for North Korea's economic growth.

As shown by the paralyzed distribution system, the second economy's rapid expansion is intimately linked with weakening of the party state's capacity for socioeconomic management and control. For example, most economic sectors, with the exception of a few priority areas such as strategic exports, are being structurally forced to survive on their own because of the continual weakening of the resource allocation function. Therefore, these sectors have no choice but to strengthen their independence and decentralization outside of the central authority's intentions or plans. In addition, socialist political governance relations are being altered by the weakened coverage of the planned economy and the increased importance of the second economy, as shown by the public's increased dependence on the black market for their daily needs.

Traditionally, central planning of investment in the planned economy was an important means of securing the party's control over the economy and society. However, with the economic collapse, the centrally planned investment function became decentralized for all practical purposes, and deviated from the party's intentions or goals. This has brought a threat to the party state system's power base and the relations governing the party hierarchy. The changes in governance relations and their middle to long term possibilities are examined below.

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<sup>4</sup> For more about the paralysis of North Korea's central distribution system and industrial raw materials distribution system since 1990, and the resulting emergence of the second economy, refer to Sei-jin Jeong, (1999), "Political Changes from North Korea's Economic Crisis," *Papers on North Korea and Unification: North Korea's Situation and Humanitarian Support II*, Ministry of Unification, pp. 10-18.

## Center's Weakened Control over Front-Line Units

An important characteristic of a traditional planned economy is concentration of authority in the central government. Local governments are not given any independence in their resources or decision-making and merely act as transmission belts for the central government. However, significant changes are occurring in the relation of the central government with lower-level administrative units (including regional governments) with the weakening of the central government's resource extraction and distribution capabilities.

First, the center's financial weakening and its structural result of economic self-sufficiency and decentralization has led to diminished central influence. Formerly, as illustrated by the saying "food is power", the center used its control over food distribution as a political lever, but this leverage has drastically fallen in the last decade. With the weakening of the center's basis of control over the lower level units, the party's policies or intentions are failing to penetrate the lower-level units, except for a few priority sectors such as munitions.

Besides food supply distribution, resource distribution from the center is also paralyzed, causing many front-line factories to procure raw materials for themselves and dispose of the goods at their own discretion. This decreases the resource extraction capaci-

### <Figure 1> Characteristics of Socialist Rule

Systemic Characteristics of  
Socialist Rule: Concentration of  
resources in the center and  
allocation based on political motives

Socialist System  
(Centrally Planned Economy +  
Party Structure)

- Lower-level units' dependence on the center
- Cadres' dependence on their superiors
- Citizens' dependence on the state and bureaucrats

ty of the central government, which in turn undermines the center's capacity to distribute resources to the lower level units. This vicious circle has gradually hampered central management and control over the lower level units' production and distribution activities.

The weakening of the central planning authority's resource distribution function has expanded to a wide variety of second economy activities such as "unofficial foreign exchange raising" by factories, state enterprises, and the army. As a result, the center's existing one-way authority relations have eroded, and lower-level units are gaining more freedom. This can be seen as "freedom by necessity" from authority brought by the structural economic breakdown. While this trend does not prove that the lower level units have the material basis for self-sufficiency, it does show that the structure of direct governance between the center and the lower-level units, formerly known as the "backbone of the sociopolitical organism", is undergoing a transformation.

In contrast to the former system of patriarchal authority, the center is losing its control over individuals, factories, or enterprises. While in the past, the party had direct management and control over the lower-level units, the recent de facto decentralization of factories and enterprises shows that the center will have to attempt indirect means of management and control. The effort to control the economy from the center has been all but abandoned for practical purposes, and the state seems to be focusing on political or ideological control. While efforts to revive the "loosened planning system" such as was mentioned in the 1999 "Democratic Economy Planning Law" may be repeated in the future, unofficial social areas and semi-state areas outside the control of the party center are expanding.

The central government's weakening resource extraction and redistribution capacity and the resulting self-sufficiency of lower level units is bringing three important political results. First, the center's "economic organization role" or "steering capacity" in managing and controlling the state's socioeconomic development is being weakened. Second, the center's legitimation capacity is being undermined. Finally, in contrast to the former system, the

center's authority and control are being eroded while the lower levels are becoming more independent.

### **Party State's Weakening Control over Party Cadres**

The second economy weakens the socialist governance structure not only between the center and lower levels, but also that among rank-and-file party cadres. With the center's weakening resource allocation capacity, the operation of official organizations becomes inefficient, the organizational dependence of bureaucrats on their superiors decreases, and the organization becomes oriented to lower-level bureaucrats through new income sources outside the planned economy. Meanwhile, the control of party superiors or upper divisions over bureaucrats is eroded. Overall, the organizational integrity of the party state system is weakened.

The party state's chain of command in a socialist system has been characterized by relationships of dependence of bureaucrats to their superiors, and of lower-level organizations to the center. The living standards of bureaucrats were determined by the so-called nomenclatura standard. A bureaucrat's career - including appointment and promotion - was decided by his immediate superiors in the hierarchy. However, with the weakening of the centrally planned economy and development of the second economy, party cadres are changing these relations of control and subordination within the party hierarchy. Cadres are no longer as dependent on their superiors because the resource allocation function of the upper divisions is weakening, and cadres are using their official positions to earn unofficial income in the second economy. Meanwhile, the cadres' incentive to restrain or observe average citizens is weakened. In particular, the task accomplishment of party cadres, the sustenance methods of regional or lower-level units, and the sustenance of middle to low level cadres are increasingly dependent on a wide range of economic activities and opportunities outside the planned system.

These political effects are expected to increase in proportion to individual activity outside of the planned system and the accompanying rise in personal income. If the decentralization of the lower

level units and overall “marketization” and decentralization of the economy continues, front-line cadres may stop acting as economic agents for their superiors and become a group pursuing semi-private profit and interests. In the future, cadres may even resist or avoid the conservative policies of the center, and support the non-socialist and market relations to which they are becoming accustomed. Therefore, in the middle to long term, the main factor of political change to the system will not be resistance from average citizens, but is likely to emerge from the altered interests of party cadres, who will have a certain level of official and non-official income.

Similar to what occurred in the former socialist countries, a new government-business cohesion or interdependence is already forming between North Korea’s party cadres and professional traders. A change is occurring in the interests and orientation of cadres, and this trend will become stronger in the future. This is because mid to low level cadres within the weakening framework are beginning to look for personal profit through unofficial means. The basis for the relationships of absolute dependence that bureaucrats formerly had with their superiors is changing. Even from the party center’s point of view, the circumstances are becoming such that the center cannot restrict these changes in the bureaucrats or ignore them.

The important point of these mid to long term systemic changes is not the shift away from socialist practices in itself, but the fact that the shift is occurring in connection with the planned economy’s erosion. Therefore, the transformation of the patrimonial socialist governance system can give important insights into North Korea’s future political changes.

### **State and Party Cadres’ Weakening Control over Citizens**

The ongoing economic hardship is leading some average citizens to actively create unofficial income sources in the second economy such as private businesses or side jobs. This illustrates that the centrally planned economy is weakening while individual economic activity is proliferating and the individual is becoming

an important economic participant. This shows that the gradual weakening of the citizenry's patrimonial organized dependence on the state and party elites is causing organized party state control over citizens (such as the so-called "unificatory guidance") to relax.

Until the recent changes, factories and enterprises in the planned economy were official appendages of the state and acted as social organizations and political institutions in addition to merely being economic entities. However, this role is eroding with rapidly declining factory operation rates and the weakening of the distribution system. Along with the shortage in materials, the increase of prices in the black market has undermined the value of wages and is causing workers to leave their jobs, and has generally made it difficult to control labor in front-line factories. If most workers leave the planned economy and start to depend on non-planned economic activity, labor may have to be attracted outside of existing factories or enterprises.

Along with this erosion of the system's foundation, the semi-private economic activities of citizens are - similar to the unofficial economic activities of bureaucrats - taking place beyond the oversight or control capacity of the party organization. In the future, as decentralization and the market system develop further, and the non-planned economy broadens its scope, the ideas of average citizens on political or economic rights may differ with those of the state. As in the case of the party cadres, the opportunity to gain a new source of income may give citizens a new group identity and interests that conflict with those of their superiors.

The above analysis explored the main changes in political governance relations and their prospects at three levels. Even by only looking at the existing events, one can see that the planned economy is weakening and the monolithic and monopolistic power base of the old system is being eroded. Therefore, the relations of political control and subordination that were based on the party system's monopoly over the economy are changing, and the state's capacity to observe or restrict the activities of party cadres or citizens is decreasing. The party state is undergoing political decline, and the main conditions for socialist governance, which were based on the party's central control, have been changing consider-



ably. The strongly centralized "Executive" system is evolving into a "Post-Executive" system. This is an important change in North Korea although there have been no official reforms or revisions in ideology.

These analyses of the weakening of the socialist governance system show that the North Korean system is already experiencing internal changes to such an extent that the system is nearly undergoing an unofficial "quiet revolution". While the dire economic hardships are not directly linked with the system's collapse, socio-economic changes, as shown by the weakening of the planned economy and the expansion of the second economy, have changed the basic framework of the party system's political relations. In other words, the changes have loosened the political institutions which were responsible for the socialist relations of control and subordination. Considering that most members of North Korean society have to depend on various economic areas outside the planned economy, such tendencies are likely to become more pronounced in the future. This tendency of a weakening party state system can occur independently of macroeconomic trends. Therefore, this is a very important aspect to consider when trying to foresee the mid to long term changes in North Korea's political governance relations.

### **The Second Economy and the Possibility of Change in the Economic System**

As shown in the experience of many former socialist countries, real reform of the economic system usually comes as the result of socioeconomic pressure from below rather than from the leadership's policy choices. In China, most reforms were ratifications of de facto changes, with the central authority approving changes from below after they had occurred.<sup>5</sup> In light of this tendency, when trying to perceive shifts in the socialist economic system, including the development of a non-planned economy, one should not overestimate the role of the central government. Official poli-

<sup>5</sup> Woo. Wingthye, (1994). "The Art of Reforming Centrally Planned Economies: Comparing China, Poland, and Russia." *Journal of Comparative Economies*, vol. 18, pp. 281-284.

cies can be seen as just one aspect of the reform process. The reform process consists of complex interactions between government units, factories and enterprises, workers, and consumers, rather than continual government control over businesses and individuals.<sup>6</sup> This fact gives an essential perspective on the authority's principles as well as the intentions and limits of official policies.

The erosion of the North Korean planning system in the 1990s can be clearly seen when one looks at the basic characteristics of a centrally planned economy. One is the existence of a state monopoly where the private sector is isolated and the public sector is under strong state control. Another characteristic is that areas outside the official plan are practically prohibited, and the state directly controls and regulates the policy decisions of economic organizations. Third, authority is concentrated in the central government. The independence of regional units is denied, and they are merely used as transmission belts for the center.<sup>7</sup>

In North Korean society, these characteristics have become so weakened that the question of whether the system is a planned economy has become practically irrelevant. The key characteristics of the planned economy have been continually weakening or evolving into different directions. The state's monopoly over the economy is weakening with the rapid emergence of the private sector in the form of individual businesses or side-jobs, and the weakening of the center's management and control over the state-run and public sector. Because of the party center's weakening resource extraction and distribution capacity, its direct control or regulation over economic policy making has weakened.

Within this crisis of the planned economy, one should remember that the change and dynamism of crisis situations often bring opportunities for change. Expansion of the non-planned economy within the continuing transition from a planned economy cannot by itself be seen as a clear proposal. However, if we look at the scope and speed of socioeconomic changes brought by the erosion

<sup>6</sup> Rawski, Thomas G., (1996), "Implication of China's Reform Experience," in Walder, ed., *China's Transitional Economy*, London: Oxford University Press, pp. 200-207.

<sup>7</sup> Wang, Shaoguang, (1996), "The Rise of Regions: Fiscal Reform and the Decline of Central State Capacity in China," in Walder, ed., *China's Transitional Economy*, London: Oxford University Press, p.98.

of the planned economy, we can see that a market economy is forming for better or worse.

There are several reasons for this forecast. First, the black market is substituting for the paralyzed distribution system. Second, state enterprises are resorting to semi-market transactions and various other informal activities to supplement the center's resource allocation function. Third, with self-sufficiency becoming necessary for factories, enterprises, and other lower-level units, their *de facto* independence has increased. Fourth, many party cadres are turning to unofficial income sources and citizens are voluntarily dealing in the second economy. In addition, considering that it is difficult for the party state to restrict the expansion of non-planned economic activity, North Korea has already started on the path to a market system, regardless of the party's original goals or intentions.

In the midst of such erosion of the planned economy as well as the compensatory expansion of the second economy's relationships, the usual focus of attention - official reform measures - may emerge from the party central's unilateral decision. However, it is far more likely that the party state will merely adjust its policies to the "gradual evolution" caused by the necessary activities of countless individuals and institutions outside the planned economy. For example, the possibility of gradual change resulting from second economy activity and its tacit approval is increasing. The second economy is not merely a response to the problems and contradictions of the official planned economy, but can also be the factor that ultimately leads the planned economy into transition. The dynamic interaction between the planned economy and the second economy will develop through a dialectic between policy decisions and the economic reality.

### **Conclusion: Transition to "Post-Executive" System**

The current North Korean system has basically abandoned the framework of the centrally planned system. In such circumstances, what will be the process of change in socialist governance relationships linked with changes in the economic system (including the

expansion of the non-planned economy)?

Even in the future, North Korea's leaders will try not to damage the overall framework of the socialist system, and they certainly will not pursue reform measures from above. However, despite this attitude, one can predict that the leadership will have little choice but to move in the direction of "gradual introduction of the free market" to reflect socioeconomic changes through measures such as legalizing more areas of the non-planned economy. From the perspective of the top leadership, ignoring socioeconomic pressures that demand change in the economic system may merely bring instability to the system. Structural limitations are forcing the leadership to adjust to the second economy, whether by gradually making it official or by tacit approval. This gradual change indicates that the leadership is passively reacting to the changing situation, or that hidden changes have been accumulating. Such changes will bring a weaker socialist governance mechanism, including changes in the party's nature.

In this process of interaction between politics and the economy, the leadership will naturally want to compensate for its political weakening by depending on despotic power and adopting crisis management measures centered on the military or the use of force. However, this will not be enough to offset the inherent tendency towards a weakened socialist system, because the process of weakening is largely self-reinforcing. Several predictions can be made about this process of a weakening socialist governance mechanism through the disintegrating planned economy.

First, the accommodation measures that the party will have to take towards the second economy will further undermine the party's internal cohesion and the basis of the planned economy. Furthermore, as economic activities outside the centrally planned system expand, the costs of repressing these activities will rise, and there is a high possibility that the party's political capacity will weaken. Also, because the party will acquire income from approved sections of the second economy by measures such as taxation, it will lose the political will to return to a planned economy. This is largely based on the fact that powerful interest groups or interest relations (such as pro-market party cadres), depending on

the weakening of the planned economy and the development of the second economy may emerge. In addition, even if the central administration tries to reverse the deterioration of the planned economy, it would only be possible through the cooperation of lower-level regional authorities. However, because these lower-level authorities are the groups that gain the most from the changes to the centrally planned economy, ordering them to return to a planned economy is unlikely to be effective. In sum, unlike in the old system with a centrally planned economy, the state, with weakened foundations for socialist governance, will have less organizational means to pursue policies that try to reverse the deteriorating planned economy.

Another likely occurrence is a serious economic and ideological conflict between the centrally planned economy and the second economy brought by the expansion of the second economy and market relationships. This conflict will continually threaten the party state system's monopoly on power. Even if the party state responds to the threat and tries to strengthen the planned economy, the lower-level units will try to stimulate the second economy. Therefore, the central authorities may pursue a passive, market-friendly reform agenda that harmonizes the planned economy and the second economy. However, it is likely that this attempt to meld two basically contradictory ideologies will bring continued conflicting pressure and tension.

In particular, as legalization of the second economy expands, the distinction between legal and illegal markets will become ambiguous, intensifying the importance of the conflict and dialectic between the second economy and the planned economy. For example, the party may pursue change in a "zigzag" manner, at times restricting second economy activities that had formerly been approved. Also, an alternating policy of loosening and tightening may be adopted in response to different political situations. When viewed from a macro perspective however, the party state's political control over the overall socioeconomic development process is faltering. In other words, the party state system's institutional power is diminishing.

While in outward appearance, Kim Jong Il's "Executive" sys-

tem will continue in the new century, the actual changes within the system are likely to be far more decentralizing and conflictual than the system ever intended. Looking at the party's decreasing leverage due to the loosening of the planning system, the so-called "party's economic policy accomplishment", or "the party's leading role" are being repeatedly emphasized, but one can foresee the party's loss of control over the development process. Meanwhile, even if there are no overall reform measures, the state's tacit approval has a similar effect to gradual and partial reforms, and the process of policy change by the lower-level regional units may cause conflict and competition among subordinate units. These changes are taking place on a scope that cannot be completely controlled and managed by the central authority. With the conspicuous weakening of the socialist governance system's foundations, the socioeconomic conditions that will force the party to retreat from a fully controlled, centrally planned economy are already in place. ■■