INNOVATION AND STRUCTURAL CHANGE IN KOREA'S SERVICE SECTOR: WITH A FOCUS ON THE WHOLESALE AND RETAIL INDUSTRY

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1. INTRODUCTION: WHAT IS THE ISSUE OF THE SERVICE SECTOR?

The transition towards a knowledge-based economy involves upgrading competitiveness through innovation. That seems obvious in the case of manufacturing where capacity to adopt new technologies and skills matters more than anything else. However, with the service sector, innovation becomes a blurred area since it comes to involve far wider issues than with manufacturing. Nonetheless, the issue of service sector innovation is of particular interest because of the sector's increasing share of employment and output and because it consists mostly of small and medium-sized enterprises. If the service sector can make a leap forward through knowledge-based activities, then it may be able to take on the role that manufacturing has played for the past century as the engine of growth. Also, such innovation would mean the transformation of small and medium enterprises (SMEs) from backward and traditional entities to modern and robust firms. This would open a new horizon of economic growth. Hence, before we proceed with further analysis of the service sector, we have to identify the possibilities for such innovation.

Most of all, the historical record shows that productivity growth is persistently lower in service activities than in manufacturing and even in agriculture, and there seems little ground to believe that the trend will reverse radically. Some argue that the recent revolutionary development of information and communication technologies may change this trend, although it remains to be seen. But, if it does happen, we have to appreciate to what extent it will transform the service sector. In particular, since most firms in the service sector are SMEs, their transformation through the ICT revolution shall have an immense impact on the employment structure and competitiveness of the whole economy.

Another issue is the actual path and method of transformation of those SMEs. There are two possibilities; traditional SMEs can transform into modern firms, or new types of modern firms can emerge to replace traditional firms. In order to set policy orientation, it is important to identify what is actually happening in the transformation of organizations, the types and innovation path of firms, in the service sector.

Section 2 examines the general trend of industrial structure in selected countries including Korea and tests some conventional wisdom about the increasing share of services in the process of industrialization. It explains the factors driving the expansion of service sector employment and output and tries to identify their role in the future in Korea. Then, the analysis focuses in on the wholesale and retail industry, because the wholesale and retail industry accounts for the largest share of both output and employment in the sector and because almost all firms in this industry are SMEs. The wholesale and retail industry, which has been the most backward and least productive, has been undergoing especially volatile changes in recent years. Section 3 re-evaluates the roles and prospect of the service industry. Section 4 discusses the recent changes and development of the service industries and Section 5 gives an overview of the general aspects and characteristics of the wholesale and retail industry. Section 6 discusses recent government policy with respect to the service sector and lastly, Section 7 provides some policy suggestions for future development of SMEs in the service sector

FACTORS BEHIND THE EXPANSION OF THE SERVICE SECTOR

According to conventional wisdom on long term structural change, the service sector's share of production and employment becomes larger in the process of industrialization. The so-called de-industrialization phenomenon, i.e., a fall in the share of industry, has been observed in the historical development of individual economies as well as between developed and developing economies (Rowthorn and Wells 1987). In the case of the United States, for example, between

1960 and 1990, the service sector's share of total employment increased from 48.5% to 72.5% and its share of production increased from 57.9% to 68.8%. Also, over the same period in the UK, service employment rose from 45.4% to 71.3% of the total and service sector production increased from 53.8% to 69.2% of total output (Illeris 1996). This trend is also confirmed in developing economies and former centrally planned economies as well. In Kenya, the share of service employment increased from 51.3% in 1977 to 59.0% in 1984 and in the USSR, that share increased from 48.6% in 1975 to 51.2% in 1985 (Daniels, 1993, ch 1).

Just as the manufacturing and service sectors once overtook agriculture, now the service sector seems to be eroding the place of manufacturing. The pattern of industrial structure is relatively consistent according to the level of economic maturity (table 1). Among advanced countries including the United States, France, UK, and Denmark service sector output is about 70% of total GDP, though the share is somewhat lower, around 60%, in Japan. For middle income countries including Korea and Thailand, the service sector's share of production reaches about 50%, while in lower income countries including Indonesia and China it is about one-third of total GDP. Hence, the pattern is: the higher the income, the larger the service sector's share of production.

Table 1: Industrial Structure of Selected Countries, 1998

(Percent of output)

	Agriculture	Industry		Service	Total Output
		Total	Manufacturing		
United States	2	26	18	72	100
France	2	26	19	72	100
UK	2	31	21	67	100
Denmark	4	29	21	67	100
Japan	2	37	24	61	100
Korea	5	44	32	51	100
Thailand	11	41	32	48	100
India	29	25	16	46	100
Indonesia	20	45	25	35	100
China	18	49	37	33	100

Notes: Industry includes manufacturing, construction, utility sectors. Based on current 1998 prices.
Source: *International Statistics*, Office of Statistics, 2000.

Although there are significant differences from one country to another, almost all countries follow a broadly similar path of economic evolution. The general pattern of economic development is distinguished by two distinctive phases: 'industrialization', which is the initial phase during which the employment share of industry including the mining, manufacturing, construction and utility sectors rise, followed by 'de-industrialization', during which industry's share of total employment declines but the employment share of the service sector rises. When economic growth first gets underway in earnest, agriculture's share of employment falls rapidly and that of non-agricultural sectors expands as all kinds of new industry arise accompanied by the parallel growth of various commercial activities to service the rising industrial sector.

As an economy enters a more mature stage, in spite of increasing industrial output, productivity growth in industry, especially in the manufacturing sector, is more rapid than in the service sector and employment in industry falls as a share of total employment or sometimes even absolutely. This decline is regarded as a symptom of economic success because new jobs are created in the service sector on a sufficient scale to absorb workers displaced from industry. Paradoxically, share of industry is a victim of its own success and a diminishing share of industrial employment is regarded as the normal result of industrial dynamism towards more advanced economic structure.

Because the evidence seems to point to the service sector's increasing share in this dynamic, some expect that in the next stage of development services will become the engine of growth, the role that industry played in the earlier stage. Especially, the development of information and communication technologies is expected to change the path and pace of economic development as they open a new horizon of innovation in the service sector.

We need to be careful in interpreting the service sector's rising share of output and employment, however. This is partly due to a classification problem and partly because of the productive nature of service activities. First, the definition and classification of services is rather puzzling because it involves so many activities other than industrial production. One widely accepted classification (Singelmann 1978) divides the service sector into four groups: distributive services (e.g., wholesale and retail, transportation); producer services (e.g., insurance, banking, legal services, business services); social services (e.g., education, medical, welfare); and personal services (e.g., hotels, restaurants, entertainment). These four groups include most activities other than industry, except the activities of the government sector, which include public services and defense-related activities.

In many countries, the government sector accounts for a substantial part of employment and output, and whether or not government activities are included in the classification affects the interpretation of the place of the service sector. For example, comparing table 1 with table 2, which shows the share of output of the private service sector separately from the share of the government sector, we see that in advanced economies the service sector's share of output declines from about 70% to 50% when government services are excluded. An extreme case is France, where public services and defense account for about 18% of output. Another extreme is Japan where the government sector is rather small, only 7.6% of output, and the private service sector share appears more or less the same relative size as in other countries. The United States seems an exception with a larger non-governmental service sector share than in other economies. Even the gap between Korea and other advanced countries narrows when government service activities are excluded from the service category. Though still lower, the share of service output in Korea is not far behind that in advanced economies.

Table 2: Structure of GDP in Major Economies by Industry

(current prices, %)

	United States 1996	France 1996	Germany 1996	Italy 1996	Japan 1996	Korea 2000
Agriculture	1.7	2.5	1.1	2.9	1.8	4.5
Mining	1.5	0.4	0.5	.	0.2	0.3
Manufacturing	17.0	20.1	27.1	20.5	23.3	31.5
Utilities	2.7	2.4	2.3	5.9	2.7	2.8
Construction	4.0	4.7	5.6	5.2	10.1	8.2
Services	62.1	51.8	52.5	52.7	54.2	48.5
Wholesale, retail, restaurants, hotels	16.1	15.8	10.3	18.7	11.7	12.0
Transportation, storage, communication	5.7	5.9	5.7	6.5	6.4	6.5
Finance, insurance, real estate	27.4	23.7	14.1	4.9	17.2	15.3
Social, personal services	12.9	6.5	22.5	22.6	18.9	14.8
Defense, public services	10.9	18.0	11.0	12.6	7.6	4.2
Total	100.0	100.0	100.0	100.0	100.0	100.0

Source: *OECD Statistical Yearbook*, OECD, 2000.

Second, the productive nature of service activities complicates the interpretation of structural changes involving the service sector. The conventional explanation of the shift in share of output and employment from agriculture to industry at the initial stage of development and then from industry to services at the later stage rests on changing demand for agricultural goods, industrial goods, and services. This line of argument has come under criticism recently because, in real terms, output of the service sector is more or less constant. This means the shift in output share toward the service sector is a statistical illusion, though the rising share of service employment is not.

While the output of services measured at current prices has risen, real output of services measured at constant prices does not seem to rise significantly faster than output of manufactured goods or industrial products in general. This phenomenon is observed in the case of Korea (table 3). . In current prices, the share of service output in Korea rose about 6.8 percentage points, from 37.3% to 44.1%, over the period 1975 to 1993. That is about twice as fast as the 3.5 percentage point increase in the share of manufacturing output, from 28.4% to 31.9%. But measured in constant prices, the trend appears strikingly different. While manufacturing's share of output share rose dramatically from 17.7% to 37.0%, the service's share of output remained a fairly constant level around 43%.

Table 3: Composition of Korea's GDP Measured at Current and Constant Prices, 1975-1993

(Percent)

	1975	1985	1990	1993
		at current prices		
Manufacturing	28.4	29.9	31.5	31.9
Service	37.3	41.4	42.1	44.1
Others	34.3	28.6	26.3	24.0
Total GDP	100.0	100.0	100.0	100.0
		at 1990 constant prices		
Manufacturing	17.7	25.9	31.5	37.0
Service	43.2	42.8	42.1	44.6
Others	39.2	31.2	26.3	18.4
Total GDP	100.0	100.0	100.0	100.0

Source: *Input-Output Table*, Bank of Korea, each year.

3. JOB-CREATING ROLE OF THE SERVICE SECTOR

This kind of statistical illusion is primarily due to productivity differences among sectors. In every economy and at any time, output per worker rises faster in industry than in services. But if the demand for goods and services from these two sectors increases more or less in parallel, which means that the relative share of real output remains roughly same, then the value of goods and services with stagnant productivity will rise. This is what Baumol and Bowen called 'the paradox of cost disease' (1966). Industries with persistently stagnant productivity have a distinctive price history that is the fundamental symptom of the cost disease of personal services. The common element that characterizes all the stagnant services is the fact that they are more difficult to automate and involve more direct labor in their supply process.

There is little prospect that the stagnant productivity intrinsic to services will change in spite of dramatic development of ICT, which may raise productivity of other sectors, especially manufacturing faster. An implication from this argument is that it is hard to expect the service sector to be the engine of growth, even under the circumstance of ICT revolution. Another implication is that to the extent that the productivity gap between industries and services becomes larger, the share of employment will shift towards the service sector. This point has a particular importance in understanding the role of the service sector.

If productivity is rising faster in industry than in the services, but output in the two sectors is growing at much the same rate, then the pattern of employment will gradually shift away from industry towards the services. Because of their slower productivity growth, the service sector will have to absorb an even larger share of total employment to keep rising in line with industry. Therefore, the main role of the service sector is to absorb employment displaced from industry and to create jobs in line with economic growth gained from the industry sector.

In Korea, the service sector's share of employment rose from 24.6% in 1970 to 57.5% in 2000 (table 4). On the other hand, the manufacturing sector's share of employment doubled from 14.3% in 1970 to 26.9% in 1990, but then it peaked and gradually declined to 20.2% in

2000. When the agricultural sector released employment, it was absorbed into both the manufacturing and service sectors. But now employment displaced from the manufacturing sector is absorbed into the service sector.

Table 4: Employment Structure by Industry

(%)

	Employment Share			
	1970	**1980**	**1990**	**2000**
Agriculture	50.9	34.0	18.3	10.9
Mining	1.0	0.9	0.4	0.1
Manufacturing	14.3	15.9	26.9	20.2
Utilities	0.3	0.3	0.4	0.3
Construction	4.6	6.1	7.4	7.5
Service	24.6	33.9	43.2	57.5
Wholesale, retail, restaurants, hotels	12.6	19.2	21.7	28.2
Transportation, storage, communication	3.3	4.5	5.1	6.0
Finance, insurance, real estate	1.1	2.6	4.2	9.9
Social, personal services	7.6	7.6	12.1	13.3
Defense, public services	4.4	3.1	4.4	3.6
Total	100.0	100.0	100.0	100.0

Source: *Input-Output Table*, Bank of Korea, each year.

Wholesale and retail is the largest industry in the service sector in terms of both production and employment. In 1995, the wholesale and retain industry accounted for 17.5% of total service sector output and 29.1% of total service employment (tables 5 and 6). The fact that its share of output is smaller than its employment share implies that productivity is particularly low in the wholesale and retail industry even compared to other service industries. The growth rate of output of this industry is still high but slowed in the 1990s. Moreover, the growth rate of employment in the wholesale and retail industry was a mere 2.3% in the 1990s which is rather disappointing compared to the robust growth of other service industries such as the finance and insurance, hotels, and business services industries.

Traditionally, the wholesale and retail industry offered the largest pool of employment and produced the largest share of output as well. But the recent trend shows that the role of the wholesale and retail industry is changing rapidly. Though output is still growing fast, it seems that such output growth no longer offers job opportunities. At first glance, this industry seems to be undergoing some fundamental changes.

Table 5: Structural Change of the Service Sector

(%)

	Share of Total Output			Growth Rate	
	1985	1990	1995	1986-90	1991-95
Wholesale and retail	23.7	22.6	17.5	12.9	8.8
Restaurant	2.0	1.4	1.4	0.9	5.9
Hotel	1.0	1.2	0.6	13.5	-4.7
Transportation	11.4	9.6	8.8	5.9	3.2
Storage	0.2	0.2	0.2	9.5	6.2
Communication	4.7	4.3	4.3	19.3	19.1
Leisure and culture	2.2	2.1	2.5	9.6	11.4
Finance and insurance	7.8	10.6	12.3	20.6	16.2
Estate	12.8	15.2	15.9	9.3	8.6
Business services	5.4	6.4	9.8	16.0	19.2
Public services	9.1	8.9	8.2	15.4	4.1
Education	11.4	11.1	11.5	7.8	4.8
Health and welfare	3.8	3.2	4.3	9.4	13.8
Other social services	1.5	1.0	1.3	4.9	14.7
Personal services	2.9	2.2	1.4	5.1	-1.1
Total	100.0	100.0	100.0		

Source: *Input-Output Table*, Bank of Korea, each year.

Table 6: Employment Change in the Service Sector

(%)

	Share of Total Employment			Growth Rate	
	1985	1990	1995	1986-90	1991-95
Wholesale and retail	35.8	32.4	29.1	2.6	2.3
Restaurant	9.0	8.9	12.8	4.4	12.3
Hotel	1.7	1.5	1.5	2.3	3.7
Transportation	9.1	9.0	8.1	4.4	2.3
Storage	0.2	0.2	0.2	-0.6	0.8
Communication	1.2	1.1	1.1	3.2	3.2
Leisure and culture	1.5	1.9	2.1	9.6	6.0
Finance and insurance	4.7	6.1	9.5	10.3	14.3
Real estate	3.2	3.8	2.7	8.5	-2.6
Business services	4.1	5.0	5.7	9.1	7.4
Public services	8.1	8.3	7.4	5.0	2.3
Education	7.7	8.5	8.6	6.8	4.7
Health and welfare	3.2	3.4	3.8	6.5	6.4
Other social services	2.1	2.1	1.8	5.2	0.8
Personal services	8.3	7.7	5.8	3.1	-1.5
Total	100.0	100.0	100.0		

Source: *Input-Output Table*, Bank of Korea, each year.

4. DRAMATIC CHANGE IN THE WHOLESALE AND RETAIL INDUSTRY

The wholesale and retail industry exhibits the characteristics of a typical traditional industry. Most establishments are small or medium-sized, both in sales and in employment, and they tend to be family-managed organizations based on no more than rule of thumb. The wholesale and retail industry has lower productivity than almost all other industries and it lags behind in accommodating new trends and innovations.

This sector, however, has been undergoing dramatic change in the face of new conditions in the market and innovations such as the liberalization of the market, the rapid expansion of internet technology and the emergence of new business models. Even the traditional wholesale and retail industry is not an exception to the new horizons being opened by these factors. Overall, the wholesale and retail industry is in the midst of radical transition towards modernization, similar to the situation of the manufacturing sector decades ago.

A critical threshold came in 1996 when the government liberalized the service market, especially the wholesale and retail industry. Until then, protection of the service market had been justified on the ground that most firms in the industry were merely subsistence ones, but it was believed that it would be difficult to bring about change in the modus operandi in this sector without implementing some radical measures. Moreover, the low productivity and the heavy cost of distribution and logistics industries increasingly became a burden to upgrading the competitiveness of the whole economy. As the liberalization of other markets had been completed by 1996, opening the service market could not be delayed any longer. The opening of the industry to some large-scale foreign firms, especially retail discount stores, accelerated change as the newcomers introduced modern styles of business, new networking methods, and a larger scale of operations. This in turn instigated competition among local firms, which pushed some retail businesses to concentrate and conglomerate while others have gone out of business.

The spread of the internet and information technology has also brought about fundamental changes in the mode of business operation in the distribution industry. Most of all, by making it possible to organize networks of member companies, the new technologies gave impetus to the concentration of firms, such as franchises. Cheaper IT cost enabled even small shops to upgrade their operational capacity. Also some new types of sales "locations" such as internet shopping malls and home shopping emerged. On top of such developments, the 1997 crisis accelerated all these trends.

The 1996 liberalization policy and the 1997 crisis created the momentum for re-organizing the distribution industry and the most apparent new development was the emergence of large-scale discount stores, both foreign and domestically owned. Korea's first discount store, 'E-mart', opened in 1993, but in ten years' time, this type of retail store became the biggest operation in the distribution industry. The number of discount stores increased from only 63 in 1997 to 115 in 1999, among which 21 were foreign companies; in 2001, it reached 220 in total with 60 foreign ones. While total retail sales diminished as a result of the crisis, the sales volume of discount stores skyrocketed, increasing almost three-fold from 1998 to 2002 (table 7). Department stores have traditionally had the largest share of retail sales, but discount stores are expected surpass them in 2002.

Table 7: Retail Sales by Type of Store

(billion won, %)

	1998		1999		2000		2001	
	Billion won	**% growth**	**Billion won**	**% growth**	**Billion won**	**% growth**	**Billion won**	**% growth**
Department stores	11,381	-9.8	13,333	17.1	15,094	13.2	16,472	9.3
Discount stores	4,974	54.8	7,571	52.2	10,636	40.5	13,818	29.9
Convenience stores	977	-4.4	1,018	4.2	1,251	22.9	1,826	46.0

Source: Office of Statistics

The hardship of economic crisis changed the spending patterns of consumers who became willing to make longer journeys to find quality items at lower prices. Due to such changing consumer habits, discount stores expanded rapidly in both number and sales volume, at the expense of conventional markets and department stores. The overall trend of the retail industry appears to move from conventional markets and small and medium-size supermarkets to department stores, discount stores, and convenient chain stores. Hardest hit are conventional markets and stores. The sales volume of small conventional shops decreased by 25% in the three years from 1999 to 2001. Modern department stores reorganized as well. Many smaller department stores, especially ones outside Seoul, went out of business during the crisis.

Larger supermarkets were also heavily affected by the growth of discount stores and foreign hypermarkets, which have aggressively extended their market share by taking advantage of business networks, bold investments, and logistics merits. Whereas large domestic supermarkets had enjoyed market power, after the liberalization they faced fierce competition from foreign firms. To meet the challenge, some turned into more specialized businesses such as health food or green product stores.

One interesting development along this trend is the resurgence of convenience stores. Convenience stores, which sell more or less the same merchandise as conventional mom-and-pop stores but in more modern surroundings with networks, were introduced to Korea in 1988. They numbered over 2,000 in 1998 and reached 3,000 in 2001. Sales of convenience stores also fell victim to the growth of discount stores in the beginning, but recently many have formed chain networks with other stores and initiated bold innovative measures by introducing new management style and technologies. Sales of convenience stores recorded grew 22.9% in 2000 and 46.0% in 2001. Thanks to their organizational structure, they are in a better position to undertake innovative upgrading.

Conventional markets consisting of numerous mom-and-pop stores have accounted for about 70% of total retail sales until recently. They have been headed toward oblivion, however, because of the rapid expansion of other modern style retail stores. For example, the number of conventional markets dropped to 1,100 in 2000 from 1,500 in 1996.

As discount stores become a major dynamic force in the retail business, foreign firms adopted a more aggressive strategy of expansion into Korea. In the beginning, foreign retail investment took indirect forms, such as technical assistance and joint ventures, but nowadays foreign firms make direct investments expanding the number of stores outside Seoul. Foreign investment in the retail industry increased from US$138 million in 1995 to US$892 million in 1997. Multinational retail chains that have moved into Korea include Carrefour (France), Promodes (France), Wal-mart (USA), Price Costco (USA), and Tesco (UK).

ICT development is also a major factor reshaping the retail market with the emergence of various new forms of retail sales such as TV home shopping, e-commerce, and cyber markets which in turn crowded out traditional door-to-door retail sales. Korea is known for taking the most aggressive steps to develop ICT. Although it is difficult to compile sales data on internet retail markets, one study claims that the internet shopping industry has been growing by 100% each year since 1999.

The rapid growth of large-scale discount stores and the reorganization of small and medium-sized stores into chain and franchise networks have changed their relationship with manufacturing. Manufacturing suppliers' traditionally dominant position in setting price is now threatened because of increasing buying power of these network-organized stores. In the face of such a development, a new type of cooperative relationship emerged between manufacturers and the stores, in which both parties seek strategic alliances in distribution and logistics by setting up SCM (Supply Chain Management). Furthermore, their business practices are also beginning to be reshaped through new technologies such as B2B, EDI, POS systems.

5. TRADITIONAL ASPECTS OF THE WHOLESALE AND RETAIL INDUSTRY

The wholesale and retail industry accounts for 18.1% of total employment but only 9.9% of GDP. This implies that although it lags in terms of productivity and value-creation, this sector absorbs more employment than any other sector. Paradoxically, due to its backwardness, this sector contributes to creating jobs more than others. Within the industry, the retail sector holds a larger share of employment than the relatively bigger operations of wholesale businesses. While wholesale business accounts for more than a half of total sales, its accounts for about one-third of total employment in this industry, and for just about 20% of establishments (table 8).

Table 8: Composition of Wholesale and Retail Industry

(%)

	Establishment	Employment	Sales
Wholesale	19.5	31.7	52.5
Retail	77.0	61.7	36.7
Auto-related	3.5	6.6	10.8
Total	100.0	100.0	100.0

Source: Office of Statistics.

According to the government's survey of Small and Medium-Size Retail Stores, in 1999

Korea had 688,025 retail stores in total with 14.9 stores per 1,000 inhabitants (MOCIE 2001). This is a much higher density of stores per capita than in other countries. For example, in 1995, Korea had 186 retail stores per 10,000 population compared to 127 in Japan, 58 in the United States, and 56 in Germany. This statistic gives a picture of the overall situation of Korean retail businesses, which is small in operation and backward in management.

General merchandise, food and tobacco, and clothing and shoe stores account for about 60% of retail stores and 53% of retail store sales (table 9). This means that about a half of all Korean retail stores are engaged in daily merchandise sales. Monthly sales averaged 1.137 million won (about US$1,000) per store, and 65% of stores sold less than 1 million won a month. Retail stores in Korea are far smaller in scale than in other in terms of sales per store. Average annual sales per store is US$127 thousand in Korea, compared to US$1.405 million in the United States, $610 thousand in Japan, US$799 thousand in Germany, and US$809 thousand in France. Taking into account other economic indices, the sales scale of Korean stores is too low.

Table 9: Distribution of Retail Establishments and Sales by Type of Store

(%)

	Establishment	Sales
General merchandise stores	20.1	19.9
Food and tobacco stores	20.6	16.0
Pharmacy and cosmetics stores	6.3	7.8
Clothing and shoe stores	19.8	17.6
Electric appliance and furniture stores	8.4	14.8
Others	24.2	23.4
Antique stores	0.5	0.5
Total	100.0	100.0

Source: Small and Medium Size Retail Business Survey, 1999, MOCIE, 2001.

Although their sales were hit by the crisis, the performance of conventional retail stores was affected more than that of other sectors. Even when the economy recovered from the crisis, sales of conventional retail stores never recovered to their previous level because their market share was already taken by new types of business like discount stores or internet shopping malls. Conventional mom-and-pop stores could not compete with large-scale operations of modern stores with big investments and new management techniques. In fact, according to a survey, 32.7% of shop owners point to the expansion of larger discount stores as the main factor in their sales decline, while only 27.4% attributed it to the economic depression even during the crisis.

The average small and medium size retail store employs 1.6 persons and 56.3% of all stores have no paid employees. Also 92% of these stores have less than 4 employees. This means that, basically, they are family-operated shops. Hence, they have no professional management skills, sales and marketing training, or education in business operations. According to the SME retail business survey, 62.0% of store managers had never conducted type of sales promotion. Facing the new wave in the retail market, however, 32.1% expressed a need for training and education to upgrade their managerial skills.

These conventional stores appeared to lag in introducing new types of business networks or strategic alliances in order to meet competition from modern stores. In fact, organizing networks among small stores for joint logistics is a key issue for upgrading competitiveness. Chain store networks offer numerous benefits including management support, saving on logistics costs, upgrading brand image, and quality maintenance, but 86.5% of stores operate independently with no such organizational membership.

Of newly establishing companies, 10.9% joined chain store networks and during operation, only 2.6% more stores joined chain membership. This implies that only new stores started with network membership whereas only limited numbers of existing stores have potential to turn into network organization. Therefore, it is difficult to expect that conventional retail stores would transform into chain store-style firms and it is possible that most of them might be crowded out in the process of restructuring this industry. A main reason for not joining a chain network is the unequal business position between individual member stores and the mother company.

Among conventional stores preparation for store establishment averaged merely 3.5 months, which is far shorter than in other industry; 38.4% spent only one month in preparation and 21.1% spent just 2 months. About 60% of stores opened within 2 months with no professional assistance or information. In deciding on business lines, 68.3% sought help and information from relatives or friends without any formal professional advice; 21.9% collected information from acquaintances with experience in the same business; and only 3.9% sought professional consulting advice.

Capital investment averaged 57.74 million won (less than US$50,000) per establishment with 82% of stores reporting capital investment of less than 100 million won (less than US$100,000). Of the capital invested in small and medium-sized stores, 73.4% was self-financed and 26.6% was raised from outside, which implies that most of stores had little opportunity to obtain funds from formal financial institutions.

These small and medium retail stores also lag far behind in utilizing new ICT technologies. Only 3.4% of all stores have POS (point of sales) systems; moreover only 11.9% even have registered cash machines. Comparing these figures to 17% of retail stores equipped with POS systems in Japan shows how backward Korean stores are in introducing new network-based technologies. On the other hand, a much higher proportion of new types of stores had POS systems. For example, all convenience stores and 42.0% of supermarkets have them. The main reasons stores gave for reluctance to introduce POS systems are that many managers have not even heard of such systems, that they are too expensive, or mostly that they are afraid of exposing the details of their business, perhaps for tax reasons. Traditionally, many small retail stores operate without formal accounting data for the purpose of tax evasion and only 30% of supermarkets have accounting data. Only 22.9% of shop managers use computers and, though 41.1% of them have experience in using the internet, it was for purposes other than business.

The emergence and expansion of large-scale discount stores and new business models are now threatening the survival of conventional stores. Only a limited number of stores are able to exploit the merits of technological development and new management skills. On balance, there seems little chance for conventional stores to transform into new operational modes. Also, other constraints like manufacturing dominance of the distribution industry and the lack of business and accounting transparency further limit such possibility.

Most of all, their productivity is far lower than other sectors and than the same industry in other countries. In 1997 value added per employee fell at an annual rate of -8.75% in the distribution sector while in other sectors it recorded 3% growth (table 10). Capital efficiency in the distribution sector was less than half of that in the communication sector and two-thirds that in the construction sector. In 1995, labor productivity of the Korean retail industry was a mere one-third the level in the United States, and capital productivity was about one-fifth (table 11).

Table 10: Productivity Comparison by Industry

(1997, %)

	Distribution	Mining	Manufacturing	Communication	Construction
Value added growth per employee	▽8.75	20.39	4.65	4.22	2.66
Capital investment efficiency	14.84	27.30	19.64	34.00	25.13

Source: *Financial Statement*, Bank of Korea, 1997.

Table 11: Productivity in Korea's Retail Sector Relative to U.S. Level

(1995, USA=100)

Total Factor Productivity	Labor Productivity	Capital Intensity
53	32	23

Source: *Reinventing Korea: McKinsey Report,* 1988, McKinsey.

6. RECENT DEVELOPMENT OF SERVICE INDUSTRY POLICY

One of the biggest obstacles to service industry development in Korea was, if not any longer at least among the policy makers, the perception of service industry. Traditionally, Korean policy makers perceived service industries, including the wholesale and retail industry, mainly as consumption-related activities, which in turn they regarded as wasteful. In the initial stage of industrialization, scarce resources were concentrated on building industrial infrastructure and export industries. An analogy can be made to the country's fostering of large firms at the expense of small and medium-sized firms. Consequently, the service sector had been subjected to systematic unequal treatment by government policies in finance, tax and location. Such a rationale could be justified to a certain stage of development. But that misperception has persisted until recently even when the size and structure of the economy has reached the stage of the advanced economies.

A change in policy came in the early 1990s when the government decided to take steps towards liberalization of service industries. But taking such measures was not a result of recognizing the role and potential of service industries as the economy entered a mature stage. It was, by and large, the result of the Uruguay Round negotiation in preparation for the country's joining the WTO in 1995. The bottom line of liberalization policy was to avoid acute trade pressure whereas the idea of promoting competition in the service sector by inviting outsiders was rather remote. Hence, the liberalization measures were taken in a gradual manner while many domestic regulations on the service sector remained intact.

The major overhaul of service industry policy in terms of liberalization, deregulation, and even perception came after the 1997 crisis. The unprecedented scale of the crisis shook almost every belief on the modus operandi of the Korean economy, which was based on the robust growth of the manufacturing industry and the dynamism of large firms. The share of manufacturing production had already begun to shrink from the early 1990s and the pace of growth could no longer be sustained solely based on manufacturing growth. Also, vulnerability to external shocks was fully exposed as a structural weakness of the economy. A solution to these problems was, on the one hand, to seek other engines of growth, and one was the service sector. On the other hand, in order to lessen the dependency on export industries, the share of the domestic market was to be widened, which was also accomplished by promoting the service sector. Since the 1997 crisis, the government initiated many publicized policies stressing the important role of the service industries.

The first full-scale liberalization including almost all service industries came in 1998 as part of the IMF and World Bank restructuring programs. Since then, as we discussed, especially the distribution industries have gone through a dramatic restructuring process. Facing competition from newly entering foreign firms with large capital and modern business models, many domestic firms rapidly adopted innovative technologies and emulated advanced managerial skills from abroad. Though concentration in larger scale firms was a certain trend, many small shops survived by networking. However, the gap between new and modern types of firms and old and traditional ones widened. In particular, the former do not provide enough jobs to absorb unemployment released from the latter. Nonetheless, the overall effect of liberalization is yet to be seen; it depends upon the balance between gains from prospective job creation through increased efficiency and social costs from temporary unemployment.

Next came the issue of deregulation, which can be distinguished by two lines of argument: first, abolishing regulations imposing unequal treatment relative to other sectors, especially manufacturing and second, deregulating the impeding laws against development of service industries. As to the first case, the ceilings on the share of bank loans and interest rate differentials were abolished in 1998. In 1997, the average annual interest rate on bank loans for distribution-related firms was 15.5% while that for manufacturing firms was 10.6% and for construction 10.7%. In spite of such a huge gap in interest rates, only 14.8% of bank loans were provided to the service sector. From 1998, however, such unequal clauses of credit allocation were discarded and, thanks to such measures, the share of loans to service firms increased to 22.5% in 2000. But this share is still low considering the fact that the GDP share of the service sector was 49%. This is partly due to Korean banks' underdeveloped credit assessment systems. Though formal regulations were scrapped, bank loans are still provided with collateral such as land and buildings, while most service firms' assets consist only of intangible assets. This situation suggests that changing laws and government policy should be coordinated with the operational tools in practice.

Since the 1980s when the economy became heavily dependent on *chaebols*, the Korean government began to implement a wide range of policy instrument to promote and assist SMEs, but most of them were applied mainly to manufacturing firms while excluding the service sector firms from such privileges. For example, the special tax exemptions for R&D, training and education expenditures of SMEs were, in effect, not available to wholesale and retail firms. Also, the government set up by various government funds to provide investment to SMEs, but the funds were mostly for manufacturing firms. There was no conspicuous statement about the unequal treatment of service firms, but there were invisible barriers to keep them from accessing such laws. Because the special laws are designed only for SMEs, the definition and classification of SMEs matters and these differ for manufacturing and service industries. In the case of the manufacturing sector, firms with below 300 employees are defined as SMEs, but for wholesale and retail firms the threshold is 20 employees. Hence, without creating new policies, the most immediate measure to take is to scrap or ease the various regulations and laws that discriminate against service firms. Recently, in an effort to promote the service industries, the government began to review such practices as unequal incentive schemes against service firms. The initial result was a revision of the classification and the scope of SMEs.

As to the regulations on the service sector such entry barriers, price controls, license systems, and the like, the government initiated a wide range of deregulation. For example, it privatized industries monopolized by public enterprises such as communication, gas and electricity and abolished price controls through various visible and invisible channels. It changed the licensing system for distribution firms to a reporting system. But the very strict land zone law, which prohibits construction of facilities, is the regulation that probably has the most significant effect on the business of distribution firms. In the case of urban habitant areas, only 1% of the land is allocated to such purpose, and for the whole nation, only 0.2% is legally available to build logistics facilities. In order to provide space and location for distribution and logistics facilities, the government relaxed the regulations on establishing facilities in the 'Green Belt' in suburban areas. Another important factor inhibiting service sector development is the astronomically high prices of land in Korea. Whereas in the United States the ratio of the value of all land to GDP is 0.7, in Korea it is 4.4, which is even higher the 3.9 ratio in Japan where the land prices are notoriously expensive. On top of the land zone law, such high prices of land leave little room for service industries.

In spite of such conditions, the retail industry in Korea seems to have rather good growth potentials. Especially, the business prospects of new types of retail firms like discount stores seem promising, at least for a while. Because the density of discount stores relative to population is far higher than in other countries, which implies that there is enough space to set up new stores. The population density per discount store in Korea is 548, which is about eight to ten times higher than in the UK, Germany, and France (table 12).

Table 12: International Comparison of Population per Discount Store

(Thousand people per store)

Korea	UK	Germany	France	Italy
548	75	73	55	315

7. POLICY SUGGESTIONS

The key issue in the development of SMEs in Korea's service sector, especially in the wholesale and retail industry, is to transform traditional firms to modern business operations. There are several policy orientations for such a purpose (table 13). First, while the growth of new types of retail firms like discount stores and convenient stores is robust, many conventional stores lag behind in adopting the recent technology developments and networking. An immediate measure for their survival is to form networks among numerous small local shops. They still have the important function to supply daily necessities. Without a large capital infusion, such stores have to exploit the benefits of franchising and chain networking, which offer cooperative supply of goods, systematic management of stocks, cost-saving logistics, and managerial support from a large organization. Various business associations and firm organizations can play a role in initiating the formation of networks and the government can implement various supportive policies to accelerate their adoption.

Table 13: Orientation and Focus of Policy Suggestion

<table>
<tr><th>Policy Issue</th><th>Orientation</th><th>Items</th></tr>
<tr><td rowspan="2">Incentive Framework</td><td rowspan="2">Indirect incentives and subsidies</td><td>To form networks, business organizations, associations</td></tr>
<tr><td>To provide information services</td></tr>
<tr><td rowspan="5">Regulation</td><td rowspan="2">Deregulation</td><td>To abolish unequal treatment of service sector activities</td></tr>
<tr><td>To minimize entry barriers, direct controls, licensing</td></tr>
<tr><td>Strengthening</td><td>To upgrade market rules, consumer rights</td></tr>
<tr><td>New regulations</td><td>To introduce standardization</td></tr>
<tr><td>Coordination</td><td>To incorporate land law with environmental and urban planning</td></tr>
<tr><td rowspan="4">Human Resource Development</td><td rowspan="2">Training, education</td><td>To mobilize organizations and networks</td></tr>
<tr><td>To focus on IT education</td></tr>
<tr><td rowspan="2">Promotion of women</td><td>To provide finance and information</td></tr>
<tr><td>To help organize women business group</td></tr>
<tr><td>Business Conventions</td><td>Public education</td><td>To upgrade transparency and fair competition</td></tr>
</table>

In the same vein, education and training are important for upgrading the business capacity of SMEs in order for them to catch up with recent developments in innovation and skills. Also, collective and cooperative endeavors can overcome the organizational barriers and heavy cost burdens of independent efforts. Membership organizations among numerous firms can offer training and education opportunities in marketing skills, customer relationships, inventory management, and information on chain and franchise formation. On the other hand, such organizations could also be initiated by business associations. They are also the essential communication link between the government and individual firms.

It is worth noting the policy orientation of service industry promotion. In the past, the framework of industrial promotion was largely based on direct incentive policy, which institutionalized various incentive provisions mainly with subsidies, financing, and taxes for target areas. The advantage of such a direct incentive system is that it can promote target firms, industries, or sectors in a relatively short time span. But also it inevitably entails numerous regulations related to selecting recipients, scope of privilege, performance checking, and the like, and it also leaves room for discretionary action by providers, i.e., the government officials. Nowadays, the government is implementing various promotional policies for the service industry, but they are mostly based on this past framework of direct incentives. Therefore, it is necessary to reorient government policies towards an indirect support system. In that sense, providing financial and administrative support to the formation of networks, business organizations and associations is desirable. And if it is necessary to provide direct subsidies to individual firms, for example to upgrade facilities and equipment such as POS system, it would be better to channel such subsidies through related organizations. Information service is another important area where the government can contribute. Communication and links with business associations and organizations are essential to disseminating information on new technologies, business prospects and strategy, education and training. The advantage of the indirect system that it helps to build institutional and material infrastructure, without inhibiting the competitive structure of the market.

Deregulation seems to be regarded as a core issue for the development of the service industry. It is necessary, however, to guard against the imprudent argument that the less regulation, the better. Needless to say, regulations concerning entry barriers and direct controls on prices and licenses should be kept minimal in order to allow wider competition. Also unequal treatment of service firms by existing policies should be scrapped. Unless proven to be still necessary, many industrial regulations devised in the early stage of industrialization should be overhauled.

On the other hand, new regulations should be introduced and some past regulations strengthened and coordinated with other regulations. For example, it is hard to assume the price and quality of services due to the characteristics of service commodities, i.e., intangibility, heterogeneity, non-storability, simultaneity. These characteristics bring about the necessity of setting up standard measures for services. Standardization enables consumers to expect price and quality of service on the one hand, and allows fair competition in and transparent supply of services. Recently the government is trying to introduce a separate KS (Korea Standard) system for services including tourism, delivery services, and outsourcing. However, it would be better to commission a related business association to set up standardization principles rather than to have the government do this.

Concerning the strengthening of the existing regulations, an important issue for the development of the service sector is to upgrade business conventions in Korea. As we have discussed, the lack of transparency is not just a matter of legality but also a factor affecting technological innovation in SMEs. The business relationship between manufacturing suppliers and small stores is distorted partly by the lack of transparency. Also, the introduction of new information systems like POS is hindered due to shop managers' desire to avoid exposing accounting data. Such conventions are hard to change. Hence, the government should make concerted efforts to establish clear and transparent trade regulations and to enforce effective market rules. Also strengthening consumers' rights is necessary not just to protect consumers' but also to promote and enlarge service markets.

Coordination of regulations is another area to consider. As discussed, the strict land zone law is the most restrictive regulation on the service industry. Nonetheless, deregulating the zone laws should be incorporated prudently with other factors affecting the quality of life. For example, in relaxing the Green Belt restrictions, only facilities without environmental hazard should be allowed. Also, remodeling traditional markets should be carried out in the context long-term urban planning involving construction laws, the transport system, and the like.

There is one last important area for development of the service industries, that is, human resource development, in particular the promotion of women in business activities. According to a government census, firms managed by women accounted for 33.9% of all firms in 2000. Recently, firms managed by women grew faster than ones managed by men, but most are small firms with under 10 employees. And firms headed by women are especially concentrated in the service sector, especially in the wholesale and retail industries and the restaurant business.

Table 14: Number and Proportion of Firm CEOs by Gender

(1,000s, %)

	1997		2000	
	Number	**% Share**	**Number**	**% Share**
Male CEO	1,929	67.6	1,995	66.1
Female CEO	924	32.4	1,023	33.9
Total	2,853	100.0	3,017	100.0

Source: *National Census on Firm Establishment*, Office of Statistics, 2000.

There are several reasons for such an upsurge of activity by women in the service sector. First, the desire and will of women to participate in the economy are getting stronger and the quality of women in the labor force has been significantly upgraded thanks to investment in education, but there are still social barriers to participating with equal rights and status. Therefore, many women choose to establish their own businesses rather than to seek jobs with little prospect. They find particular opportunity in service firms, which require relatively small capital investment and fewer skills. According to a report, firms managed by women have a lower rate of default on bank loans and they are more prudent in credit management Industrial Bank of Korea 2001). Female heads of firms show a particular interest in participating in business associations and organizations, probably because they have less opportunity than males for informal meetings and because participation in associations is an important way to acquire business-related information. Also, they exhibit a greater willingness than male heads of companies to utilize outside assistance on management information and skills. According the same study, 49.1% of female CEOs said that business information offered by banks is very useful for management, but only 38.8% had such assistance.

These results show that female managers have a stronger commitment and desire to upgrade their business capacity and to form networks. Also, once organized, they can fully utilize the merits of organizations and networks. Highly skilled committed women are an important resource for the further development of the economy as a whole and the development and transition of the service sector in particular may depend on the widening business opportunities for women. In this regard, it is necessary for the government to focus on a policy package that promotes women's participation in business on the one hand and helps women form various organizations and networks.

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