

## **The Kaesong Industrial Complex: Lightning Rod or Banner?**

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A flashy banner advertisement on the Hankyoreh English language website proclaims the Kaesong Industrial Complex “an area for common prosperity,” “nurturing economy for peace and peace for economy.” A polemically different view was offered by U.S. Envoy for Human Rights in North Korea Jay Lefkowitz who raised concerns of “worker exploitation” at Kaesong and warned of channeling unmonitored aid to North Korea that might “unwittingly help prop up the regime.”<sup>1</sup> For a relatively innocuous and as of yet economically insignificant project, the Kaesong Industrial Complex has garnered an inordinate amount of attention related to issues as diverse as human rights, denuclearization, and free trade.

The focus of this panel offers a no less grandiose description of the Kaesong project as “a touchstone for East Asian peace,” and it is in this context that we are asked to assess its present and future. Realistically, however, it would be presumptuous for this particular author to travel to Korea and attempt to describe to Koreans the present or future of a project run by Koreans for Koreans, which few other than Koreans are allowed to visit, and about which most materials are available only in the Korean language—a task akin to trying to teach literature to Confucius.

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<sup>1</sup> Lefkowitz, Jay, “Freedom for All Koreans,” *The Wall Street Journal*, April 28, 2006

Given my perch in Washington, D.C., my remarks are far better served being focused on the varied U.S. perceptions of the Kaesong Industrial Complex and its implications, not just for North Korea, but for U.S.-Korea relations and the region as a whole. In so doing, I must readily admit that, despite several attempts, I have never visited Kaesong and thus I enjoy full freedom of assessment unencumbered by the facts on the ground. In all seriousness, however, the merits of the Kaesong project cannot be evaluated solely from a ledger sheet or the grounds of the industrial complex itself, nor can it be accurately assessed from Washington, Seoul, or Pyongyang alone. How one evaluates Kaesong depends largely on the context in which the project is viewed, a classic case of where one stands depending on where one sits.

### **Kaesong in the context of inter-Korean reconciliation and peace**

The strongest possible justification for active South Korean governmental support for the Kaesong Industrial Complex is the role of the Kaesong zone in an overall policy of inter-Korean reconciliation and peace. At the same time, this justification is the most difficult for American observers to assess due to its sensitivity. The *New York Times* quoted a senior Ministry of Unification official, Ko Gyoung-bin, describing the Kaesong project as “de facto unification,” further noting that “it’s already underway.”<sup>2</sup> On an official level it is nearly impossible and certainly unwise for the U.S. to be seen as opposing unification or even the process of reconciliation that is hoped to lead to unification. This

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<sup>2</sup> Onishi Norimitsu, “South Brings Capitalism, Well Isolated, to North Korea,” *The New York Times*, July 18, 2006.

is in part why, despite some misgivings about the efficacy of the policy and its possible implications for broader issues in the region, the official U.S. position is to support inter-Korean initiatives including the Kaesong Industrial Complex.

It is really up to South Koreans to frankly evaluate several core assumptions that underlie the engagement policy and official support for the Kaesong Industrial Complex: that the project has led North Korea to mitigate its behavior; that the zone has provided South Korea with additional leverage in its dealings with the North; and that South Korea's policy has led North Korea to regard South Korea as a legitimate partner in addressing the security concerns that remain the primary obstacles to reconciliation and peace on the peninsula.

From a U.S. perspective, it often seems that South Korea's support for Kaesong is driven more by domestic politics and domestic expectations in Korea than by any real expectation of change in North Korea. This is entirely appropriate in a democracy like South Korea but speaks more to tension reduction on the peninsula than to the changes that must inevitably take place in North Korea if real reconciliation and peace are to be achieved.

At the same time, it is important for outside observers to recognize the very real national interest that South Korea has in reducing tensions on the peninsula. Perhaps the least appreciated aspect of President Kim Dae Jung's initiatives toward the North was the

calming and stabilizing effect they had upon South Korea's economy and investment environment in the months and years following the Asian financial crisis.

### **Kaesong in the context of economic reform in North Korea**

One of the original justifications not just for the Kaesong Industrial Complex but for the entire South Korean "engagement" policy toward the North was that it would foster reform within North Korea. To reference former President Kim Dae Jung's preferred fable, the policy was premised on the belief that the sun would be far more effective than the cold wind in convincing Aesop's traveler to remove his cloak. This normative element ostensibly remains a core justification for Seoul to continue to indirectly subsidize the Kaesong project. In this light, the decision of the Ministry of Unification to remove the words "reform" and "opening" from the Kaesong section of its website days after the October Roh-Kim Summit does appear to send mixed messages. If the objective of the Kaesong Industrial Complex is not reform and opening, what are the real prospects for reconciliation and peace without reform and opening? If nearly ten years of planning and implementation of the Kaesong zone have yet to create an environment where words like "reform" or even something as innocuous as "opening" cannot be used, what does that say about the pace of change in North Korea? More importantly, what does it say about the South Korean government's role in the project and its subjugation of economic priorities to political imperatives?

While the more than 19,000 North Korean workers currently employed in the zone certainly have more exposure to South Koreans than most of their North Korean compatriots, it appears to be too early in the process to observe any measurable impact in their thinking or views. At any rate, if the mere use of words such as “reform” or “opening” even within South Korea is proscribed, it would seem logical that exposure would also be proscribed.

Herein is an important distinction. Just as the environment in North Korea mandates some degree of understanding about the difficulty of establishing operations within the Kaesong Industrial Complex that are fully compatible with international norms, it is also true that the oft-cited choice between accepting North Korean conditions for the zone and the complete abandonment of the project in favor of policy of antagonism and conflict is a false dichotomy. The normative aspects of South Korea’s engagement policy, and more specifically the policy as implemented in Kaesong, should not be compared to the abyss of conflict or to the environment in a similar project south of the DMZ. Rather, they should be compared with viable alternatives, particularly those driven by market mechanisms.

It is the role of the South Korean government that makes the Kaesong Industrial Complex so very different from similar projects in such countries as Vietnam or China. The motivations of the South Korean government understandably extend beyond simple profit motives and market mechanisms. However, at the same time, it is the pursuit of other objectives such as peace, stability, inter-Korean reconciliation, and even South Korean

presidential politics that have the inherent potential to undermine any likelihood of the Kaesong Industrial Complex to instigate opening and reform in North Korea.

Without going into much depth here, there is a reasonable argument to be made that the specific modalities of inter-Korean economic interaction to date have actually served to slow down the pace and scope of opening and reform within North Korea over the past decade. In principle, the most effective agent of change in North Korea should be market mechanisms. In other words, private enterprises saying to Pyongyang “I would invest in North Korea, but...” would have just as much influence on North Korean behavior as those who actually invest. The determining factor would of course be the profitability of any action. The degree to which the South Korean government has been involved in and supportive of inter-Korean economic activity means that this is one case where moral hazard<sup>3</sup> has come into play. Strong South Korean government support for select inter-Korean interactions effectively removed market principles from the equation, or at a minimum subjugated market principles to other considerations. Not only have many official exchanges been literally “bought and paid for,” but indirect support for certain enterprises has also meant that those operating on a strictly for profit basis could not compete, and more importantly, North Korea has reduced the incentive to make according adjustments to its own system.

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<sup>3</sup> The concept of moral hazard is hard to define, but relatively easy to recognize. Moral hazard is generally understood to be the risk that one party to a contract or agreement can change their behavior to the detriment of the other party once the contract has been concluded, or of greater concern, that the conclusion of the contract or action itself will lead to such a change in behavior. Examples of moral hazard can be found in fire insurance giving people an incentive to commit arson or encouraging sloppy fire prevention, the risk that a social safety net might discourage personal responsibility, or the possibility that subsidies may discourage needed reforms.

A careful examination of Kaesong to date will likely reveal that in most cases not only were market incentives distorted, but also that the South Korean side accepted restrictions and conditions that would have been unacceptable in any other context. It is against this acquiescence that other interlocutors are ultimately judged and by which North Korea is likely learning all the wrong lessons.<sup>4</sup> Equally importantly the capital flows from South to North during this period, while small by any international standard, are almost certainly significant in a North Korean context and may have enabled the regime in Pyongyang to put off the stark choices it might have otherwise faced.

These criticisms are by no means an absolute repudiation of the effect that the Kaesong Industrial Complex has had on prospects for reform in North Korea. The more than 19,000 workers are most certainly impacted positively by their experience and exposure. However, South Korea's attention should remain focused on how to make the Kaesong Industrial Complex more of an engine of opening and reform than it currently is...something that will matter even more if the optimistic scenarios of expanding the zone to include some 700,000 workers by the 2012 are realized.

### **Kaesong in the context of economic merit**

Whether or not investing in the Kaesong Industrial Complex makes sense economically, is a decision that should be viewed almost entirely from the perspective of the potential

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<sup>4</sup> Although I am unaware of any serious comparisons on this issue, there is some suggestion that similar initiatives that took place prior to German Unification were rendered essentially useless following Unification. A careful assessment of the fate of such enterprises in Germany might provide some useful lessons for standards and implementation as the Kaesong Industrial Complex is further expanded.

investor. However, here once again the prevalence of other motives behind the Kaesong project complicates any accurate assessment. In contrast to more traditional models of export processing zones where a host government establishes a zone and courts outside investment, the role of the South Korean government in negotiating, establishing, promoting, and maintaining the Kaesong Industrial Complex raises questions about direct and indirect subsidies and enterprise activities that are more political than economic.

This is in no way intended to imply that there is no genuine market-driven activity taking place in the zone. According to the Ministry of Unification, as of September 2007 the cumulative production in the Kaesong Industrial Complex since January of 2005 has surpassed the \$200 million mark (\$213,854,000), and the level of monthly production has increased to \$16 million.<sup>5</sup> As of October 2007, there are 45 companies operating in the Kaesong Complex and the number of North Korean workers has risen to 19,433. More encouraging still, two Chinese investors and one German investor have also reportedly decided recently to begin operations in the Kaesong Industrial Complex. If realized, this would represent a very positive economic development.

The key question in any accurate economic assessment of the project is the transparency regarding the extent of subsidies to firms actively engaged in the zone. The anecdotal data and reports that have emerged from the project to date are so disparate as to limit any confidence in the current state of business in the zone. The news from the Kaesong Industrial Complex and from the Ministry of Unification is almost propagandistic in its

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<sup>5</sup> Ministry of Unification, "Key statistics for Gaeseong Industrial Complex (As of September 30, 2007)," November 2, 2007.

nature. Likewise, negative critiques tend to be sweeping in their condemnation. Just last month Representative Lee Hanh-Koo, an opposition National Assemblyman on the Financial and Economic Committee, claimed that 13 out of 16 of the companies that had established a presence in Kaesong with the backing of the Korean ExIm Bank have suffered losses for the past two years, and that all had seen a rather dramatic increase in debt ratios<sup>6</sup> These results are obviously not unique to the Kaesong project; businesses fail regularly. An estimated 40 percent of South Korean firms that have invested in China are no longer in business.

The real question is whether or not the ExIm Bank would have made loans to these firms had they not been in Kaesong. A similar issue of transparency has been raised over the proposed incorporation of the cost of electricity supply for the Kaesong Industrial Complex in North Korea into South Korea's own electricity fee system, something that possibly allows losses from the Kaesong Complex to be absorbed into the overall scheme.<sup>7</sup>

These are but two examples of a myriad of indirect ways in which the South Korean government is able to subsidize the Kaesong complex and which must be considered in any attempt to render judgment on the financial performance or prospects of the zone. Such questions are particularly important considering the plans, the first phase of which was announced in the October 4 North-South Summit, to expand the zone. Any corresponding expansion of the zone will also increase the necessity of public outlay and

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<sup>6</sup> "Businesses Still Struggling at Kaesong Complex—Lawmaker," *The Chosun Ilbo*, October 30, 2007.

<sup>7</sup> S. Koreans to Subsidize Kaesong Power Supply, *The Chosun Ilbo*, September, 19, 2007.

further necessitate transparency, as South Korean lawmakers decide how to pay for the expansion of Kaesong.

### **Kaesong in the context of human rights**

It is in the field of human rights and labor rights that the Kaesong Industrial Complex is most vulnerable to U.S. criticism. This is not necessarily due to the actual state of affairs on the ground in Kaesong. Rather it is the confluence of issues of concern to both the political left and the political right in the U.S. that make Kaesong such an easy target. For reasons religious and otherwise, the issue of human rights in North Korea has drawn particular support from American conservatives. Among these there is certainly an element actively advocating regime change in North Korea. However, even more progressive elements among conservatives, who are willing to engage with North Korea on issues of concern, would likely be hesitant about overt support for the regime itself.

On the other side, the more progressive community shares a deep concern about the human rights situation in North Korea, even while being wary of involvement in activities or positions that hint of support for “regime change.” Furthermore, concerns about labor standards and a growing skepticism about free trade itself add to progressive reticence on support for a project like the Kaesong Industrial Complex. For example, Human Rights Watch issued a report in 2006 saying labor laws in the zone do not meet world standards and the AFL CIO continues to express concern about lack of rights to organize unions within the Kaesong Industrial Complex.

The issue of wages in the zone has been a particular focus of debate, although the scope of this debate has been remarkably narrow given the relatively small numbers under discussion. Kaesong Industrial Complex officials claim that the average wages paid to North Korean workers in the zone are \$70 per month, including basic wage and overtime pay, and that a total benefits package including transportation and “snacks” reaches \$90 per month. While clearly low by South Korean or Western standards, these wages are considerably higher than the average North Korean salary and also higher than wages in similar special economic zones in Vietnam. The real focus of the debate is over how much of these wages actually goes to the workers. Hong Jae-Hyung, Director General of the Kaesong Industrial Complex Project, claimed that only \$15 is taken by the state as a “socio-cultural policy fee”....something he compared to an income tax.<sup>8</sup> However, there remains concern about the ongoing practice of paying the wages directly to the North Korean government officials rather than to the workers themselves. Here too it is the issue of transparency that continues to vex U.S. views of practices within the zone.

As with the other issues mentioned above, the question of human rights and labor rights is complicated by the role of the South Korean government. It is quite a natural thing for international firms to seek to secure the least expensive labor with the smallest amount of regulation possible. It is quite another when the South Korean government is involved in the negotiations, particularly since South Korea is a signatory to many of the international treaties and agreements that guarantee conditions in South Korea not extended to the Kaesong Industrial Complex.

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<sup>8</sup> “Kaesong Workers are Treated Fairly,” *The Wall Street Journal Online*, September 12, 2007.

## **Kaesong in the context of the KORUS-FTA**

Unfortunately, the context in which the Kaesong Industrial Complex has been most prominently raised in the U.S. is also the context in which it is most indefensible, as an appendage to the Korea-U.S. FTA Negotiations. From the beginning of the negotiations on the FTA, the South Korean team sought ways to explicitly include products made in Kaesong into the FTA. This can be viewed in part as an indication of the anticipated scale of the future expansion of the Kaesong Industrial Complex. At the same time, however, it was also a clear attempt to secure an explicit U.S. endorsement for the Kaesong Industrial Complex.

This combination of controversial economic, social and security issues resulted in a perfect storm of opposition that threatened the FTA negotiations and which still threatens its ratification. In the South Korean insistence on the inclusion of Kaesong products, all sides could find something to oppose, without being labeled anti-business or anti-free trade. Members of Congress from pro-labor districts, skeptical of free trade to begin with, could oppose the inclusion of Kaesong products based on the lack of labor protections in the zone. Those who espouse and even genuinely support free trade would be equally concerned regarding the issue of human rights and worries the Kaesong Industrial Complex funneled support directly to the North Korean regime.

Here it is important to make a clear distinction; the fate of the FTA is now in the hands of the U.S. Congress. The views of individual members of Congress are much more susceptible to public opinion than those of USTR negotiators and other administration officials. It is always a useful reality check to remember that the most famous Korean in the U.S. is not a sports star, actor, or even a South Korean President, but instead Kim Jong Il. This relative infamy is not a positive when it comes to the FTA, as the images of Kim Jong Il and North Korea remain cartoonish and overwhelmingly negative. For individual members of Congress who might already have a difficult time trying to sell the FTA to an American public already skeptical about free trade, mixing in the politics of supporting Kim Jong Il makes FTA approval all the more unsalable. In this context, if South Korea does indeed push forward with phase II expansion of the Kaesong Industrial Complex in the absence of a resolution of the nuclear issue, such a move may complicate passage of KORUS FTA

### **Kaesong in the context of denuclearization**

The highest priority for the U.S. in dealing with North Korea remains concerns about North Korea's nuclear program. While Kaesong is also seen in other contexts, it will ultimately be assessed by whether it helps or hinders the resolution of the nuclear crisis. Through much of the past five years, the Kaesong Industrial Complex was viewed with particular skepticism because it was so out of sync with a broader U.S. approach of isolating and putting pressure on North Korea. In particular, the South Korean decision to continue the project, if not its expansion, despite North Korea's long-range missile

tests in July 2006 and more importantly its nuclear weapons test in October of 2006, came under particular criticism. Despite South Korean rhetoric about never accepting a nuclear North Korea, the decision to maintain both the Kumgang and the Kaesong projects—both primarily seen as aid to North Korea—raised serious questions about South Korea’s commitment to denuclearization and its support for the U.S. position.

An apparent change in the U.S. approach and recent progress in the six party talks seems to have given South Korea a green light for further expansion of the Kaesong project. The October 4 North-South Joint Statement directly addresses short term plans for not only expansion of the Kaesong Project, but the initiation of new projects elsewhere in North Korea. Such plans are premised, however, on the assumption that the nuclear issue is ultimately resolved. While current trends are positive, it is useful to remember the enormity of the task that lies ahead. Disabling and ultimately dismantling the small 5 megawatt research reactor at Yongbyon is a positive step, but we have not even begun the “real” negotiations over the North’s actual nuclear weapons and fissile material. Even in the most optimistic of scenarios it is difficult to imagine progress on these ultimate stages in the waning days of the Bush administration. If that is indeed the case, then there remain very significant strategic limitations on the pace and scope of development in Kaesong.

## **Conclusion**

From a South Korean perspective, the Kaesong project may well be justifiable for the role it plays in inter-Korean reconciliation and tension reduction on the peninsula alone. However, the extent to which it provides leverage to Seoul or leverage to Pyongyang will depend upon the skill with which and the standards upon which the project is implemented as it expands. Likewise, in the long run, the zone may provide the impetus for opening and reform in the North. To date, however, such effects have been largely undermined by the nearer term political demands of the strategy.

The economic assessment of the Kaesong Industrial Complex should be the easiest to make, but a lack of transparency regarding the full extent of South Korean government subsidies and perhaps more importantly non-economic political considerations, complicate the task. At any rate, with a production record of less than three years, it is too early to declare the complex a success or a failure.

It is unlikely that strong proponents of human rights or labor rights in North Korea will ever be convinced of the merits of the Kaesong Industrial Complex. At a minimum, the link between the complex and the Free Trade Agreement should be de-emphasized so as to limit damage to both the prospects for ratification of the FTA and to support for the Kaesong project itself.

At the end of the day, like so many issues, the prospects for the Kaesong Industrial Complex remain hostage to the North Korean nuclear program. If the current direction continues and there is continued progress on disabling and ultimately dismantling North Korea's nuclear program, one can expect a continued expansion of the Kaesong project. However, only if and when North Korea is willing to place its actual nuclear weapons and fissile materials on the table and abandon its nuclear ambitions will there be any chance that the Kaesong Industrial Complex will reach the potential foreseen by the organizers of this conference and become a "touchstone for East Asian peace."