

# CRS Report for Congress

## The Kaesong North-South Korean Industrial Complex

Updated February 14, 2008

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Prepared for Members and  
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# The Kaesong North-South Korean Industrial Complex

## Summary

This purpose of this report is to provide an overview of the role, purposes, and results of the Kaesong Industrial Complex (KIC) and examine U.S. interests, policy issues, options, and legislation. The KIC is an industrial park located in the Democratic People's Republic of Korea (DPRK or North Korea) just across the demilitarized zone from South Korea. Currently, over 50 medium-sized South Korean companies are using North Korean labor to manufacture products in Kaesong, but projections are for as many 2,000 firms to locate there. The complex was planned, developed, and financed largely by South Korea, and it has become a symbol of the growing level of engagement between the North and the South. The United States officially supports the KIC.

The KIC enters into the U.S. policy debate because: (1) South Korea would like the United States to consider products made in the KIC as South Korean in origin for purposes of the Korea-U.S. Free Trade Agreement (KORUS FTA); (2) the KIC has become a growing source of foreign exchange for the communist government in Pyongyang; (3) the KIC is part of the strategy by South Korea to ease tensions with North Korea; (4) the KIC is a part of the DPRK's economic reforms (similar to China's special economic zones) that could lead to greater liberalization in the rest of its economy; (5) the KIC raises issues of security, human rights, and working conditions in North Korea; and (6) U.S. government approval is needed for South Korean firms to ship to the KIC certain U.S.-made equipment currently under U.S. export controls.

The language of the proposed KORUS FTA (signed but not yet approved by Congress) does not provide for duty-free entry into the United States for products made in Kaesong. Annex 22-B to the proposed FTA, however, provides for a Committee on Outward Processing Zones (OPZ) to be formed and to designate zones, such as the KIC, to receive preferential treatment under the FTA. Such a designation apparently would require legislative approval by both countries.

The fundamental issue with respect to the KIC is whether the United States should support a project that provides revenue to the Kim Jong-il regime in Pyongyang — considering the regime's nuclear and human rights policies — and that includes questionable labor practices, even though the project seems to be enhancing cooperation between South Korea and the DPRK, lowering labor costs for Korean businesses, and providing a possible beachhead for market reforms in the DPRK.

U.S. policy options include maintaining the status quo of supporting, but not actively promoting, the KIC, using the debate over the KORUS FTA to focus attention on labor and other conditions in the KIC, encouraging reforms in the KIC, providing close oversight to the Committee on Outward Processing Zones (if formed), tightening or loosening sanctions and export controls with respect to the DPRK, encouraging or prohibiting U.S. companies from doing business in the KIC, placing restrictions on South Korean companies that do business in North Korea, and encouraging other countries to (or not to) include the KIC in their respective FTAs with South Korea. This report will be updated as circumstances warrant.

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# The Kaesong North-South Korean Industrial Complex

The Kaesong Industrial Complex (KIC) is an industrial park located in the Democratic People's Republic of Korea (DPRK or North Korea) just across the demilitarized zone from South Korea. As of November 2007, over 50 medium-sized South Korean companies were using North Korean labor to manufacture products there, employing around 20,000 workers. The complex was planned, developed, and financed largely by South Korea, and it has become a symbol of the growing level of engagement between the North and the South.

**Figure 1. Location of the Kaesong Industrial Complex**



Source: Map Resources. Adapted by CRS. 06/07

This purpose of this report is to provide an overview of the role, purposes, and results of the KIC and examine U.S. interests, policy issues, options, and legislation.

The KIC enters into the U.S. policy debate because: (1) South Korea would like the United States to consider products made in the KIC as South Korean in origin for

purposes of the Korea-U.S. Free Trade Agreement (KORUS FTA);<sup>1</sup> (2) the KIC has become a growing source of foreign exchange for the communist government in Pyongyang; (3) the KIC is part of the strategy by South Korea to ease tensions with North Korea and lower the eventual costs to South Korea of a hoped-for reunification of the two Koreas in the future; (4) the KIC is a part of the DPRK's economic reforms (similar to China's special economic zones) that could lead to greater liberalization in the rest of its economy; (5) the KIC raises issues of security, human rights, and working conditions in the DPRK; and (6) U.S. government approval is needed for South Korean firms to ship to the KIC certain U.S.-made equipment currently under U.S. export controls.

The United States currently has an embargo on trade with the DPRK.<sup>2</sup> Even without the embargo, the United States has not granted North Korea normal trade relations status (most favored nation status), so products made in North Korea currently are assessed the high tariff rates of the 1930s (column two in the U.S. Harmonized Tariff Schedule) when they enter the U.S. market. For example, a woman's cotton suit (H.S. code 6204.12.00) from South Korea currently is assessed a U.S. tariff of 14.9% while the tariff on a comparable item from North Korea is 90%. Under the proposed KORUS FTA, the tariff on this item for South Korea would be eliminated, but even if it were allowed to be imported from the DPRK, its tariff rate would remain at 90%.

The language of the KORUS FTA (signed by representatives of each government but not yet approved by Congress) does not provide for duty-free entry into the United States for products made in Kaesong. The Office of the U.S. Trade Representative has been clear that the Agreement does not include goods from the KIC.<sup>3</sup> Annex 22-B to the proposed FTA, however, provides for a Committee on Outward Processing Zones (OPZ) to be formed. This committee is to meet annually to consider identifying geographical areas that may be designated as outward processing zones and whose products could qualify as goods originating in South Korea. The committee would establish criteria to be met to include but not be limited to "progress toward denuclearization of the Korean Peninsula; the impact of the outward processing zones on intra-Korean relations; and the environmental standards, labor standards and practices, wage practices and business and management practices prevailing in the outward processing zone with due reference to the situation prevailing elsewhere in the local economy and the relevant international norms." Decisions reached by the unified consent of the committee are to be recommended to the Parties to the Agreement which shall be responsible for seeking "legislative approval for any amendments to the Agreement with respect to outward processing zones."

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<sup>1</sup> For information on the FTA, see CRS Report RL34330, *The Proposed U.S.-South Korea Free Trade Agreement (KORUS FTA): Provisions and Implications*, coordinated by William H. Cooper.

<sup>2</sup> For more, see CRS Report RL31696, *North Korea: Economic Sanctions*, by Dianne Rennack.

<sup>3</sup> Korea, U.S. Still at Odds Over Kaesong Goods, *Digital Chosun Ilbo* (English Edition), April 4, 2007.

The fundamental issue with respect to the KIC is whether the United States should support any project that provides revenue to the Kim Jong-il regime in Pyongyang — considering the regime’s nuclear and human rights policies — and that includes questionable labor practices, even though the project seems to be enhancing cooperation between the DPRK and South Korea, lowering labor costs for South Korean businesses, and providing a possible beachhead for market reforms in the DPRK.

The future course of the Kaesong Industrial Complex could undergo some changes as a result of the December 2007 victory of Lee Myung-bak in South Korea’s presidential election. Lee, who will take office at the end of February 2008, has indicated he generally will seek more reciprocity from Pyongyang in non-humanitarian inter-Korean cooperation programs, and that he will link future large-scale economic programs to progress on the North Korean nuclear issue and will also weigh heavily the financial costs of these programs. Statements from his transition team members indicate that the new administration plan to continue projects that are commercially viable. Both President-elect Lee and his transition team have been somewhat vague on what these principles would mean for the KIC. However, the incoming administration has indicated it will not suspend the KIC.<sup>4</sup> If this proves to be the Lee government’s policy, a major question for the future will be whether the Lee government would support a major expansion of the KIC. One policy shift that may occur, according to some South Koreans who have contacts with the transition team, is that Lee may seek to raise the commercial focus of the KIC by reducing the government’s involvement in running the complex.<sup>5</sup>

U.S. policy options include maintaining the status quo of supporting but not actively promoting the KIC, using the debate over the KORUS FTA to focus attention on labor and other conditions in the KIC, encouraging reforms in the KIC, providing close oversight to the Committee on Outward Processing Zones (if formed), tightening or loosening sanctions and export controls with respect to the DPRK, encouraging or prohibiting U.S. companies from doing business in the KIC, placing restrictions on South Korean companies that do business in North Korea, and encouraging other countries to (or not to) include the KIC in their respective FTAs with South Korea.

## **The Development of the Kaesong Industrial Complex**

The KIC resulted from an initiative led by the Hyundai Group beginning in 1998 that coincided with the Republic of Korea’s (ROK) “sunshine policy” that attempted to improve relations between South Korea and the DPRK. The KIC is located about 106 miles southeast of Pyongyang and 43 miles north of Seoul just across the

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<sup>4</sup> Ahn Yong-hyun, “Lee Gov’t to Postpone Some Inter-Korean Mega Projects,” *Chosun Ilbo*, January 8, 2007.

<sup>5</sup> Conversations with South Korean government officials and think tank researchers, January and February 2008.

demilitarized zone (DMZ) in the DPRK. The purposes of the KIC as stated by South Korea have been to develop an industrial park in which South Korean businesses could manufacture products using North Korean labor, provide an opening for North Korea to liberalize and reform its economy, and ease tensions across the DMZ. Although begun primarily as a private sector venture, both governments are heavily involved in the project. Groundbreaking occurred in June 2003 and again in April 2004. Hyundai Asan and the Korea Land Corporation (both from South Korea) have been developing and managing the complex.

South Korean companies operating in Kaesong receive certain incentives from the ROK government and have certain rights as determined by negotiated agreements with the DPRK. The KIC is a duty-free zone, with no restrictions on the use of foreign currency or credit cards and no visa required for entry or exit. Property and inheritance rights are ensured. South Korean law breakers in Kaesong are not to go on trial in the North.<sup>6</sup> The corporate tax rate is 10 to 14% with an exemption for the first five years after generating profits and a 50% reduction for the ensuing three years. The South Korean government (through its Inter-Korea Cooperation Fund) offered companies that established their operations in the KIC (in the pilot project and first phase) loans with low interest rates equal to those applied to public works projects. These loans totaled about \$40 million as of the end of 2005.<sup>7</sup> Out of the first 26 firms to either begin operations or contemplate beginning operations in the near term, 25 of them applied for loans from the Inter-Korea Cooperation Fund.<sup>8</sup> South Korea also provides political risk insurance that will cover financial losses up to 90% of a company's investment in the KIC up to five billion South Korean won (\$5.4 million). Under a South Korean law passed in April 2007, South Korean small and medium-sized firms operating in the KIC are eligible for state subsidies and other benefits equal to their counterparts at home.<sup>9</sup>

**Table 1** shows the first three phases of the master plan for the project. The first phase encompasses 800 acres with as many as 300 South Korean firms operating in the complex. At the end of phase 3, the plan calls for as much as 4,800 acres in the industrial zone with as many as 1,500 firms employing 350,000 North Korean workers and producing \$16 billion worth of products per year. It also includes 2,200 acres in a supporting zone with residential facilities (dorms), commercial establishments (hotels, restaurants, offices, conference rooms), and tourist facilities (golf course, peace park, theme park). The Master Plan also includes an Expansion

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<sup>6</sup> Under the Agreement Regarding Admission and Staying in the Kaesong Industrial Complex and Mt. Kumgang Special Tourism Zong (a.k.a. the Passage Agreement), the principle of compulsory repatriation of offenders was acknowledged by Pyongyang. This was important for South Korean businesses because under North Korean law, even crumpling a newspaper that displays Kim Jong-il's picture is considered a criminal act. (See Lim, Eul-chul. *Kaesong Industrial Complex, History, Pending Issues, and Outlook*, Seoul: Haenam Publishing Company, 2006, pp. 42-43.)

<sup>7</sup> Hyundai Asan. *Kaesong Industrial Park*, brochure. c. 2006. ROK. Ministry of Unification. Gaesong Industrial Complex: Frequently Asked Questions (May 21, 2006).

<sup>8</sup> Lim, Eul-chul. *Kaesong Industrial Complex*, op. cit., p. 172.

<sup>9</sup> South Korean Assembly Passes Bill on Inter-Korean Industrial Complex. Yonhap News Agency, April 27, 2007. Reported by BBC Monitoring Asia Pacific.

Zone of 1,600 acres for industrial use and 4,000 acres for support. This would be used after phase 3 and would accommodate an additional 500 companies, 150,000 employees, and estimated production of \$4 billion per year. Counting the expansion zone, the grand totals for the Master Plan would be 6,400 acres for the Industrial Zone (10 square miles), 6,200 acres for the Supporting Zone, 2,000 companies, 500,000 workers, and \$20 billion per year in products. The industrial and supporting zones together cover an area roughly one-fifth the size of Washington, DC.

**Table 1. Hyundai's Original Concept of the First Three Phases of the Master Plan for the Kaesong Industrial Complex**

Year	Phase 1 (includes pilot) 2002-2007	Phase 2 2006-2009	Phase 3 2008-2012
Total Land at Completion of Stage	800 acres in Industrial Zone. Kaesong City as a Supporting Zone	2,000 acres in Industrial Zone 800 acres in Supporting Zone	4,800 acres in Industrial Zone 1,600 acres in Supporting Zone
Total ROK Firms at Completion of Stage	300	800	1,500
Total DPRK Workers at Completion of Stage	100,000	200,000	350,000

Source: ROK, Ministry of Unification.

The development of the KIC has been subject to some modifications and delays, such as the moratorium on new factories that the South Korean side imposed for several months after North Korea test-fired medium and long-range missiles in July 2006. As of late 2007, the 800 acres of the industrial zone envisioned in phase 1 had been prepared. The South Korean government estimates that this site will be fully operational at the end of 2010, with about 450 manufacturers and about 100,000.<sup>10</sup>

As of mid-2006, 1,800 companies had applied for entry into the KIC and had requested 5,112 acres. Of these 1,800 companies, 365 were in mechanical manufactures (auto parts, bolts, etc.), 298 in garments, 261 in textiles, 198 in electronics, and 112 in chemical materials (rubber, plastic, etc.). Other products to be manufactured include shoes, bags, toys, accessories, and other products.<sup>11</sup>

The KIC aims to attract South Korean companies, particularly small and medium sized enterprises, seeking lower labor and other costs for their manufactured products as an alternative to establishing subsidiaries in China or other low-wage markets. As indicated in Table 2, by November 2007, over 50 companies had begun operations in Kaesong and were employing about 20,000 North Korean workers. As

<sup>10</sup> Ministry of Unification. Current Status of Operation in the Gaeseong Industrial Complex. November 23, 2007.

<sup>11</sup> Hyundai Asan. *Kaesong Industrial Park*, brochure. c. 2006.



of September 2007, about 2,000 North Korean workers were engaged in the construction of the complex, over 500 were working in managing the complex, with the remainder employed by South Korean tenant firms.<sup>12</sup>

**Table 2. Number of Firms and Workers in the Kaesong Industrial Complex**

	End 2005	End 2006	November 2007
No. of South Korean Manufacturing Firms	11	15	52
Approx. No. of North Korean Workers	6,000	11,000	20,000
Approx. No. of South Korean Workers	n.a.	700	800

**Sources:** ROK, Ministry of Unification, Update on the Gaeseong Industrial Complex (As of February 17, 2006); Key Statistics for Gaeseong Industrial Complex (As of January 31, 2007); Current Status of Operation in the Gaeseong Industrial Complex, November 23, 2007.

Of the \$374 million initial cost for the first stage, \$223 million was to be provided by the South Korean government. The supporting infrastructure is gradually being built. In December 2006, the Korea Electric Power Corporation connected North Korea and South Korea by a 100,000 kilowatt power-transmission line and in June 2007 began transmission of high-voltage electricity for use by the companies in the KIC. This was in addition to low-voltage electricity that had been in use since March 2005.<sup>13</sup> In December 2007, the two Koreas started daily train service across the demilitarized zone. The plan is for the trains to connect the KIC to South Korea in the south and to China in the north. Currently, the trains terminate south of Kaesong, in Bongdong, which does not have loading facilities.<sup>14</sup> Meanwhile, Kaesong is connected to South Korea by a road that has more than 100 vehicles per day passing through the checkpoints.<sup>15</sup>

The 15 companies operating in the Pilot Industrial Complex in Kaesong in 2006 and their products include Sonoko Cuisine Ware (kitchenware), SJ Tech (semiconductor component containers), Shinwon (apparel), Samduk Trading (footwear), Bucheon Industrial (wire harness), Taesung Industrial (cosmetics containers), Daewha Fuel Pump (automobile parts), Munchang Co. (apparel), Romanson (watches, jewelry), Hosan Ace (fan coils), Magic Micro (lamp assemblies for LCD monitors), JY Solutec (automobile components and molds), TS Precision

<sup>12</sup> Ministry of Unification. Key Statistics for Gaeseong Industrial Complex (as of September 30, 2007).

<sup>13</sup> S. Korea Starts Large-scale Supply of Power to N. Korea's Kaesong Complex. *Yonhap*, June 21, 2007.

<sup>14</sup> Economist Intelligence Unit. South Korea Country Report. January 2008.

<sup>15</sup> Republic of Korea. Ministry of Unification. Key Statistics for Gaeseong Industrial Complex, as of March 31, 2007.

Machinery (semiconductor mold components), Yongin Electronics (transformers, coils), and JCCOM (communication components).<sup>16</sup>

Twenty additional companies have purchased lots for the First Phase Industrial Complex. By 2007, six of them had begun operations: Cotton Club (underwear), Pyongan (textiles), Korea Industry Complex Corp. (garments), Good People (underwear), Pyonwha Distribution (shoes), and Manson (garments). By June 2007, 23 companies (including the Korea Land Corporation and Hyundai Asan's Kaesong Head Office) were operating in the KIC and more were preparing to start operations. The additional companies intended to produce items of apparel, bags, shoes, and paragliders.<sup>17</sup>

As shown in **Table 3**, in 2006, the KIC-produced goods totaled \$73.7 million, up from \$14.9 million worth in 2005. Production for the first nine months of 2007 was on course to be more than double that in 2006. As of the end of September 2007, 43.2% of the cumulative production total had been in textiles, 25.2% in metals and machinery, 19.2% in electronic products, and 12.4% in chemical products.

Currently, all products made in the KIC are shipped to South Korea for sale there or for export after clearing customs in the ROK. The primary export destinations are China and Russia. Other than labor, land, and site construction materials, there now is no local procurement of inputs into the manufacturing processes in the KIC nor are products manufactured in the KIC sold in North Korean markets. Most companies there use labor-intensive manufacturing processes with raw materials and intermediate goods from South Korea shipped to Kaesong for final assembly. As the KIC is expanded, however, companies could procure some of their manufacturing inputs locally.<sup>18</sup>

**Table 3. Production by Category in the  
Kaesong Industrial Complex**  
(US\$1,000)

	Textiles	Chemical Products	Metals and Machinery	Electric and Electronic Products	Total
2005	6,780	1,768	5,250	1,108	14,906
2006	27,793	10,900	20,853	14,261	73,737
Jan.-Sept. 2007	57,726	13,893	27,872	25,720	125,211
Total	92,299	26,561	53,975	41,089	213,854

**Source:** ROK, Ministry of Unification, Key Statistics for Gaeseong Industrial Complex (as of September 30, 2007).

<sup>16</sup> Republic of Korea. Ministry of Unification. Gaeseong Industrial Complex Project — Status and Tasks, June 2005.

<sup>17</sup> Hyundai Asan. *Kaesong Industrial Park*, brochure. c. 2006.

<sup>18</sup> ROK. Ministry of Unification. Gaesong Industrial Complex: Frequently Asked Questions (May 21, 2006).

It is not yet clear whether South Korean companies operating in the KIC are doing so primarily for political purposes or whether their operations in the complex are economically viable. Also, it is not clear whether companies in the complex would be economically viable without South Korean government support in providing infrastructure and loans with below-market interest rates. The KIC does provide small and medium-sized businesses access to labor costs lower than those in China or Vietnam, a workforce that speaks the same language, and proximity to large markets in South Korea. Some companies appear to be using production in Kaesong to replace that in China, South Korea, or elsewhere, but others may be using government-subsidized loans and political risk insurance to invest in politically popular projects. The long list of companies that have applied to enter the KIC, however, indicates that investments there likely are seen as profitable for most businesses. It also should be noted that an estimated 40% of the small and medium-sized South Korean companies that established operations in China have not been successful there. Many have withdrawn from that market. The KIC is viewed as essential for survival by some of these companies.<sup>19</sup>

The experience of some of the early investors in Kaesong may be indicative of the economic viability of the project. ShinWon (clothing) established operations in the KIC to take advantage of the dexterity and lower cost of North Korean workers, favorable logistics, and to avoid nontariff barriers in China and Southeast Asia. By manufacturing about 16% of five of its clothing lines there, it expects to accrue considerable savings in production costs. It considers its Kaesong factory to be optimal when compared with those it has in China, Indonesia, Vietnam, and Guatemala.<sup>20</sup>

Samduk Trading Company produces high-quality shoes in the KIC. Start-up costs were high because of the need to train workers. It took eight months for some production lines to reach 60% of the productivity level of South Korean companies. The Romanson company (watches) finds the KIC superior to production in China because of the common language and low labor costs. It reportedly plans to move 75% of its watch production to the KIC. The Moonchang company (uniforms, seat covers, leisure clothes) faced a rough start in dealing with its North Korean workers but feels it is now on the right track. The Woori Bank is in a difficult situation because of the limited customer base and low demand for personal or business loans. Its main business is currency exchange. It provides zero interest rates on deposits because there are no means to make profits by investing deposits elsewhere in North Korea.<sup>21</sup>

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<sup>19</sup> Lim, Eul-chul. *Kaesong Industrial Complex, History, Pending Issues, and Outlook*, Seoul: Haenam Publishing Company, 2006, pp. 68-69.

<sup>20</sup> *Ibid.*, pp. 101-103.

<sup>21</sup> *Ibid.*, pp. 108-126.

## Issues Related to the Kaesong Industrial Complex

The KIC has raised several issues with U.S. policy makers. These include labor conditions, financial benefits for Pyongyang, the KIC in the KORUS FTA, and the control of U.S. exports to Kaesong.

### Labor Issues

A question with respect to the KIC has been the conditions for North Korean workers there and whether they are being exploited.<sup>22</sup> In January 2007, Jay Lefkowitz, President Bush's special envoy for human rights in North Korea, wrote that one of the concerns he had with the Kaesong Industrial Complex is that authorities take a portion (as much as 45%) of the wages paid by the South Korean companies. He noted that verified details are elusive, and neither the DPRK nor South Korean government, nor any company, has been able to state definitively how much of his or her wage a Kaesong worker is allowed to keep.<sup>23</sup>

According to South Korean officials, average wages and working conditions at Kaesong are far better than those in the rest of North Korea.<sup>24</sup> The monthly minimum wage is \$50 (\$57.50 including the cost of social insurance) or \$2 per day. Increases in the minimum wage are capped at 5% per year. General workers receive \$50, team leaders receive \$52-\$55, and heads of companies receive \$75 per month. Workers also receive overtime pay of about \$10 per month and average about six hours per week in overtime. The normal workweek is 48 hours. For extended working hours, the overtime premium is 50% of the hourly wage rate. For public holidays and nighttime work (10 p.m. to 6 a.m.), the overtime premium is 100% of the hourly wage rate. In some cases, North Korean workers have asked for additional night shift or weekend work in order to qualify for additional pay.<sup>25</sup> Companies also may pay cash rewards as a special incentive. KIC employees receive 14 days per year in vacation time. At first, North Korean workers were reluctant to ask for leave time, but now they do.<sup>26</sup> Female employees receive 60 days paid maternity leave.<sup>27</sup> Labor

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<sup>22</sup> Rights Body Criticizes South Korea Over Refugee Protection, Inter-Korean Complex. Yonhap News Agency, Seoul. Reported by BBC Monitoring Asia Pacific. London, January 12, 2007.

<sup>23</sup> Lefkowitz, Jay P. For a Few Dollars More, *Wall Street Journal*, January 10, 2007. p. A16.

<sup>24</sup> The DPRK has ratified no International Labor Organization conventions.

<sup>25</sup> Kaesong Industrial Complex Management Council. Survey of North Korean Workers from Fifteen Different Companies. February 2007. (Partial translation by the ROK Embassy in Washington, DC.)

<sup>26</sup> Ibid.

<sup>27</sup> ROK. Ministry of Unification. Gaesong Industrial Complex: Frequently Asked Questions (May 21, 2006).

costs in Kaesong are approximately 8% of those in a South Korean metropolitan area.<sup>28</sup> South Korean labor laws extend to South Korean workers in the KIC.<sup>29</sup>

In April 2007, Unification Ministry officials confirmed that the DPRK had requested pay raises of 30% and 10% for members of the North Korean workforce who are graduates of four- and two-year colleges, respectively. The two categories make up about 11% each of North Korea's workforce in the KIC.<sup>30</sup>

The wages of North Korean workers are paid in dollars (or other hard currency other than South Korean won) first to the Central Special Direct General Bureau, a North Korean government agency. Article 34 of the Labor Law of the Kaesong Industrial Complex, however, states that wages must be paid directly to employees in cash. The DPRK claims that this is not being implemented now because of the lack of foreign exchange centers in the KIC.<sup>31</sup> The ROK Ministry of Unification has stated that of the \$57.50 minimum monthly salary, \$7.50 or 15% of the base pay goes for social insurance (providing for unemployment and occupational hazards). The government also deducts \$15 or 30% for a socio-cultural policy fee that goes for rental of state-owned housing, education, medical services, social insurance, and social welfare and reportedly is given to the Kaesong City People's Committee. According to the Ministry, the remaining \$35 is paid to the workers in cash (upwards of 5% in North Korean won) or as chits that can be exchanged for daily supplies (food and necessities).<sup>32</sup> At the exchange rate of 140 North Korean won per dollar, the \$35 translates into 4,900 won. (A kilogram of rice costs about 44 won if bought from North Korea's public distribution system but as much as 1,000 won if bought on the open market. The average family consumes about 60 kilograms of rice per month.)<sup>33</sup> Companies provide the workers with a way to verify their wages by having them sign a ledger or provide a pay slip when they receive their pay.

The ROK Ministry of Unification announced in November 2006 that it was working with an Australian-South Korean company (Lobana Trading Company) to provide basic necessities to Kaesong. These items are sold primarily at the Kaesong

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<sup>28</sup> Hyundai Asan. *Kaesong Industrial Park*, brochure. c. 2006.

<sup>29</sup> South Korean Assembly Passes Bill on Inter-Korean Industrial Complex. Yonhap News Agency, April 27, 2007. Reported by BBC Monitoring Asia Pacific.

<sup>30</sup> South Korea Considers Expanding Joint Industrial Complex in North. Yonhap News Agency, Seoul. Reported by BBC Monitoring Asia Pacific. London, July 26, 2006. Ministry of Unification (South Korea). *The Gaesong Industrial Complex. Status of North Korean Workers*. November 14, 2006. *North Korea Economy: Kaesong Zone Expansion to Resume*. Economist Intelligence Unit ViewsWire. New York: May 8, 2007.

<sup>31</sup> ROK. Ministry of Unification. *Gaesong Industrial Complex: Frequently Asked Questions* (May 21, 2006).

<sup>32</sup> Ko, Gyoung-Bin. *All the Salary Goes to the North Korean Workers at the Gaeseong Industrial Complex (GIC)*, January 31, 2007. Ministry of Unification document #uni4101.

<sup>33</sup> *North Korea Today*, No. 38, September 2006. Good Friends: Centre for Peace, Human rights and Refugees. September 27, 2006.

Department Store.<sup>34</sup> Since the government distribution system covers only part of a family's needs for items such as rice and sugar, the rest of the basic necessities are obtained by barter or purchased at the department store, even though prices are higher there.

North Korean workers commute to the KIC by bus provided by the Kaesong Industrial Complex Management Council and by some 1,000 bicycles also provided for workers living closer to the complex. According to the KIC Management Council, the health condition of workers at the KIC has visibly improved as they have had access to better nutrition.<sup>35</sup>

The actual recruitment of workers is done by North Korea's Central Guidance Agency on Special Zone Development, a cabinet level administrative body. The South Korean hiring company, however, may reject any recruit provided or if the recruit does not demonstrate the requisite skills (e.g., sewing), hire the worker as a trainee at 70% or less of the minimum wage. Employers cannot freely punish or fire incompetent workers. They must give instructions through North Korean mid-level managers. Directly scolding employees is regarded as humiliation and prohibited.<sup>36</sup> The experience of many companies, however, is that labor management is a challenge during the start-up phase of a factory in the KIC. Gradually, however, North Korean workers begin to identify with the company, and a level of trust is developed between the South Korean executives and the North Korean managers and workers.<sup>37</sup>

Currently, North Korean workers do not have the right to change employers. This promises to keep labor costs from escalating as they have in other developing markets as foreign firms bid for skilled workers. This also provides companies in the KIC with a stable (though aging) workforce.<sup>38</sup> This practice, however, conflicts with what would be consistent with internationally accepted workers' rights.

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<sup>34</sup> Lim, Eul-chul. *Kaesong Industrial Complex, History, Pending Issues, and Outlook*, Seoul: Haenam Publishing Company, 2006, p. 148.

<sup>35</sup> Kaesong Industrial Complex Management Council. *Survey of North Korean Workers from Fifteen Different Companies*. February 2007. (Partial translation by the ROK Embassy in Washington, DC.)

<sup>36</sup> Lim, Eul-chul. *Kaesong Industrial Complex*, op. cit., p. 144.

<sup>37</sup> *Ibid.*, p. 98ff.

<sup>38</sup> *Ibid.*, p. 103.

**Figure 2. Leased Space Factory Building to be Constructed in the Kaesong Industrial Complex**



Source: ROK, Ministry of Unification.

## Financial Benefits for Pyongyang

A key aspect of the KIC for U.S. interests is how much the North Korean government derives in hard currency from the project, including leasing fees and its share of the wages of North Korean workers. The wages are first paid in hard currency (dollars) to a North Korean government agency that deducts for certain items before paying the North Korean workers in won or in chits to be exchanged for food and necessities. If the government collects about \$22.50 per month (in social insurance taxes plus the socio-cultural fee) for each of the 12,446 workers at Kaesong in March 2007, its monthly take from wages would amount to approximately \$280,000 per month or \$3,360,000 over a year (although the socio-cultural fee reportedly goes to the Kaesong city, not the central government). In addition, there are land lease fees and other payments to the North Korean government. When the project was initiated, Hyundai Asan paid North Korea \$12 million for a 50-year lease on the entire Kaesong site. Hyundai Asan and the Korea Land Co. also purchase sand and gravel and other raw materials from North Korea for use in site development at Kaesong.<sup>39</sup> Companies in the KIC also pay North Korea's job reference agency (recruiting agency) a commission of \$17 per employee sent.<sup>40</sup>

Under an agreement on taxation, businesses in the KIC are subject to a 10% to 14% corporate income tax, but the tax has an exemption for five years after first generating profits and a 50% deduction for the ensuing three years. This compares

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<sup>39</sup> Communication from the Office of Korean Affairs, U.S. Department of State to the Congressional Research Service, June 7, 2007.

<sup>40</sup> Lim, Eul-chul. *Kaesong Industrial Complex, History, Pending Issues, and Outlook*, Seoul: Haenam Publishing Company, 2006, p. 144.

favorably to corporate tax rates in South Korea (12% to 28%), China (15%), and in Vietnam (10% to 15%).<sup>41</sup> In 2007, the companies in Kaesong had not been operating long enough there to have to pay corporate income taxes to the DPRK.

In 2004, the Hyundai Research Institute estimated that North Korea could receive \$9.55 billion in economic gains over the course of nine years if the KIC were to be developed fully and operated successfully. This would include \$4.6 billion in foreign currency earnings with \$700 million derived directly from the operation of the KIC, \$2.5 billion from sales of raw materials and other industrial products, and \$1.4 billion from corporate taxes.<sup>42</sup> Considering that in international trade in goods in 2005, North Korea exported \$1.8 billion and imported \$3.6 billion, the estimated total gains of \$9.55 billion over nine years associated with the Kaesong Industrial Complex would be quite significant (provided it progresses according to plan).

### **Kaesong and the Proposed Korea-U.S. Free Trade Agreement**

During the negotiations on the KORUS FTA, South Korea requested that products exported from the complex be considered to have originated in South Korea in order to qualify for duty-free status under the proposed FTA. Under the South Korea-ASEAN FTA, for example, preferential tariffs are applied to 100 items manufactured in the Kaesong Industrial Complex.<sup>43</sup> The Korea-Singapore and Korea-European Free Trade Association (EFTA) FTA agreements also include products from the KIC.<sup>44</sup> Singapore accepts 88.6% of the traded products from the KIC as long as no products are directly exported from the DPRK. The Korean FTA with EFTA limits coverage to 2.9% of the total trade and only for those exports that have first been brought into the South Korean territory and which have 60% of the total materials cost as South Korean.<sup>45</sup> In the current negotiations between South Korea and the European Union, Seoul has similarly requested products from Kaesong be covered by the proposed FTA. In 2006, the European Union (15 nations) imported \$185.7 million worth of goods from North Korea. Switzerland imported \$0.8 million and Singapore \$6.6 million.

For the United States, however, from the beginning of the FTA negotiations, the U.S. position was that only products originating in South Korea would be included.<sup>46</sup>

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<sup>41</sup> Ibid., pp. 73-74.

<sup>42</sup> Ibid., p. 61.

<sup>43</sup> Merchandise FTA with Five ASEAN Countries to Take Effect Next Month. Yonhap News (Seoul), May 30, 2007.

<sup>44</sup> Channel News Asia, Singapore. *South Korea, Singapore Initial Free Trade Accord*, April 17, 2005. EFTA includes Iceland, Liechtenstein, Norway, and Switzerland. ROK, Ministry of Foreign Affairs and Trade. *Korea-European Free Trade Association (EFTA) FTA*, June 16, 2007.

<sup>45</sup> Lim, Eul-chul. *Kaesong Industrial Complex, History, Pending Issues, and Outlook*, Seoul: Haenam Publishing Company, 2006, p. 189.

<sup>46</sup> For details, see CRS Report RL34330, *The Proposed U.S.-South Korea Free Trade Agreement (KORUS FTA): Provisions and Implications*, coordinated by William H. Cooper.



At a U.S. House International Relations Committee hearing on July 20, 2006, Assistant U.S. Trade Representative Karan Bhatia indicated that the proposed FTA would not cover goods made in a free-trade zone in North Korea.<sup>47</sup>

The text of the Korea-U.S. Free Trade Agreement (signed by representatives of each government but not yet approved by Congress) does not provide for duty-free entry into the United States for products made in the Kaesong Industrial Complex. Annex 22-B to the proposed FTA, however, provides for a Committee on Outward Processing Zones (OPZ) on the Korean Peninsula to be formed and to “identify geographic areas that may be designated outward processing zones,” determine whether any such zone “has met the criteria established by the Committee,” and recommend them to the respective governments, which “shall be responsible for seeking legislative approval for any amendments to the Agreement with respect to outward processing zones.” The Committee also is to “establish a maximum threshold for the value of the total input of the originating final good that may be added within the geographical area of the outward processing zone.” Decisions of the Committee would require unified consent (this arguably provides the U.S. side with veto power over any recommendation of the committee). The criteria to be met include but are not limited to “progress toward denuclearization of the Korean Peninsula; the impact of the outward processing zones on intra-Korean relations; and the environmental standards, labor standards and practices, wage practices and business and management practices prevailing in the outward processing zone, with due reference to the situation prevailing elsewhere in the local economy and the relevant international norms.” The OPZ committee is to meet at least annually beginning a year after the agreement goes into effect.

A question has arisen with respect to language in Annex 22-B pertaining to labor standards and practices in the KIC with due reference to the “situation prevailing elsewhere in the local economy and the relevant international norms.” Is the local economy in this case that of the DPRK or that of South Korea, and can products from the KIC be produced under conditions contrary to International Labor Organization agreements that lay out basic international standards or worker rights yet still be recommended by the OPZ Committee to be included under the FTA?<sup>48</sup>

Another issue raised by the KORUS FTA is whether intermediate products made in the KIC can enter the United States under the provisions of the FTA if they are incorporated into products that are manufactured in South Korea and that qualify as originating in South Korea. The same concern exists with respect to products made in China or elsewhere if they have North Korean inputs. Currently, goods of North Korean origin may not be imported into the United States either directly or

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<sup>47</sup> Hyde Warns USTR to Keep Kaesong, Visas out of Korea FTA. *Inside US Trade*, July 21, 2006.

<sup>48</sup> See Letter, Rep. Sander Levin, Chair of the House Ways and Means Subcommittee on Trade to Ambassador Susan Schwab, USTR. June 12, 2007.

through third countries, without prior notification to and approval of the Office of Foreign Assets Control of the Department of the Treasury.<sup>49</sup>

A further issue with respect to the KIC and the KORUS FTA is that if KIC products made with the low-cost North Korean labor are allowed to be treated as South Korean in origin under the proposed KORUS FTA, South Korean exporters would enjoy a large cost advantage over their counterparts in the United States.

## The Control of Exports to Kaesong

The United States maintains a comprehensive economic embargo against the DPRK because of its designation as a state sponsor of international terrorism. The Departments of Commerce and the Treasury jointly administer the trade embargo under the Trading With the Enemy Act of 1917 and the Export Administration Act. The Department of Commerce licenses U.S. exports and re-exports, while Treasury grants general and/or specific licenses for financial transactions by U.S. persons with DPRK entities. The Department of Commerce requires a license for the export to North Korea of virtually all commodities, technology, and software, except for technology generally available to the public and gift parcels (not exceeding \$400).<sup>50</sup>

In FY2006, the U.S. Bureau of Industry and Security approved two items for export to the DPRK. They were glass (fiber optic) transmission items (5A991) worth \$213,919 and software (5D992) for \$3,600.<sup>51</sup> The transmission items were telecommunications equipment used by Korea Telecom in setting up the communications lines between the two Koreas and into the KIC.<sup>52</sup>

The South Korean government also maintains strict controls over exports to the DPRK. The restricted items include machinery and inspection equipment to produce metal and machines, electronics, optics, laser-related equipment, microorganism cultivating devices and chemical product facilities, and sophisticated high-technology equipment and materials. Even the latest versions of personal computers, commonly available in the South, are restricted and, if their export is approved, they have to be kept under lock and key in the KIC.<sup>53</sup> New high-technology monitoring systems, including tracking devices, are also being used for items with sensitive dual-use technology.

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<sup>49</sup> U.S. Treasury, Office of Foreign Assets Control. *North Korea: What You Need to Know About Sanctions*. c. 2007. See Title 31, Part 500, U.S. Code of Federal Regulations.

<sup>50</sup> U.S. Bureau of Industry and Security. Embargoed Countries and Entities (Section 746), Export Control Program Description and Licensing Policy. For information on U.S. export controls, see CRS Report RL31832, *The Export Administration Act: Evolution, Provisions, and Debate*, by Ian F. Fergusson.

<sup>51</sup> Bureau of Industry and Security, U.S. Department of Commerce, *Bureau of Industry and Security Annual Report, Fiscal Year 2006*. c. 2007, p. 93.

<sup>52</sup> The export license was approved by the U.S. Export Administration on November 16, 2005. (See Lim, Eul-chul. *Kaesong Industrial Complex, History, Pending Issues, and Outlook*, Seoul: Haenam Publishing Company, 2006, p. 206.)

<sup>53</sup> *Ibid.*, p. 204.

In the October 2007 summit between South Korean President Roh Moo-hyun and North Korean leader Kim Jong-il, the North agreed to improvements in how Kaesong operates, including swifter customs clearance for goods crossing its border, and better computer and cell-phone communications connections between Seoul and Kaesong factories. The transition team of incoming President Lee Myung-bak has indicated that it likely will continue with these plans.<sup>54</sup>

## Long-Term Geopolitical and Economic Issues

The Kaesong Industrial Complex sits at the hub of spreading concentric sets of economic and geopolitical interests and concerns. At its narrowest sense, the KIC is a business venture in which participants are seeking profits and business advantages. On the South Korean side, the KIC provides small and medium-sized companies with a manufacturing platform and opportunity to access low-cost labor without having to go overseas to establish subsidiaries or to outsource the assembly of their products to China or other markets. On the DPRK side, the KIC provides jobs for workers who can earn relatively higher wages without crossing their borders illegally or working under contract in labor-scarce countries such as those in the Russian Far East or in Middle Eastern countries.

At a somewhat wider set of interests, the KIC provides a channel for rapprochement between the DPRK and South Korea. Kaesong developed partly from South Korea's sunshine policy of economic engagement with the North. It can be viewed as a confidence-building measure between two countries whose hostility toward each other has lingered since the 1950-52 Korean War. As has been the case with the extensive economic interchange between China and Taiwan,<sup>55</sup> the KIC may provide a bridge for communication and a catalyst for cultural interaction, and it can create stakeholders in each other's economies with a shared interest in stability, liberalization, and increased communication across the DMZ.

At a still wider set of interests, the KIC may be the proverbial camel's nose under the tent in attempts to reform, liberalize, and modernize the North Korean economy. In neighboring China in 1978, foreign businesses were first allowed to operate in special economic zones. Now foreign invested businesses generate more than half of China's exports and imports. The Chinese speak of practicing socialism with Chinese characteristics and, indeed, many state-owned enterprises still encumber the Chinese economic system. The state-owned enterprises that are successful, however, operate much like privately owned enterprises, and one is hard pressed to find other significant differences between the Chinese brand of socialism and market capitalism. In January 2006, Kim Jong-il paid his fourth visit to China to see its special economic zones. There he observed modern high-technology

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<sup>54</sup> Ahn Yong-hyun, "Lee Gov't to Postpone Some Inter-Korean Mega Projects," *Chosun Ilbo*, January 8, 2007.

<sup>55</sup> For a discussion of this issue, see CRS Report RL32882, *The Rise of China and Its Effect on Taiwan, Japan, and South Korea: U.S. Policy Choices*, by Dick K. Nanto and Emma Chanlett-Avery.

factories — many of them foreign-owned — in operation.<sup>56</sup> Likewise, the KIC exposes average North Koreans to modern business methods and to the accouterments of Western industrial society.

According to the Economist Intelligence Unit, the decrepit North Korean economy has “three crying needs: deeper market reforms, greater openness, and above all, massive investment to modernize decrepit plant and infrastructure.”<sup>57</sup> The KIC potentially addresses all three of these needs to a limited extent. However, reports from North Korea indicate that the economic reforms there currently are stalled — even being reversed. Unlike China’s reforms, moreover, the initiative for the KIC came from abroad, is viewed with suspicion by many, and is an isolated case. (Although, Pyongyang seems to be attempting to revive the Sinuiju Special Administrative Region — a similar free trade zone — along the border with China.)<sup>58</sup> In sum, it is still too early to tell if Kaesong will succeed, much less have a large effect on the rest of the North Korean economy.

At a geopolitical level, Kaesong is one part of the standoff between the DPRK and the United States, China, South Korea, Japan, and Russia, over North Korea’s nuclear weapons program. Under the rubric of the six-party talks lie a bundle of strategic issues, such as the ability of North Korea to finance its nuclear program, the need for humanitarian and energy aid, the stability of the Kim Jong-il regime, and the enforcement of various economic sanctions being applied to North Korea. A major goal of the United States in the six-party talks is to halt and verifiably dismantle North Korea’s capability to produce nuclear fuel and nuclear bombs or to proliferate nuclear material or technology to potentially hostile countries or groups. The U.S. strategy to accomplish this is a combination of sticks (sanctions, diplomatic isolation, name calling) and carrots (promises of aid, diplomatic recognition, security guarantees) conveyed to North Korea through the six-party talks, bilateral meetings, and occasional media blasts. Under this strategy, there is little reason to provide the DPRK with any financial reward, even if it is to the benefit of South Korea, unless it shows significant progress in its commitments under the six-party talks.

The South Korean goals with respect to North Korea, however, not only include the denuclearization of the Korean peninsula but eventual reunification and reconstruction of the DPRK’s economy. A major South Korean concern is the potential cost of reunification either in the form of a flood of economic emigrants to the South or in actual budgetary outlays to help rebuild the North’s civilian economy. The high cost to West Germany of the integration of East Germany after the fall of the Berlin Wall has provided little comfort to the policy makers in Seoul. The South Korean strategy, therefore, has tended to be longer on carrots (promises of food, fuel, and fertilizer) and shorter on sticks (sanctions) with a heavy reliance on engagement across the interactive spectrum and on diplomacy to resolve the issue. Even after the

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<sup>56</sup> See, for example, Onishi, Norimitsu. "On his Visit to China, Kim Traveled a Familiar Path," *The New York Times*, January 26, 2006.

<sup>57</sup> The Economist Intelligence Unit. *Country Report, North Korea*, May 2007. p. 13.

<sup>58</sup> Institute for Far Eastern Studies. Interest Revived in the Sinuiju Special Administrative Region. Reported by Nautilus Institute, Policy Forum Online 06-25A, March 30, 2006.

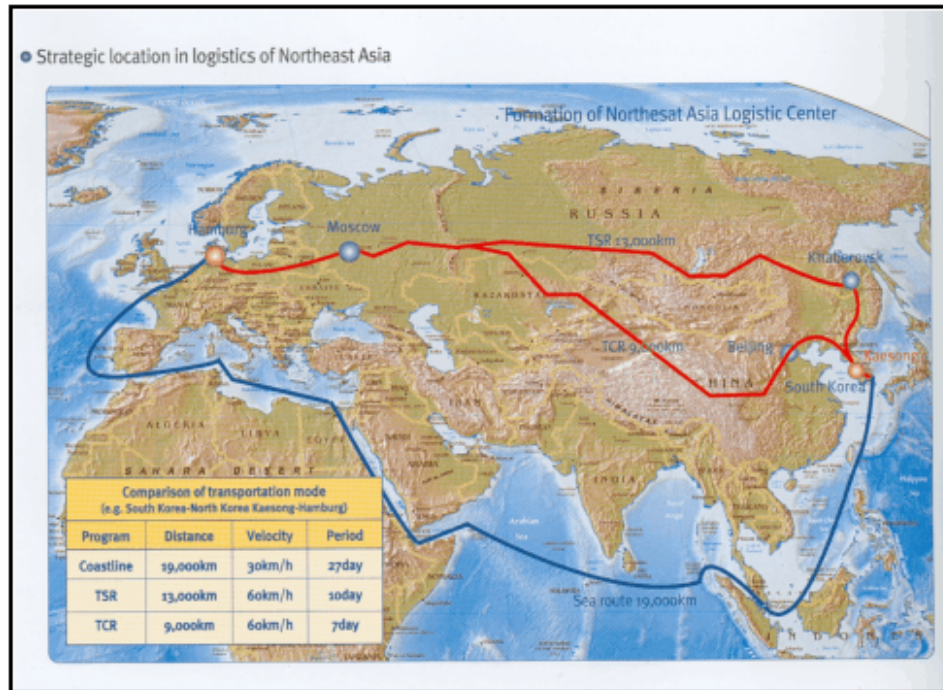
North Korean nuclear test in 2006, South Korea continued the KIC operations. It only halted its plans to call for new applicants to enter the KIC. Existing production facilities continued to manufacture, and existing applications moved forward. Although incoming ROK President Lee Myung-bak has said he will seek more reciprocity in Seoul's dealings with Pyongyang, and he has been somewhat vague about how he will treat the KIC, his statements to date have been widely interpreted to mean that phase 1 of the complex, at a minimum, will continue operating. Undoubtedly, the KIC would be a centerpiece of if Lee enacts his proposed "3,000 Policy" to help North Korea raise per capita income to \$3,000 in ten years. Lee has made this policy contingent upon progress in the denuclearization of North Korea.

For South Korea, not only does Kaesong provide entry into the decrepit DPRK economy, but it is a key factor in building up and reforming the economy in the North with an eye toward eventual reunification. Beijing's strategy before the return of Hong Kong in 1997 has been instructive to Seoul. A major reason that many of the first economic reforms in China occurred in nearby Guangdong Province, particularly just across the border from Hong Kong in Shenzhen city, was that Beijing tried to stem pressures to immigrate to Hong Kong by raising the standard of living and industrial development in the region abutting the returning territory. This strategy has been so successful that some immigration, particularly of Hong Kong retirees, has been going from Hong Kong to Guangdong Province and not the other way around. Likewise, Beijing has broadened ties with Taiwan through allowing cross-strait investments, travel, business visas, communication, and other business-based activities. In some sectors, particularly in the manufacture of computers and other electronic products, Taiwan and the east coast of China have become one integrated economy. Kaesong arguably could begin a similar process with North Korea.

South Korea also aims to become a hub of East Asia. In order to accomplish this, it would like to be connected to China, Russia, and to Europe via railways that pass through North Korea. As part of the KIC project, North and South Korea have reconnected a railroad line connecting the north and south and have conducted a test run on it. (A second line on the opposite side of the peninsula also was connected.) In terms of logistics, a shipment by rail from South Korea via Kaesong to Hamburg, Germany would take about 27 days by ship, 10 days via the Trans-Siberian Railway, and 7 days via the Trans-China Railway.<sup>59</sup> (See **Figure 3**.)

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<sup>59</sup> Hyundai Asan. *Kaesong Industrial Park*, brochure. c. 2006.

**Figure 3. Kaesong's Potential Logistical Role**

Source: Hyundai Asan

## U.S. Interests and Policy Options

The three national interests of the United States that form the basis of all policy discussion are security, economic well-being, and value projection. These three national interests all play into consideration of the Kaesong Industrial Complex.

The main security concern for the United States is the location of the KIC in the DPRK. U.S. security concerns with respect to North Korea center on two major considerations: (1) the DPRK's nuclear program and (2) potential conflict across the DMZ separating North Korea and South Korea. The KIC has opposing effects upon these security considerations. On one hand, since income in any country is fungible, anything that increases revenue to the Pyongyang regime has the potential to contribute to the DPRK's military (including its missile and nuclear program). It is likely, however, that the DPRK's nuclear program has assured funding from the government. Also, given Kim Jong-il's "military first" policy, the North Korean military has top priority in the allocation of scarce economic resources. It also has call on certain economic activities and government subsidies for them. It is not clear how much, if any, income (over that used to pay for expenses related to Kaesong) for Pyongyang from the KIC currently is directed toward the DPRK military or nuclear program. Since the KIC land formerly was a military base that had to be vacated,<sup>60</sup> some arrangement may have been made to compensate the military for relinquishing a strategically important piece of ground. Even if the income from the KIC does not

<sup>60</sup> Lim, Eul-chul. *Kaesong Industrial Complex, History, Pending Issues, and Outlook*, Seoul: Haenam Publishing Company, 2006. p. 37.

go directly into military purposes, it may bolster funds for civilian purposes that had been cut because of the budgetary demands of the military. The Kim regime, moreover, uses scarce foreign exchange to bolster the loyalty of its inner circle of elites who use it to buy imported luxury goods.

U.N. Security Council resolution 1718 (adopted October 2006) explicitly prohibits any member state from providing funds that go to support North Korea's nuclear weapons program. The resolution states in Section 8(d) that all Member States shall, in accordance with their respective legal processes, ensure that any funds, financial assets or economic resources are prevented from being made available by their nationals or by any persons or entities within their territories, to or for the benefit of persons or entities engaged in or providing support for the DPRK's programs related to nuclear weapons, other weapons of mass destruction, and ballistic missile related programs.

As for tensions across the DMZ, the KIC already has played an important role in increasing the level of engagement between the DPRK and South Korea and in raising the priority of economic activity relative to security concerns. Even though the border between North Korea and South Korea is heavily guarded and crossings had been rare, the military on both sides have acquiesced to the daily traffic on the North-South highway to Kaesong and the re-connection of two railways across the DMZ (along with limited tourist visits and family reunions).

In terms of the second U.S. national interest of economic well-being, the KIC currently has little relevance, although it has some effect through U.S. trade and investment relations with South Korea. U.S. companies have no investments in Kaesong and U.S. trade with North Korea in 2007 was virtually non-existent. South Korea, however, is the seventh largest trading partner of the United States, and the United States is South Korea's third largest trading partner. If the six-party talks on the denuclearization of the Korean Peninsula were to progress far enough, the United States could re-establish diplomatic relations with the DPRK, lift economic sanctions, and eventually grant that country normal trade relations (most-favored nation) status. If so, trade with North Korea could be done on the same basis as trade with most other countries of the world. Absent that development, South Korea's request to treat products made in the KIC as South Korean in origin would seem to be the only way to bring the KIC into the set of industrial locations open to normal or preferential trade with the United States. Meanwhile, South Korean companies exporting KIC products likely will continue to avoid the U.S. market rather than face economic sanctions and high U.S. tariffs. This may give countries that include the KIC in their FTAs with South Korea (such as ASEAN and EFTA and possibly the European Union) a possible small diplomatic advantage over the United States in dealing with Seoul. Moreover, South Korea is likely to press the United States to change its KIC policy. This could be a source of future U.S.-ROK tension even if the KORUS FTA is passed.

The third U.S. national interest is projecting U.S. values such as a market-based economy, representative government, and nations adhering to world standards for working conditions, environmental regulation, and other humanitarian considerations. In this respect, the KIC potentially could play a significant role as a demonstration project to educate North Koreans on the workings of a market-based

economy. The KIC provides an opportunity for businesses to operate in North Korea according to what may be higher labor and environmental standards than exist in the rest of the country and to educate North Korean middle managers on how such standards work.

Currently, the 20,000 North Koreans employed in the KIC are too few and the project too small to have a significant impact on the development of the North Korean middle class (a factor in the development of a more representative society), and the number of the elites in the DPRK with an economic interest in the complex probably is still relatively small. If the project continues to develop and the DPRK opens other free-trade zones, however, something akin to the economic reforms in China or the economic transformation that is now occurring in Vietnam<sup>61</sup> could occur in North Korea. This could weaken the hold by Pyongyang on the daily lives of citizens and bring the country more into the globalized world. Such economic liberalization also could reduce pressures on North Korea to engage in illicit trade in order to cover its trade deficit<sup>62</sup> and diminish the need for Pyongyang to saber rattle in order to divert attention from its domestic problems.

In the short run, however, increased revenues strengthen the regime's hand and make it less vulnerable to outside pressure. Also, spillover effects will depend on North Korea adding much more value to the production processes which it has yet to do. Finally, there is some question about the extent to which KIC is commercially viable, or whether incentives and supports given to South Korean firms are critical as opposed to marginal in their profit and loss calculations. Trade between the DPRK and South Korea tends to be government-based, in contrast to trade between China and North Korea. This may blunt the lessons learned by Pyongyang.

The United States currently has a mixed policy with respect to the KIC. Since South Korea is a close ally of the United States, Washington has been supportive of efforts by South Korea to engage the North in inter-Korean projects that benefit South Korea. On the other hand, the United States has been firm in predicating any economic or other concessions on actions by the DPRK to curtail or eliminate its nuclear program.

Major policy considerations and options for Congress, given the above U.S. interests, include the following:

- In considering whether or not to approve the KORUS FTA, Congress may express its support or non-support of the exclusion of the KIC from the FTA as negotiated. Congress may also specify the conditions under which the KIC can or can not be brought under the provisions of the proposed FTA. Congressional disapproval of the proposed KORUS FTA likely would have a large negative impact on prospects for the future of the KIC with respect to the United States.

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<sup>61</sup> See, for example, Bradsher, Keith, Vietnam's Roaring Economy Is Set for World Stage, *The New York Times*, October 25, 2006.

<sup>62</sup> See, for example, CRS Report RL33885, *North Korean Crime-for-Profit Activities*, by Liana Sun Wyler and Dick K. Nanto.



- In the debate over the KORUS FTA, Congress may focus attention on labor and other conditions in the KIC and encourage reforms.
- If the KORUS FTA is approved, Congress may provide close oversight of the Committee on Outward Processing Zones.
- Since the United States already imposes a range of economic and financial sanctions on the DPRK, the United States could either tighten or loosen them. This could affect non-South Korean businesses in determining whether to invest in the KIC or to purchase products made there. The United States also could tighten (or loosen) U.S. controls on the export of dual-use technology items to the KIC.
- The United States could impose restrictions on or provide inducements to U.S. business activity in KIC.
- The U.S. government could encourage other countries (or groups of countries, such as the European Union) to (or not to) include the KIC in their respective FTAs with South Korea.
- If the DPRK takes the necessary steps to halt its nuclear program as outlined in the six-party talks, support (or oppose) measures leading toward normal trading relations status for the DPRK and the lifting of economic sanctions.
- The U.S. government could place restrictions on South Korean firms that do business in North Korea.

## Legislation

Legislation and other congressional action related to the Korea-U.S. FTA are covered in CRS Report RL34330, *The Proposed U.S.-South Korea Free Trade Agreement (KORUS FTA): Provisions and Implications*, coordinated by William H. Cooper.

The following bills in the 110<sup>th</sup> Congress may affect the KIC even though they may not be specific to the KIC.

**H.R. 571 (Tancredo).** Would require additional tariffs be imposed on products of any nonmarket economy country until the President certifies to the Congress that that country is a market economy country.

**H.R. 937 (Garrett).** Expresses the sense of Congress that the United Nations should: (1) ensure that the United Nations Development Program (UNDP) enforces its rules regarding financing, staffing, accounting, and auditing of its activities in the Democratic People's Republic of Korea (North Korea); (2) authorize an external

investigation of all UNDP activities in North Korea; and (3) ensure that any UNDP local staff in North Korea who committed crimes are prosecuted or who violated regulations are sanctioned. Expresses the sense of Congress that the President should use U.S. influence to ensure that UNDP: (1) ceases activities in North Korea that are in violation of UNDP regulations; (2) conducts a full audit of UNDP activities in North Korea since 1998; and (3) establishes regulations to ensure that no funds allocated to UNDP activities in North Korea are provided to the government of North Korea. Directs the Secretary of State to withhold U.S. contributions to the general funds of UNDP until the Secretary certifies to Congress that UNDP meets such provisions.

**S. 527 (Feingold)** Iran, North Korea, and Syria Nonproliferation Enforcement Act of 2007. Amends the Iran and Syria Nonproliferation Act respecting the imposition of sanctions under such Act to: (1) apply sanctions for a minimum two-year period; (2) apply sanctions to an identified foreign person, a successor or subsidiary, and an entity controlling more than 50% of such foreign person, successor, or subsidiary (currently, such provision applies only to a foreign person); (3) include among applicable sanctions under Executive Order 12938 certain exemptions for military, medical, or humanitarian purposes; (4) establish investment, financing, and financial assistance prohibitions; and (5) require publication of sanctions applicable to such expanded entities in the Federal Register.