

KOREAN UNIFICATION COSTS: AFFORDABILITY AND REDUCTION MECHANISMS

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Estimates for Unification Costs Vary Widely

Unification costs refer to all the costs that are entailed in the process of unifying two different systems, and more relevantly, integrating two different economic systems into a unified one. In terms of the purpose and timing, Korean unification costs would be composed largely of three distinct costs: crisis

management costs, system transformation costs, and economic investment costs. As the short-term costs, crisis management costs include those needed to deal with the post-unification crisis. System transformation costs, as the mid-term costs, refer to the costs for transforming North Korea's social, political, and economic systems. Finally, economic investment costs are the long-term costs that are necessary for revitalizing the North Korean economy and thus reducing the economic gap

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〈Table 1〉 Estimates for Korean Unification Costs

Researcher	Year of Unification	Major Assumptions	Estimated Costs (US dollars)	Concept of Unification Costs
Hwang, E. G.	2000	- German-style Unification - N.K. Income Rise Target: same as S.K. level	2.5 trillion	Gross Investment
KDI (1991)	2000	- German-style Unification - N.K. Income Rise Target: 60% of S.K. level by 2010	263-274 billion (1990 price)	Government Spending
Shin, C. M. (1992)	2000	- German-style Unification - N.K. Income Rise Target: same as S.K. level by 2010	1.77 trillion (1990 price)	Gross Investment
Pai, J. Y. (1993)	2000	- German-style Unification - N.K. Income Rise Target: same as S.K. level by 2010	448 billion (1990 price)	Gross Investment
Lee, Y. S. (1993)	2041	- Gradual Unification - Utilizing the Concept of Opportunity Costs	388-842 billion (1990 price)	Gross Investment
Kim, D. Y. (1994)		- Two Scenarios: ① Abrupt Unification ② Gradual Unification - Adding up Components of Unification Costs	① 270 billion ② 128 billion	Government Spending
Park, T. G. (1997)	1995	- German-style Unification - Adding up Components of Unification Costs		Government Spending

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between the two regions.

Estimates for the Korean unification costs vary widely among researchers, from the lowest estimate of 128 billion US dollars to the highest of 2.5 trillion US dollars. (refer to <Table 1>) There are three reasons for this wide variance. First, researchers have different concepts of unification costs. Some consider only governmental spending as unification costs, while others include both governmental spending and private investment in the concept. It is only natural that the latter type tends to project much higher estimates for the costs.

Second, they also make different assumptions on the unification process. Most of them presume a German-style "big bang" unification, although the expected year of unification varies from 1995 to 2041. Only two researchers (Lee and Kim) consider the possibility of a gradual unification process, and expectedly their estimates are significantly lower than most others'.

Third, they employ different estimation techniques. Most of them estimate unification costs based on their income target. They first set the target level for the North Korean income rise within a given period (e.g., 60% or 100% of the South Korean income level within 10 years), and then estimate the investment costs necessary for the target to be met. In contrast, some use a different method: dividing unification

costs into several components, estimating the costs for each component, and then adding them up.

Foreign experts and institutions also have their own estimates for the Korean unification costs. For example, Marcus Noland at the Institute for International Economics uses a general equilibrium model of the North Korean economy with a market economy capital-output ratio, and estimates the costs to add up to 2.2 trillion US dollars. Other estimates are listed in <Table 2>.

Can South Korea Afford the Financial Burden of Unification?

Regardless of the wide variation in the estimates for the unification costs, there is no question that Korean unification, and especially a "big bang"-style one, would be accompanied by considerable costs on the part of South Korea. Could South Korea afford such a heavy financial burden? What effects would it have on the South Korean economy? These are more pertinent questions for us to ask.

Dr. Marc Piazzolo at the Dresdner Bank of Germany addresses these questions in his recent article, "Could South Korea Afford German-style Reunification?" (published in *The Economics of Korean Reunification*, Spring 1997,

<Table 2> Foreign Institutes' Estimates for Korean Unification Costs

Institution/Researcher	Expected Year of Unification	Estimated Costs (US dollars)
Harvard University	2000	250-500 billion
Japan Long-term Credit Bank	2000	200 billion
Far Eastern Economic Review	2000	40-300 billion
EIU(Economic Intelligence Unit)	2010	1.88 trillion
Institute for International Economics/ Marcus Noland	2000	2.2 trillion for 25 years

HRI vol.2 no.1). While drawing heavily from the German experiences, he makes an explicit comparison between the German and Korean cases, and points out many differences in terms of the size of population to be absorbed, the extent of divergence between the two unifying systems' economic trends, and the economic capabilities of the absorbing side. Taking into account these differences, he expects that the Korean unification would exert much more severe strains on the South Korean economy than the German unification did on the West German economy.

According to his calculation, the South Korean government would have to make net transfers of around 55 billion dollars annually for investment purposes alone, which could only be financed through dramatic tax increases and increased borrowing in domestic and foreign markets. While he admits that such a capital transfer is possible in principle, Dr. Piazzolo argues that it would jeopardize South Korea's macroeconomic stability and dampen its favorable economic outlook. The country is currently projected to achieve an average annual growth rate of 5.5% from 2000 to 2010, and 4% from 2011 to 2020. In the event a German-style unification occurs, however, he predicts that growth would be reduced by up to 2% points a year, at least during the first one or two decades after unification.

Inter-Korean Economic Cooperation Is the Key to Reducing Unification Costs

Given these heavy strains a German-style Korean unification could impose on the South Korean economy, is there any way that the unification costs could be reduced? Two factors seem to be most important in reducing the costs. One is the state of the North Korean economy. It is only natural that a more

prosperous North Korean economy would relieve South Korea of much of the heavy financial burden. It is that much more important, therefore, to help the ailing North Korean economy to recover from the current crisis and to become revitalized through domestic reforms and external opening.

The other factor is the method of unification. In this respect, a gradual and peaceful unification process over a long period of time would entail the least financial burden on the South Korean economy. Recently, some have argued rather convincingly that "the faster unification comes, the smaller its costs will be." It must be emphasized, however, that this argument is valid only when one presumes an abrupt unification process following North Korea's system collapse, either through internal crisis ("implosion") or through external military attack ("explosion"). Notwithstanding the many political and economic uncertainties in the Northern system, the chances for such a sudden collapse should not be overrated. Thus, we should not yet give up the most ideal, and at the same time the most economical, method of unification--that is, a gradual and peaceful process.

Finally, it is instructive to note here that these two factors are in a sense closely related to each other, and that the critical element connecting the two is the economic cooperation between North and South Korea. On one hand, inter-Korean economic cooperation could induce North Korea's reforms and opening, and thus revitalize the economy. On the other hand, it could also increase the possibility of a gradual and peaceful unification process by laying the foundation for the improvement of inter-Korean relations. The key to reducing unification costs, therefore, is to strengthen and vitalize economic cooperation between North and South Korea. VIP

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