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Author: Youngsun Koh

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Reforming the Fiscal Management System in Korea

Youngsun Koh

9.1 Introduction

The Korean government has maintained a strong fiscal discipline since the early 1980s, keeping its budget more or less in balance and its debt at low levels. The fiscal balance showed large deficits after the economic crisis of 1997, but returned to surplus in 2000 thanks to the buoyant economy and the resumed consolidation efforts. The surplus has continued since then.

Fiscal soundness is a characteristic common to many East-Asian countries. Little has been known, however, about the working mechanism of fiscal policies in these countries. Korea is an interesting case in this regard because there is an indication that its fiscal discipline, which was firmly established under the authoritarian government of the early 1980s, is weakening these days with the democratization of Korean politics.

In addition, the Korean government is faced with various risks that can adversely affect its financial position. The aging population and the technological catch-up with the advanced economies imply a much slower economic growth in the decades ahead. While the revenue growth slows down, the demand for public expenditure is increasing rapidly. The financial sector restructuring in the wake of economic crisis has left irretrievable debts of 69 trillion won (9 percent of 2004 GDP) in the public sector, and the burden is expected to fall mostly on taxpayers. All public pension schemes have structural problems due to the imbalance between contributions and benefits. Some of them (those for civil servants and military personnel) are already in serious trouble. The economic cooperation with North Korea

Youngsun Koh is senior research fellow, director of Macroeconomic and Financial Policies, and head of Programs Evaluation Division at the Korea Development Institute.

will demand more and more government support in the future. The spending on social welfare programs has increased substantially after the crisis, and is set to increase further.

The government expenditure has stabilized since 2001 at around 25 percent of GDP after rising rapidly in the 1990s, but it may resume its growth and result in worsening fiscal balances when these risk factors materialize. The Korean government embarked on an ambitious reform agenda to cope with these challenges and to modernize its system of financial management. Its efforts have been concentrated on (a) introducing a medium-term expenditure framework as embodied in the yearly *National Fiscal Management Plans* that cover five years on a rolling basis; (b) moving away from a bottom-up to a top-down approach in budgeting; (c) strengthening performance management; and (d) introducing *program budgeting,* that is, reorganizing budget accounts around a program structure.

This chapter aims to (a) overview the development of public finance in Korea since the 1970s and analyze its current status; (b) explain the Korean fiscal management system and outline the recent reform efforts; and (c) propose ways to improve on these reforms. It is too early to tell to what extent the newly introduced systems are contributing toward stronger aggregate fiscal discipline and greater allocative and operational efficiency. At a more fundamental level, fiscal outcomes depend on the political, social, and economic context of a nation as well as its fiscal management system. In particular, the democratization of Korean politics and the rapid population aging will play a dominant role in shaping fiscal outcomes in the future. The discussions in this chapter will hopefully help readers understand the challenges we are facing and gauge the probability of successful implementation of reforms.

9.2 Korean Public Finance in the Last Three Decades

9.2.1 Large Deficits in the 1970s

In the 1970s and into the early 1980s, the Korean government ran a persistent budget deficit (see figure 9.1). The deficit of the consolidated central government averaged about 3 percent of GDP in this period. Income transfer to the agricultural sector, heavy investment in social infrastructure, and various subsidies to promote heavy and chemical industries required large amounts of public money. But rapid economic growth helped contain the spending at around 20 percent of GDP (see figure 9.2).

9.2.2 Fiscal Tightening in the 1980s

A major change in policy stance took place in the early 1980s. The second oil shock together with political instability left Korea with spiraling inflation and negative income growth in 1980. The new government that

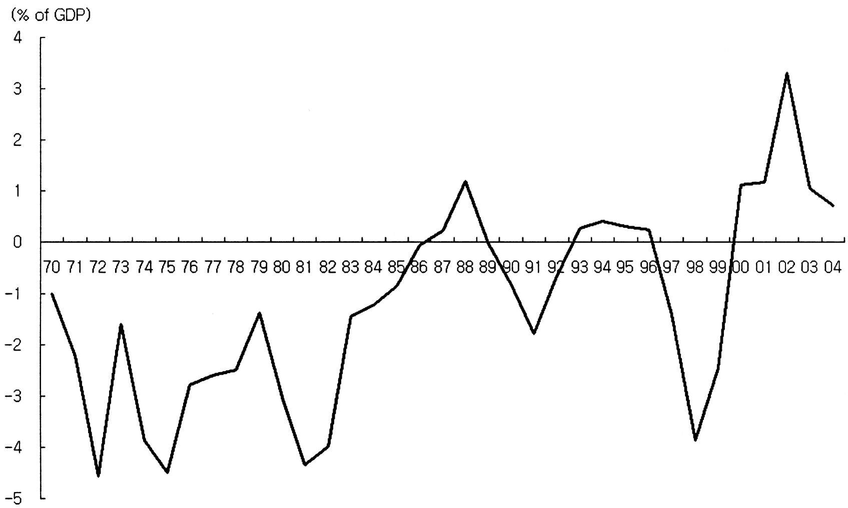

Fig. 9.1 Budget surplus/deficit of the central government
Source: Ministry of Finance and Economy.

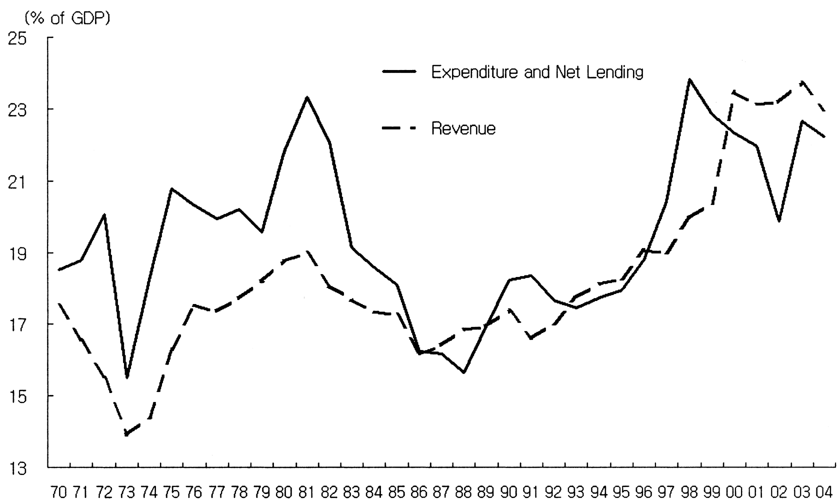

Fig. 9.2 Central government spending
Source: Ministry of Finance and Economy.

came into office in 1981 tightened monetary and fiscal policies rather drastically.[1]

1. The new government recognized the intrinsic problems of the government-led growth strategy, especially those coming from the promotion of capital-intensive industries. This strategy distorted the efficient allocation of resources, helped the formation of large business

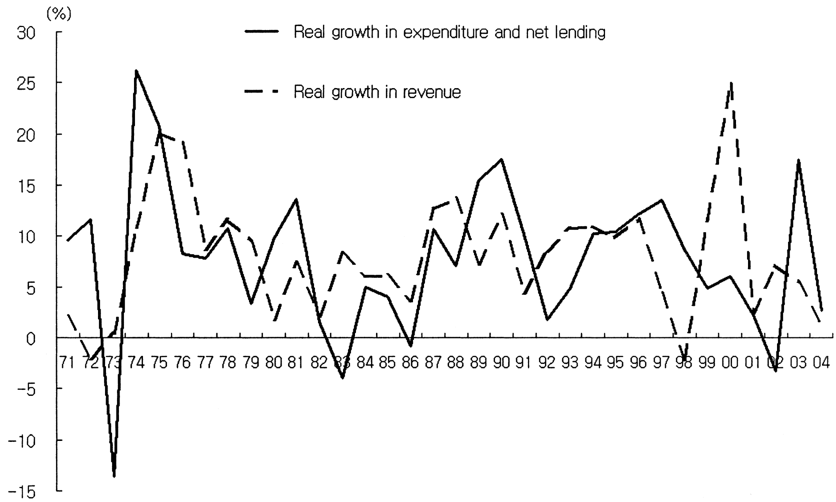

Fig. 9.3 Growth of real spending and revenue of the central government
Note: Real values were obtained by deflating nominal values with GDP deflator.
Source: Ministry of Finance and Economy.

On the monetary front, the annual growth rate of M2 was halved by the middle of the 1980s. On the fiscal front, consolidation took the form of reduced expenditure. The growth of real government spending was –3 percent in 1983, and remained at low levels until 1987 (see figure 9.3). These changes coincided with a substantial reduction in inflation. Overall, the economy grew at a healthy pace up until the recent economic crisis (see figure 9.4).

One important principle in fiscal management was established in this period. It was the principle of *Expenditure within Revenue* or the balanced budget principle. While not formalized in a law or a regulation, it acted as self-discipline imposed on the budget authorities against imprudent management of the tax money.[2]

In fact, the strong economic growth and the moderate-to-high inflation

conglomerates (the so-called *chaebol*), aggravated income inequalities, and produced macroeconomic instability. Consequently, the new government adopted "liberalization and stabilization" as its slogan for economic policy. While the stabilization policy was carried out successfully as explained in the text, the liberalization policy did not induce sufficient structural reforms in the economy. Many people think that this sowed the seed for the economic crisis of 1997.

2. One innovation during this period is worthy of note. The Budget Review Committee (BRC) was set up within the budget office in 1982 (Bahn 2003). BRC is composed of senior management of the budget office. The recommendations of budget examiners regarding the ministerial budget requests are reviewed by the BRC and then final decisions are made in sessions closed to outsiders. When faced with lobbies from line ministries and other interested parties, budget examiners find it convenient to pass the burden of budget cuts to the BRC. The BRC has been very effective in containing the spending increase and establishing fiscal discipline.

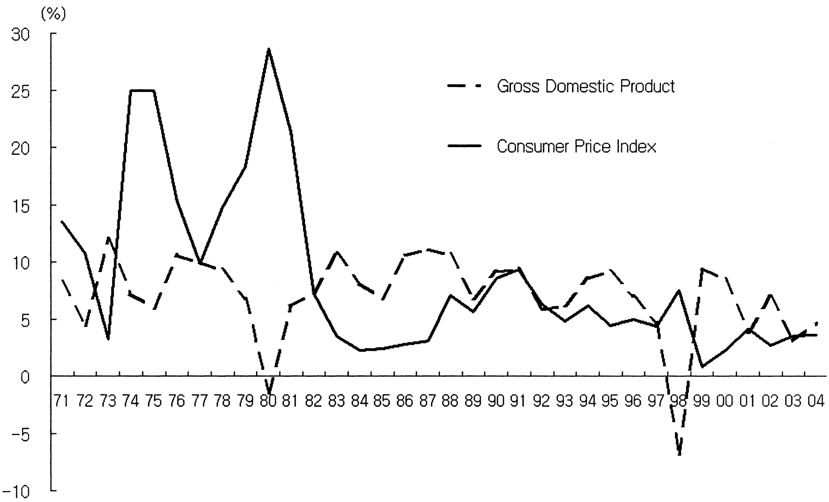

Fig. 9.4 Output growth and inflation
Source: Bank of Korea (2001).

produced larger-than-expected tax revenues in most years. This in turn made it relatively easy to keep the budget in balance. The National Pension Scheme (NPS) that was introduced in 1988 also contributed to the total revenue by 1 to 3 percent of GDP each year.[3]

The balanced budget principle kept the public debt to a minimal level. In 1996, the year before the crisis, the gross debt of the central government was less than 10 percent of GDP, and the net debt was negative; that is, the central government was a net creditor to the other sectors in the economy.[4] The local governments were generally in good shape as well.

Of course, there were costs as well as benefits associated with the balanced budget principle. Some argue that the counter-cyclical role of fiscal policy was constrained, and essential investment in social infrastructure was often postponed to contain the overall spending growth. But the Korean economy was able to achieve strong growth without much cyclical fluctuation in the decades following the adoption of the balanced budget principle.[5]

3. But the long-term prospect of the NPS is quite bleak. To finance the system, the contribution rate that stands currently at 9 percent will have to rise substantially in the future.

4. There are doubts, however, about the quality of government assets, which are mostly loans to private entities and local governments.

5. Specifically, the average growth rate was 7.2 percent (with a standard deviation of 3.5 percent) during 1971 to 1982 and 7.0 percent (with a standard deviation of 3.9 percent) during 1983 to 2004. The growth performance does not appear fundamentally different in these two periods. In addition, following the estimation method suggested by Bayoumi and Eichengreen (1995), a formal test can be carried out to see whether the cyclical response of the fiscal policy was weakened in the latter period. I could find no evidence for such claims.

Most importantly, strict application of the principle enabled the Korean government to keep the size of government debt at a manageable level, and provided it with room for maneuver when the crisis hit the economy. Without too much worry about the rapid explosion of the budget deficit and public debt, the Korean government could plan massive fiscal supports to troubled financial institutions. It also expanded the welfare programs for the poor and the unemployed substantially.

9.2.3 Economic Crisis and Ballooning Budget Deficit

The fiscal support to financial sector restructuring primarily took the form of loans to two public corporations—the Korean Deposit Insurance Corporation (KDIC) and the Korea Asset Management Corporation (KAMCO).[6] The loans were spent on repaying the interest on the restructuring bonds issued by these corporations. The total outstanding stock of restructuring bonds stood at 102 trillion won (21 percent of 1998 GDP).

Social welfare expenditure also increased significantly after the crisis. The unemployment rate surged from less than 3 percent in 1997 to 7 percent in 1998, with an accompanying deterioration in income distribution and an increase in poverty (see figures 9.5, 9.6, and 9.7). In response to these developments, public assistance to the poor was almost doubled.[7] The unemployment insurance scheme, which had been introduced in 1995, rapidly enlarged its coverage and increased its benefit level.

These developments left an unmistakable mark on the government finance. The consolidated budget, which remained more or less in balance before the crisis, dipped into deficit in 1998 of 4 percent of GDP. The ratio of government debt to GDP rose from 8 percent in 1996 to 15 percent in 1998 (see figure 9.8). When government debt-guarantees were included, the total public burden climbed to 30 percent of GDP. The bonds issued by the KAMCO and KDIC constitute most of these government guarantees.

Beginning in 1999, the Korean government resumed its efforts to contain the expenditure growth (see figures 9.1, 9.2, and 9.3). Aided by the dramatic rebound of the economy (see figure 9.4) and the rapid growth in revenues, the budget recorded a surplus of 1.1 percent of GDP in 2000. It remained in surplus in following years.

On the other hand, the debt-to-GDP ratio kept rising despite surpluses since 2000. This anomaly is due to the fact that these surpluses came mostly from the National Pension Fund (NPF). The surplus in NPF was 2.6 percent

6. The KDIC was responsible for recapitalizing underfunded institutions and paying out the deposits in closed institutions. The KAMCO sold the assets purchased from troubled financial institutions in return for the KAMCO bonds.

7. But these expenditures still take up only a small portion of the total budget compared to western countries, as the social welfare system in Korea is in its early stage of development. In the future, however, public pension benefits and other welfare spending are certain to drive up the social welfare expenditures to a level that is comparable to those in western countries.

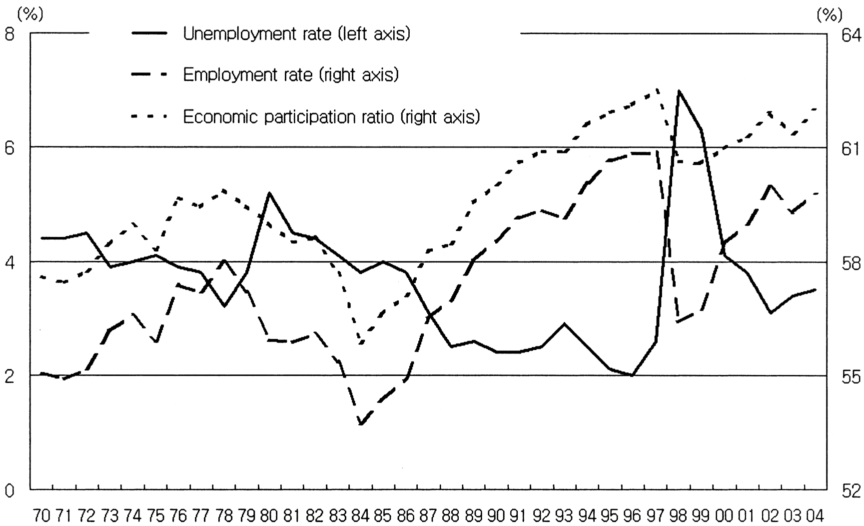

Fig. 9.5 Labor market indicators

Note: The employment rate refers to persons aged 15 and over who are employed divided by the working age population.

Source: National Statistical Office.

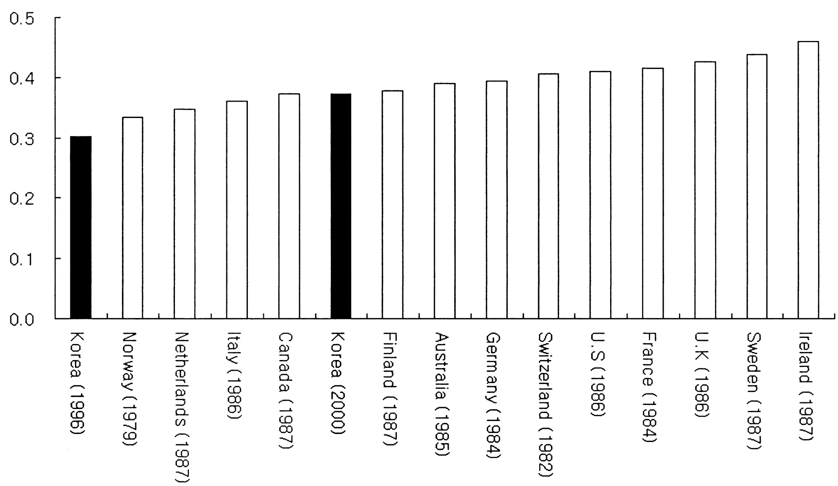

Fig. 9.6 Gini coefficient

Source: Yoo (2003).

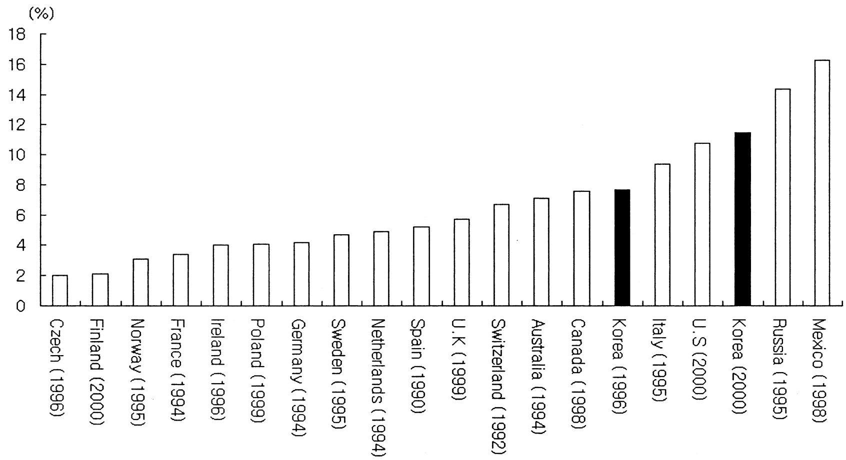

Fig. 9.7 Relative poverty

Note: The relative poverty refers to the households with incomes below 40 percent of the median household income divided by the total households.

Source: Yoo (2003).

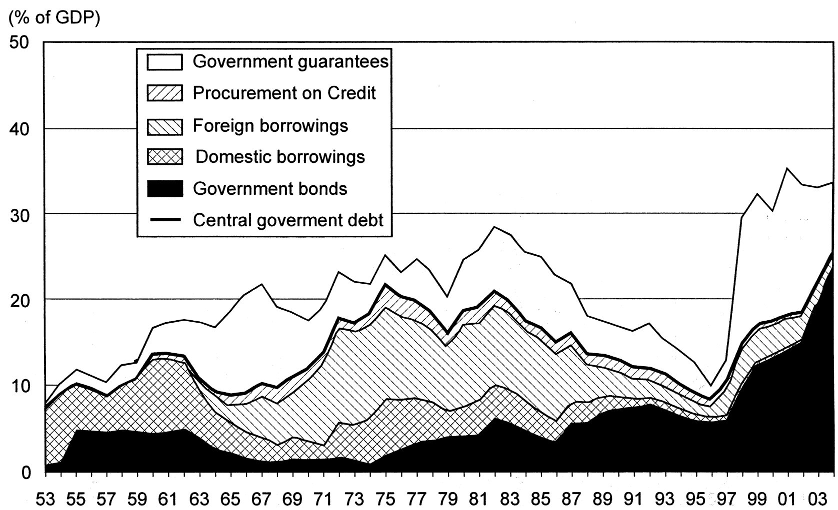

Fig. 9.8 Debt/GDP ratio

Source: 1953–90, Korea Development Institute (1991); 1991–2004, Ministry of Finance and Economy.

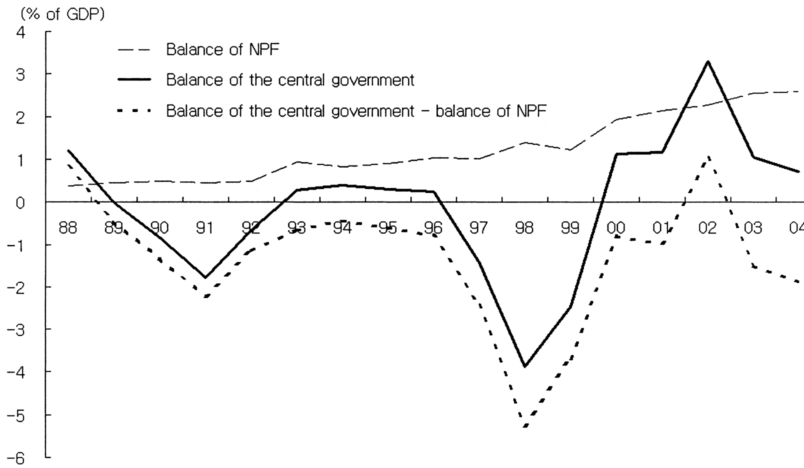

Fig. 9.9 Budget balance excluding the national pension fund
Source: Ministry of Finance and Economy.

of GDP in 2004. Most of the surpluses are used to buy assets in the financial market. These assets will be liquidated later to pay pension benefits to eligible retirees. When we exclude NPF from the consolidated budget, the government has consistently run budget deficits since 1989, except in 2002 (see figure 9.9).

9.3 Current State of Public Finance

9.3.1 Financial Balance

As shown in figure 9.9, the consolidated central government budget balance is overstated due to the surpluses in the NPF. To better assess the financial soundness of the government, we need to exclude the NPF from the consolidated balance. There are two more factors to consider in addition to the NPF in this regard. One is the net lending and the other is the repayment of restructuring bonds by the government.

The large amount of net lending has been a major factor behind large deficits in 1998 and 1999. In fact, the government lending activity has been quite extensive since the early days of government-led economic growth (see figure 9.10). The official statistics show that the default rate on government loans is close to 0 percent.[8] If this is true, loans do not reflect any

8. But it should be noted that the actual deficit rate may be higher. After all, the government has frequently introduced rescheduling programs for agricultural loans.

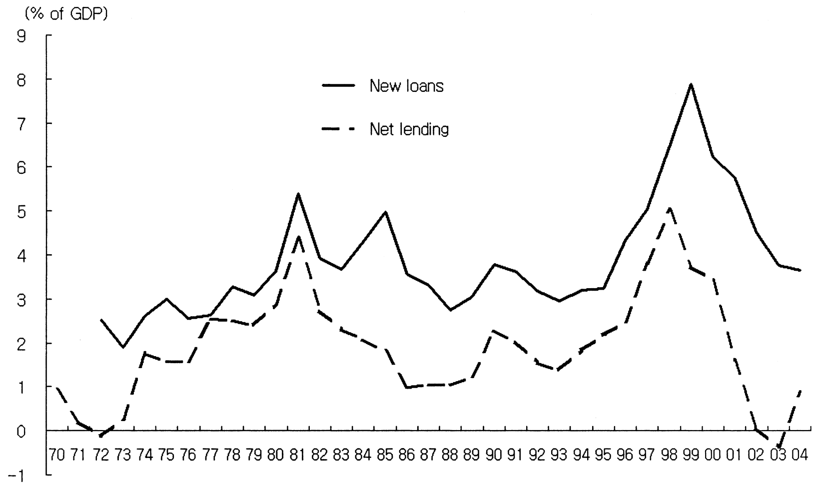

Fig. 9.10 Central government loans

Source: Ministry of Finance and Economy.

Note: Net lending equals new loans minus repayments.

deterioration of the government asset position, and we should disregard the net lending when assessing the financial health of the government.[9]

One exception is the government loans made to the KDIC and KAMCO. In 2002, the government announced a plan to exempt the KDIC and KAMCO from repaying the loans to the government. This decision essentially converted the loans into direct spending in the years they were made. The total amount exempted was 22 trillion won. We include these loans in the consolidated budget balance in the following discussion.

In addition to the loan cancellation, the government is sharing with the KDIC and KAMCO the obligation on restructuring bonds. According to the government estimates, the irretrievable loss incurred during financial sector restructuring would amount to 69 trillion won. The government announced that it would take up a total of 49 trillion won of restructuring bonds, repaying their interest and principal. In 2003, 13 trillion won was spent on transforming part of these bonds into government bonds. The figure for 2004 to 2006 is 12 trillion won each year. As these expenditures mirror the results of past restructuring activities, we exclude them from the consolidated balance in 2003 to 2006 and include them in 1997 to 2002.

Table 9.1 shows the results of these adjustments. The adjusted balance is

9. To be precise, the subsidy cost of loans emerging from the disparity between market interest rates and concessional lending rates should be included in government expenditures. With no reliable estimates on the subsidy cost, however, I decided to simply ignore it.

Table 9.1 **Consolidated budget balance and its adjustment**

	1998	1999	2000	2001	2002	2003	2004	2005[a]
Consolidated balance	–18.8 (–3.9)	–13.1 (–2.5)	6.5 (1.1)	7.3 (1.2)	22.7 (3.3)	7.6 (1.1)	5.6 (0.7)	5.6 (0.7)
NPF balance	6.7 (1.4)	6.5 (1.2)	11.2 (1.9)	13.3 (2.1)	15.6 (2.3)	18.5 (2.6)	20.2 (2.6)	24.4 (2.9)
Net lending	24.4	19.8	19.8	10.1	0.4	–2.5	1.4	6.4
Loans to KDIC and KAMCO	1.3	4.0	5.6	6.0	6.9			
Issuance of restructuring bonds[b]	15.8	9.8	4.6	16.0	1.9			
Assumption of restructuring bonds						13.0	12.0	12.0
Adjusted balance[c]	–18.2 (–3.8)	–13.6 (–2.6)	5.0 (0.9)	–18.0 (–2.9)	–1.3 (–0.2)	–0.4 (–0.1)	–1.1 (–0.2)	0.3 (0.0)

Note: Numbers in parentheses are a percentage of GDP. All other numbers are in trillions of won.

[a]The figures for 2005 are based on budget.

[b]Issuance of restructuring bonds is based on the assumption that out of 49 trillion won, 2.1 percent was issued in 1997, 32.2 in 1998, 19.9 in 1999, 9.4 in 2000, 32.6 in 2001, and 3.8 in 2002, which are the shares of total restructuring bonds issued in 1997 to 2002.

[c]Adjusted balance = consolidated balance – NPF balance + net lending – loans to KDIC and KAMCO – issuance of restructuring bonds + assumption of restructuring bonds.

close to the consolidated balance in 1998 to 2000 but much lower than in 2001 to 2005. For example, in 2004, the balance declines from 5.6 trillion (0.7 percent of GDP) to –1.1 trillion won (–0.2 percent of GDP) after the adjustment. But they have been within ±0.5 percent of GDP since 2001, and we can still say that the financial soundness of the government is not a very serious problem at this stage.

9.3.2 Government Liabilities

Another indicator for the soundness of public finance is government liabilities. The debt-to-GDP ratio amounted to 25 percent at the end of 2004 (see figure 9.5). When government guarantees are included, it rises to 34 percent. The transformation of restructuring bonds is reducing the amount of guarantees at the expense of direct liabilities. But with the *adjusted balance* remaining close to zero, the total public burden including direct liabilities and guarantees is stabilizing at 33 to 34 percent of GDP. If an appropriate amount of control is exercised on the spending growth, the total burden will remain at the current level in the years ahead.

9.3.3 The Size of Government Expenditure

Of course, it is not certain at all whether we would be able to contain the spending growth successfully in the future. Figure 9.11 shows the consoli-

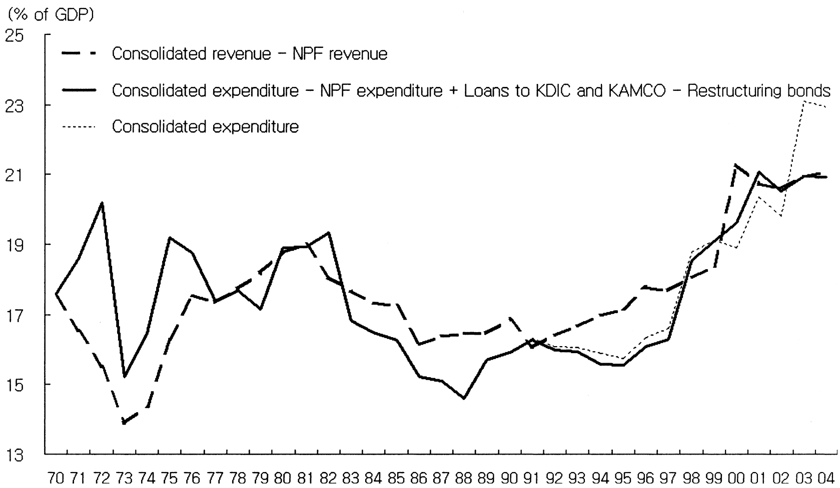

Fig. 9.11 Adjusted revenue and expenditure
Source: Ministry of Finance and Economy.

dated central government expenditure and the adjusted expenditure. Here the adjustment was made in the same way as in table 9.1 (subtracting the NPF expenditure, moving forward the repayment of restructuring bonds to earlier years, and adding the loans to the KDIC and KAMCO). The consolidated expenditure has been increasing rapidly since the mid-1990s. Unless conscious efforts are made to contain it, the spending growth is likely to produce persistent deficits and rising government liabilities in the future.

Of particular importance are the public pension schemes such as the National Pension Scheme (NPS), the Government Employees' Pension Scheme (GPES), the Private School Teachers' Pension Scheme (PSTPS), and the Military Personnel Pension Scheme (MPPS). These pension schemes share one common feature—too generous benefits in relation to contributions. With rapidly aging population (see figure 9.12), this imbalance has produced and will continue to produce devastating effects on their finance.[10]

In addition to pensions, health spending will increase rapidly with the aging population. All in all, the age-related spending will rise from 5 percent of GDP in 2004 to 25 to 30 percent in 2070 according to a projection by the Korean Institute of Public Finance (see figure 9.13).

Increased spending on pensions and other age-related spending will

10. MPPS has been in deficits over 10 years and requires government supports of about 1 trillion won each year. GPES entered into deficit in 2001, and the deficit is expected to grow exponentially in coming years. PSTPS has basically the same problem but will experience difficulties in later years. NPS, with its huge coverage, can become a major drain on government budget.

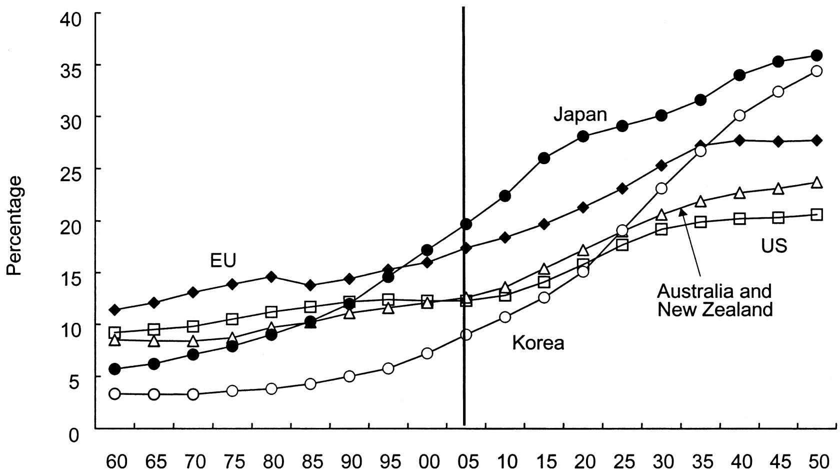

Fig. 9.12 Population aging
Source: United Nations.

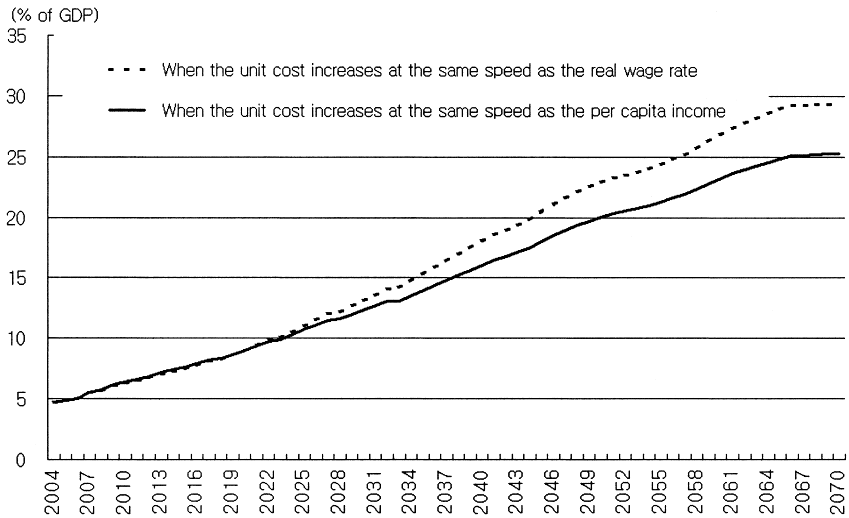

Fig. 9.13 Projected age-related spending
Source: Korea Institute of Public Finance (2005).

drive up the total size of government expenditure. Table 9.2 compares the general government spending across six countries including Korea. In 2000, the spending-to-GDP ratio was 23.0 percent in Korea and ranged between 30 and 50 percent in other countries. But when income transfers are excluded, the ratio declines to 19.4 percent in Korean and 20 to 30 percent in other countries. In particular, the United States has a lower ratio than

Table 9.2 General government expenditures (% of GDP)

	U.S.	Japan	Germany	France	U.K.	Korea
Consumption	15.1	16.8	19.0	23.3	19.4	10.1
Net capital outlays	0.9	6.0	3.0	3.3	2.2	8.3
Income transfers	13.7	10.0	18.9	17.8	13.7	3.6
Subsidies	0.5	0.9	1.6	1.2	0.5	0.3
Interest payments	3.4	3.3	3.3	3.2	2.4	0.7
Total	31.2	37.0	45.7	48.8	38.2	23.0
Excluding income transfers	(17.5)	(27.0)	(26.8)	(31.0)	(24.5)	(19.4)

Source: OECD (2003).
Note: The data for Japan and Korea refer to year 2000. Others refer to year 2001.

Korea. With the increase in age-related expenditures in Korea, the gap between Korea and other countries will diminish in the future.[11]

Containing the spending growth is critical in attaining fiscal sustainability. It will gain greater importance in the future as the growth potential of the Korean economy declines. Han and others (2002) forecast the potential income to grow at a much slower rate in coming years (see table 9.3). Its growth rate already declined from 7.7 percent in the 1970s to 5.6 percent in the 1990s, and will decline further to 5.1 percent in 2000 to 2005 and to 4.2 percent in 2005 to 2010, primarily due to the slower growth of labor force. In fact, the total population is expected to shrink in absolute numbers beginning in around 2030.

The slower economic growth will imply a slower growth in tax revenue. Expanding government expenditures at the same rate as in previous years is likely to produce widening deficits, accelerate the decline in national saving, hamper the fixed capital formation, and further reduce the growth potential.

9.3.4 Functional Classification of Expenditures

Government expenditures can be classified in various ways. Table 9.4 shows the functional classification of the central government expenditure and net lending in Korea. Defense spending declined rapidly in the 1980s and 1990s and now corresponds to 11.4 percent of total spending. Education has traditionally taken up a large share (15 to 17 percent) of total spending, but an even larger share has been allocated to economic affairs (20 to 28 percent). Among the economic affairs, agriculture and transportation have been the major items of spending. On the other hand, social

11. It is interesting to note in table 9.2 the relatively small size of government consumption in Korea. It stands at 10.1 percent of GDP. This seems mainly due to the small size of public employment in Korea. On the other hand, government investment as a percentage of GDP is larger in Korea than in other countries except Japan.

Table 9.3 **Forecasts of national income (%)**

	1963–70	1970–79	1979–90	1990–2000	2000–05	2005–10
Growth in national income	8.94	7.67	7.29	5.61	5.14	4.17
Contributions from:						
Inputs	4.35	4.23	4.80	3.00	2.85	2.06
Labor	3.67	3.06	2.90	1.60	1.28	0.89
Workers	3.44	2.90	2.39	1.28	1.21	0.82
Capital	0.68	1.17	1.90	1.40	1.57	1.17
Total factor productivity	4.59	3.44	2.49	2.61	2.29	2.11

Source: Han et al. (2002).

protection has received relatively little attention in budgetary spending though its share is growing rapidly in recent years.

The concentration of spending on economic affairs may reflect the less-developed-country status of Korea. Perhaps we still need large investment in roads, ports, and railways. Perhaps we still need to provide large government loans to the agricultural, manufacturing, and construction sectors because the financial market is not yet fully developed. But there are strong doubts about these assumptions.

First, the rapid increase in spending on social infrastructure during the 1990s need not be sustained in the future. Many (but certainly not all) experts in this area agree that, with the ever-stringent budget constraint and the completion of major road-building programs, it is time to reorganize the overall investment strategy. In particular, we should pay more attention to the demand-management (e.g., through an increased use of user-charging) and the proper maintenance of existing stocks of infrastructure.

Second, the Korean financial market has undergone a rapid change since the 1980s and especially after the economic crisis. Banks are rapidly expanding their lending to households and small- and medium-sized enterprises, and large corporations are turning ever more to capital (stock and bond) markets. The government appears to be playing a substitutive, rather than complementary, role to commercial banks in many cases. It is now generally believed that the government should reduce its role as a provider of financial resources for businesses. The reduced government role in this area will not only help restrain the growth of public spending but also promote the development of private financial markets and reduce the distortion in resource allocation.

On the other hand, the government should increase its effort in the provision of basic public service such as security and safety, fire-fighting, judicial services, promotion of competitive business practices, prudential regulation of financial institutions, statistical services, environmental protection, and so on. These services are vital for the long-term economic growth and social development. Unfortunately, their importance has been

Table 9.4 **Central government expenditure and net lending**

	Percentage of GDP					Percentage of total spending				
	1970	1980	1990	2000	2003	1970	1980	1990	2000	2003
General public services	3.9	0.8	0.7	1.1	1.4	23.1	4.0	4.2	5.2	6.7
Defense	3.8	6.1	3.6	2.5	2.5	22.7	30.6	20.0	11.4	11.4
Public order and safety	0.0	0.9	0.8	1.0	1.1	0.0	4.6	4.3	4.6	5.3
Education	2.8	2.9	3.0	3.3	3.3	16.7	14.6	17.0	15.3	15.0
Health	0.2	0.2	0.3	0.2	0.1	1.3	1.0	1.7	0.7	0.4
Social protection	0.8	1.1	1.4	3.3	2.9	4.9	5.7	8.1	15.3	13.5
Housing and community amenities	0.0	0.5	1.8	1.2	1.1	0.3	2.5	10.1	5.3	5.0
Recreation, culture, and religion	0.2	0.1	0.1	0.2	0.3	1.4	0.7	0.5	0.8	1.2
Economic affairs	4.6	5.1	3.6	5.5	6.2	27.4	26.0	20.4	25.2	28.7
Fuel and energy	0.6	0.4	0.1	0.1	0.4	3.8	2.1	0.6	0.7	1.8
Agriculture, forestry, fishing, and hunting	1.9	1.2	1.8	1.4	1.4	11.2	5.9	10.2	6.2	6.7
Mining, manufacturing, and construction	–0.5	1.5	0.4	0.6	1.0	–3.0	7.4	2.0	2.6	4.5
Transportation and communication	1.3	1.3	1.1	2.2	2.0	7.9	6.7	6.1	9.9	9.3
Other economic affairs	1.3	0.8	0.2	1.3	1.4	7.5	3.9	1.4	5.8	6.5
Other expenditures	0.4	2.1	2.4	3.5	2.8	2.2	10.4	13.7	16.2	12.8
Total	17.0	19.8	17.8	21.9	21.7	100.0	100.0	100.0	100.0	100.0

Source: Ministry of Finance and Economy.

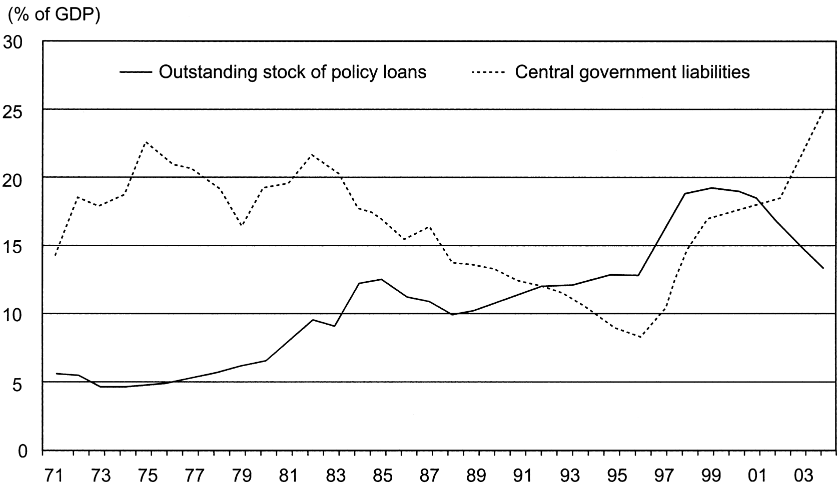

Fig. 9.14 Government assets and liabilities
Source: Ministry of Finance and Economy.

generally understated to this day in Korea. For example, competition policy is still at its early stage of development. Statistical services also have large room for improvement, as illustrated by the lack of reliable data on gross regional product even though the government has historically emphasized the importance of mitigating regional disparities.

At the same time, more efforts are needed to reduce the outstanding stock of government loans. Figure 9.14 shows that in 1997 to 1999, government loans grew by about the same amount as government liabilities. That is, the government issued bonds and other debt instruments and used the proceeds to extend loans to the private sector. The trend was reversed in recent years, but the outstanding stock of loans still stood at 13 percent of GDP at the end of 2004.

Government loans typically have maturity of 5 to 10 years while most of government bonds have maturity of less than 5 years. The interest rates on loans are lower than those on government bonds. Such differences in maturities and interest rates impose a financial burden on the government over longer terms.

9.4 Institutional Setup and Reform Efforts in Korea

9.4.1 The Structure of the Budget

General Accounts, Special Accounts, and Funds

The budget of the central government as voted on in the National Assembly is comprised of one general account and various special accounts.

There were a total of 23 special accounts in the fiscal year 2005 budget (see table 9.5). Revenue sources for the general account include general-purpose (not ear-marked) taxes and nontax revenues. On the other hand, many special accounts have their own special ear-marked taxes or quasi-taxes (i.e., fees, charges, and other mandatory contributions). Transfers from the general account also make up a large portion of resources for special accounts.

On a consolidated basis, the central government budget includes, in addition to the general and special accounts, numerous funds. There were 57 funds in 2005 including the National Pension Fund, the Employment Insurance Fund, and the Foreign Exchange Stabilization Fund. These funds were established much like special accounts to achieve specific policy objectives, and many of them have their own revenue sources including quasi-taxes.[12]

The difference between the funds and the general and special accounts lies in the managerial flexibility allowed for the former. Ministries can freely change fund expenditures within 30 percent of the planned amount without notice to the budget authorities and the National Assembly (see table 9.6). The line items in the operational plans of funds are much less detailed than those in the general and special accounts. Their cash flows are managed independently by line ministries and do not pass through the treasury single account held in the Bank of Korea.

The general account, special accounts, and funds form the consolidated central government budget (see figure 9.15). The share of general account in the total consolidated expenditure and net lending stood at 55 percent in 2004, and those for special accounts and funds at 16 percent and 29 percent, respectively.[13]

Drawbacks

The highly complex structure of the budget has been criticized in many aspects.[14] First, it limits the ability of the budget authorities to centralize all national resources and then allocate them based on national priority. As mentioned previously, special accounts and various funds have their own sources of revenue, which are not easily transferable to the general account or any other special accounts and funds in response to changing circum-

12. There were 101 quasi-taxes for special accounts and funds at the end of 2001 and their total revenue was estimated to be around 1 percent of GDP (OECD 2003).

13. The U.S. federal government also has a large number of trust funds, special funds, and public enterprise funds in addition to the general fund (U.S. GAO 2001). In 1999, the spending of the funds other than the general fund corresponded to around 55 percent of total federal spending. But most of them (33 out of 55 percent) represented *long-term commitments* such as social security. In the case of Korea, *long-term commitments* occupy only about 10 percent of total spending.

14. There is much similarity between the Korean and the Japanese budget system. See Bayoumi (1998) for the Japanese system.

Table 9.5 Special accounts

Fiscal financing	Environmental reconstruction
National property management	National medical center management
Agriculture and fisheries structural adjustment	Land management and balanced regional development
Rural development tax management	Postal insurance service
Transportation facilities	Automobile traffic management
Registration	Patent management
Management of funds transferred to local governments	Balanced national development
Prison operation	Grain management
Military personnel pension	Agency
Management of funds transferred to local educational agencies	National railroad
Energy and resources	Communication service
	Government procurement

Table 9.6 Characteristics of the general account, special accounts, and funds

	General account	Special accounts	Funds
Objective	Supporting general fiscal activities.	Supporting specific programs.	Supporting specific programs.
Revenues	General-purpose taxes and nontax revenues.	Ear-marked taxes, mandatory contributions, transfers from other accounts and funds, etc.	Mandatory contributions, transfers from other accounts and funds, etc.
Expenditures	Unrequited expenditures.	Unrequited expenditures and loans.	Unrequited expenditures and loans.
Linkages between revenues and expenditures	None.	Clear linkages.	Clear linkages.
Authorization and execution of expenditure plans	Voted on in the National Assembly. Controlled and monitored during execution as mandated by the Constitution.	Same as general account.	Same as general account but larger flexibility guaranteed in implementation.[a]

[a]Ministries can change fund expenditures within 30 percent of the planned amount without notice to the budget authorities and the National Assembly. Cash flows are managed independently by the ministries in charge and do not go through the treasury single account held in the Bank of Korea. Unlimited carry-overs of unused cash are allowed.

stances. This compartmentalization and fragmentation of resources reduces the allocative efficiency of the budget.

Second, fiscal transparency and program efficiency are also undermined by the complicated budget structure. Various accounts and funds are intricately interrelated through complicated flow of grants and loans. It is difficult to see how much funding is being allocated to various spending areas. The functional classification of spending is not reported for the consolidated budget, and it is reported only for the previous year's outturns with

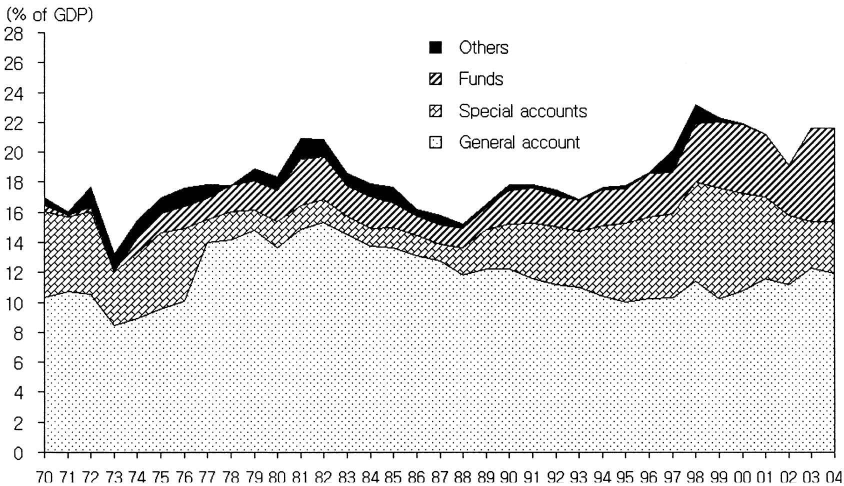

Fig. 9.15 Expenditure and net lending by accounts and funds
Source: Ministry of Finance and Economy.

a considerable time-lag of more than a year. We can find many programs with similar policy objectives and tools but under different accounts and funds. Consolidating similar programs would contribute to greater allocative and technical efficiency with increased transparency.

Government Efforts

The government is making efforts to simplify the budget structure and strengthen transparency and accountability. The most important change occurred with the revision of the Fund Management Act and the National Assembly Act in 2001. Previously, there were two types of funds—"public funds" and "other funds." The operational plans of "public funds" were prepared by responsible ministries and reported to the National Assembly but did not require the latter's approval. Those of "other funds" were not even reported to the National Assembly. In this sense, public and other funds were off-budget accounts.

In 2001, they were regrouped into "funds" and "financial funds." "Funds" include all of the previous "public funds" and some of "other funds." "Funds" were moved from off-budget to on-budget: the operational plans of "funds" now require the approval by the National Assembly and their financial reports are submitted to the latter, just like the general account and special accounts.[15] In 2004, further changes were made to move "financial

15. This change in typology produced discontinuity in the time series of fiscal data. Before 2001, the consolidated spending and revenue data included "public funds" and excluded "other funds." After 2001, they include "funds" and exclude "financial funds." As a result, several important funds such as the Teachers' Pension Fund are now included in the consol-

funds" from off-budget to on-budget and subject them to the same degree of control by the National Assembly.

The government also introduced a review process in the Fund Management Act to abolish obsolete funds and consolidate those with similar objectives. The first such review was conducted in 2004 and subsequent reviews are scheduled every three years in the future.[16] In addition, a separate, ad hoc review was conducted on special accounts in 2004. The results of these two reviews were presented to the president in May 2005 in a combined report and received his approval. The government is in the process of revising various laws that provide legal bases for individual special accounts and funds. It remains to be seen how many of the recommendations will survive the opposition from diverse interest groups and succeed in the revision of relevant laws.

The past experience does not offer a very good prospect. The number of funds declined from 114 in 1994 to 53 in 2002 but since then has stayed at around 55 (see table 9.7) despite the government's effort to reduce it further. A few special accounts were to be closed down in past years (the Transportation and the Registration Special Accounts in 2003 and the Rural Development Tax Management Special Account in 2004). But the pressure from interest groups saved their lives and none were closed down.

On the other hand, a series of new initiatives that are recently being introduced—the medium-term expenditure framework, top-down budgeting, performance management, and program budgeting—are expected to reduce the line ministries' incentives to secure funding through special accounts and funds and to help MPB in improving the allocative and operational efficiency of spending. More will be discussed in the following on these initiatives.

9.4.2 Major Players and the Fiscal Discipline

Major Players

Major players in the budget process include the Ministry of Planning and Budget (MPB), the Ministry of Finance and Economy (MOFE), and the Board of Audit and Inspection (BAI, see table 9.8). MPB is responsible for preparing the draft budget with the help of the Tax and Customs Office in MOFE that provides revenue forecasts. When the budget is authorized by the National Assembly, MPB prepares the quarterly budget implementation plans usually within a month and allocates funds to line ministries.

idated financial statistics. But no attempt has been made to revise previous data to eliminate discontinuity.

16. These reviews are called *Retention Reviews.* Apart from the Retention Review, the government has also been conducting annual *Management Reviews* since 1999. Management Reviews look at the operational efficiency of funds, including the adequacy of their asset management practices.

Table 9.7 **Number of funds**

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
At the start of the year	114	106	99	76	75	76	75	62	53	58	59	
Established during the year	6	4	4	3	3	2	2	1	8	3	2	57
Closed during the year	–14	–11	–27	–4	–2	–3	–16	–8	–4	–2	–4	
At the end of the year	106	99	76	75	76	75	61	53	58	59	57	

Source: Ministry of Planning and Budget (2005).
Note: Includes public and other funds before 2002 and funds and financial funds since then.

Table 9.8 **Major players in Korea's budget process**

Players	Roles
Ministry of Planning and Budget (MPB)	• Compiles budget bids and prepares the draft budget. • Allocates funds to spending ministries (apportionment). • Approves the transfers of funds between line items (virements).
Treasury Bureau of the Ministry of Finance and Economy (MOFE)	• Releases cash to spending ministries. • Manages the treasury single account held in the Bank of Korea. • Issues treasury bonds and manages assets and liabilities. • Collects ministerial financial reports, prepares the whole-of-government financial reports, and sends them to the BAI. • Produces the government financial statistics.
Tax and Customs Office of MOFE	• In charge of tax policy. • Prepares revenue forecasts. • Oversees the National Tax Service and the Customs Service.
Ministry of Government Administration and Home Affairs (MOGAHA)	• In charge of local government tax and spending policies. • Allocates the Local Shared Taxes (a formula-based block grant) to local governments. • Coordinates the central government subsidies to local governments. • Approves the borrowing by individual local governments.
Board of Audit and Inspection (BAI)	• The supreme audit institution in Korea, whose head is nominated by and reports to the president. The National Assembly can also request audits on specific issues to the BAI. • Checks the regularity of ministerial activities. • Prepares and tables the financial report to the National Assembly.
National Assembly	• Deliberates and votes on the budget. • Approves the transfers of funds between programs. • Reviews and approves audit reports.
Spending ministries	• Execute the budget and prepare financial reports.

The Treasury Bureau of MOFE then prepares the monthly cash plans and releases cash to line ministries. The Treasury Bureau keeps track of cash flows into and from the treasury single account held in the Bank of Korea. It is also responsible for issuing government bonds and managing government assets and liabilities.

An important issue concerning the interplay among various players is that of fiscal discipline. The budget process in Korea has generally taken a highly centralized, strategic dominance-based approach in the terminology of von Hagen and Harden (1996). These authors distinguish between two approaches in budgeting. Under *a target-based approach,* the government collectively negotiates a set of binding, numerical targets for the budget. The budget process starts with negotiations among concerned parties over binding limits on the spending total or budget deficits. Once these limits have been agreed upon, they must be observed during the remainder of the budget process. On the other hand, under *a strategic dominance-based approach,* the budget process vests the budget authorities with special strategic powers. Often the main budgeting decisions are made in bilateral negotiations between the budget authorities and spending ministries.

The 1970s and 1980s

In the 1970s and 1980s, the Economic Planning Board (EPB) played a central role in budgeting as well as in preparing and implementing economic development plans. EPB was the leading ministry within government, as reflected in the title of the head of EPB as deputy prime minister. Negotiations over spending bids were conducted bilaterally between the deputy prime minister and spending ministers. Little reconciliation occurred in the cabinet regarding the draft budget prepared by the deputy prime minister.

The authoritarian nature of previous governments also limited the role of the National Assembly in the deliberation of draft budget. The National Assembly has been traditionally dominated by the party of the president. Insofar as the government had already consulted the ruling party before presenting the draft budget to the National Assembly, amendments typically entailed minor changes in the budget (see figure 9.16). In addition, the constitution prohibits the National Assembly from increasing the total spending or introducing new spending items unless agreed on by the government.

EPB also exercised tight control on expenditures in the implementation stage. Ministries were required to spend within the limits set in the quarterly budget implementation plan. EPB could postpone or block part of the expenditures (those classified as *discretionary allocation items*) when deemed necessary. All limits on expenditures were imposed in cash terms. Transfers across appropriation accounts (*virements*) were prohibited un-

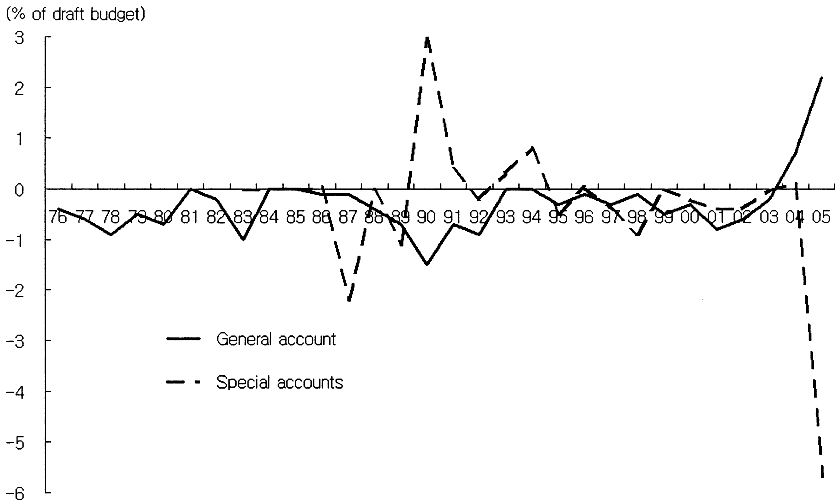

Fig. 9.16 Budget amendments

Source: Ministry of Planning and Budget (2005).

less authorized by the National Assembly or by EPB. In addition, supplementary budgets were normally introduced only once a year.

The Treasury Bureau of MOFE also had a tight grip on cash outflow. All cash disbursements were made strictly within the limits set in the monthly cash plans. Before the crisis of 1997, it was not uncommon for the Treasury Bureau to delay disbursements to line ministries when there was not enough cash left in the treasury account due to the seasonality in tax collection. This was in spite of the fact that they could issue short-term debt instruments within the limit set by the National Assembly to bridge the gap between tax collection and cash needs. In addition, the revenue forecasts prepared by the Tax and Customs Office were often very conservative with the actual tax collection overshooting the forecast by substantial margins.

The 1990s and After

Most of these characteristics carried over until recently. In the early 1990s, EPB and the Ministry of Finance were merged into the Ministry of Finance and Economy (MOFE), and the deputy prime minister-ship was handed over to the head of the MOFE.[17] The latter exercised the same degree of centralizing power in budgeting as the head of the EPB (see figure 9.17).

But the recent reorganization in government resulted in a subtle change

17. This merger signaled the official closing of the *planning-based development era.* At the same time, the newly established Korea Fair Trade Commission took charge of competition policies in place of EPB, and the evaluation function of EPB was moved to the prime minister's office.

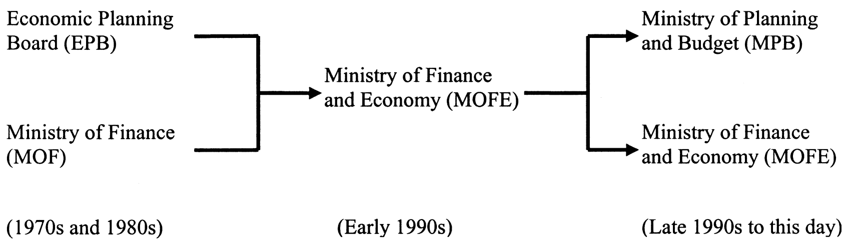

Fig. 9.17 Organizational change in the budgeting function

in the budget process. After the economic crisis, the budgeting function was separated from MOFE and moved to the newly created MPB.[18] Previously, the EPB and then the MOFE had the formal role in setting the overall policy agenda and coordinating activities across the government. After the reorganization, the coordination role together with the prime ministership was kept in the MOFE, and the MPB was devoid of such functions.[19] All these factors can act to reduce the centralizing power of MPB. In addition, the balance of power between the executive branch and the legislature is tipping toward the latter with the democratization of Korean politics.

Assessment

There is not yet a visible sign that these changes have weakened the centralizing power of MPB and the fiscal discipline substantially. But the risk is increasing, as illustrated for example in the increasing number of annual supplementary budgets after the crisis (see figure 9.18). In most cases, the supplementary budgets were introduced to stimulate the economy.

We also observe some changes in the cash management and revenue forecast practices in the post-crisis period. To bridge the gap between tax collection and cash needs, and to finance the front-loading[20] of annual spending that has been popular since 1999, MOFE is resorting more and more to short-term debt issues. The downward bias in revenue forecasts is

18. Before the separation, MOFE was a super-ministry in charge of general economic policy coordination, macroeconomic policies, budget preparation, tax policies, financial market policies, external economic relations, and treasury function. Many believed that the lack of check-and-balance as seen in the previous periods between EPB and MOF, together with the unmanageably large span of control of the Minister for Finance and Economy, veered economic policy-making off the right track, and contributed to the outbreak of financial crisis. The focus of criticism was laid on the bureau of financial market policies within MOFE, which was subsequently reduced in size and whose regulatory function was transferred to the newly created Financial Supervisory Commission. In addition, the Bank of Korea was granted instrumental independence from MOFE.

19. Compared to EPB's responsibilities, MPB's exclude economic policy coordination, external economic relations, and competition policies.

20. In front-loading exercises, MPB would allocate more funds than usual to the first half of the year, and urge line ministries to spend the allocated funds as early as possible. When necessary, that is when the growth is slower than expected despite front-loading, MPB would consider introducing a supplementary budget in the latter half of the year.

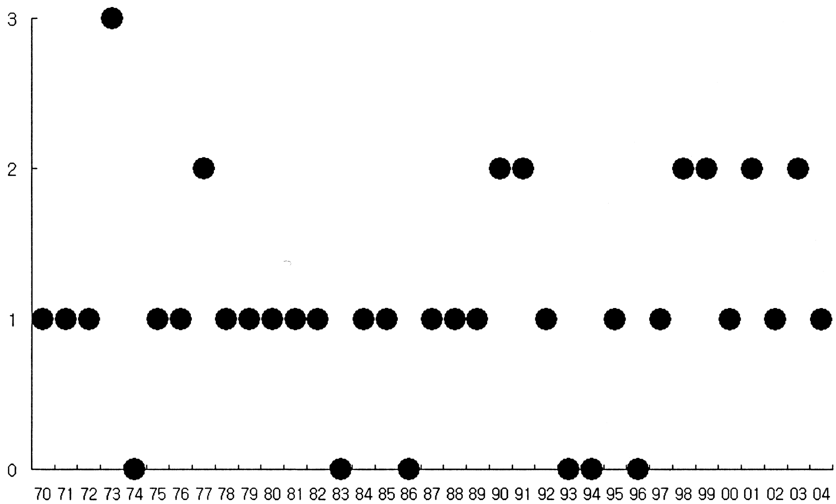

Fig. 9.18 Number of supplementary budgets introduced
Source: Ministry of Planning and Budget (2005).

also being reduced. In 2004, we actually had a large shortfall in tax collection, which was partly blamed on an overly optimistic assumption on the economic growth, which was in turn claimed by some to have been politically motivated.

Part of these changes look inevitable. The democratization of the Korean politics and the devolution of budgetary power to line ministries are an unavoidable trend. The separation of budgeting function from policy coordination function was intended to reduce the concentration of powers in one large *dinosaur* ministry (Ministry of Finance and Economy) that is believed to have contributed to the outbreak of the financial crisis. Utilizing short-term debt instruments to neutralize the impact of seasonality in tax collection is in itself a desirable practice.

But it is also true that there is an increasing risk of overspending and weakened fiscal discipline. We are in need of a new system of expenditure management that can cope with such a risk, for example by gradually moving away from strategic-dominance approach toward target-based approach. The medium-term expenditure framework (MTEF) is one such option. Under MTEF, the budget authorities prepare annual budgets with a medium-term perspective in a top-down way. More will be discussed in the following on the MTEF.

9.4.3 The Budget Process

Before the Introduction of the MTEF

The budget process in the Korean central government has undergone a significant change in recent years. The government introduced the MTEF together with a top-down budgeting in 2004 for fiscal year 2005.[21] The budget process before the change is summarized in table 9.9.

The recent reform was intended to address several defects found in the previous budgeting practice. First, prior to the introduction of the MTEF, budgeting was centered on the next single budget year, lacking a medium-term perspective. MPB and the National Assembly gave little consideration to the out-years beyond the budget year. Line ministries had little information on how much resource would be available to them in the future, and their medium- to long-term planning function was severely limited. Limited planning function in turn reduced the effectiveness and efficiency of overall public spending.

It was also difficult for MPB to identify and cope with the trend increase in spending. Without a long-term view on the appropriate level of tax burden, MPB would simply allow an ever-increasing public spending to accommodate rising demands from various sectors. The focus on a single budget year also fostered incrementalism in budgeting and hindered a strategic reprioritization of spending.

In addition, the counter-cyclical role of fiscal policy could be constrained when the attention was focused on a single year. The principle of *balanced budget in each year* had the potential to produce a procyclical fluctuation in spending as illustrated in panel (a) of figure 9.19. If, on the other hand, spending increases at a constant rate as in panel (b) and the balanced budget is pursued on average over the business cycle, the so-called *automatic stabilizer* can be given a full force.

Second, before the introduction of the top-down process, budgeting relied excessively on a bottom-up approach. At the initial stage of budget preparation, MPB made rough estimates of the total size and the sectoral allocation of the next year's budget. But the estimates were not transmitted to line ministries and therefore could not guide line ministries in preparing their budget requests. When reviewing their budget requests, MPB focused on the microscopic spending control of individual programs. The sectoral allocation and the total size of the budget were determined at the last stage of budget preparation by aggregating the expenditures on individual programs.

As a result, the control of inputs assumed a major significance in budget discussions and little attention was paid to outputs or outcomes. Absorbed

21. Potter and Diamond (1999), Schiavo-Campo and Tommasi (1999), and World Bank (1998) provide a useful guide on the reform in this direction.

Table 9.9 Key steps of the budget process before the introduction of the MTEF

	Action
January	• The fiscal year starts on January 1st.
March	• The Ministry of Planning and Budget (MPB) sends the Guide to Budget Compilation to spending ministries.
May	• Ministries send budget bids to MPB by the end of May.
June–July	• MPB compiles the budget bids and prepares a preliminary budget proposal.
August–September	• MPB goes through bilateral negotiations with spending ministries between mid-August and mid-September. • MPB discusses the budget proposal with the ruling party.
October	• Authorized by the cabinet and the president, the draft budget is sent to the National Assembly by October 2nd. • In mid-October, the Committee on Budget and Accounts begins deliberation on the draft budget. Ministries are typically requested to testify at committee meetings. Meetings are normally open to the public.
December	• The draft budget is modified and approved by the Committee on Budget and Accounts and finally by the National Assembly by December 2nd.

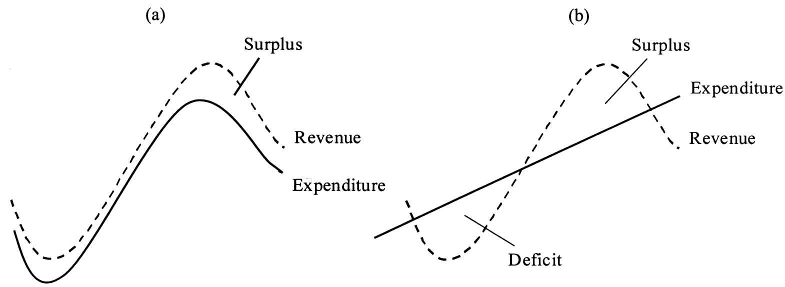

Fig. 9.19 Management of spending over the business cycles

in details, MPB had little time to review and analyze important policy issues, and the linkage between budgeting and policy making was very weak. The budget negotiation between MPB and line ministries was a very time-consuming process for both parties. The accountability and autonomy of line ministries in preparing and managing their budget were also severely limited. Line ministries usually requested an unrealistically large amount of budget, and massive cuts by MPB were inevitable.

A third characteristic of the previous budgeting practice was the central stage accorded to the general account. MPB spent most of its efforts on reviewing and preparing the budget of the general account and paid less attention to special accounts and funds.

The previous approach had certain merits. The budget authorities had large discretion over the annual spending and used their power to contain the spending growth and adjust it to changing revenue conditions. To some degree, such short-termism was inevitable in Korea where the socioeconomic environment changes quite rapidly and unexpectedly. In addition, by emphasizing the input control and the regularity of budget execution, the abuse or misuse of tax money could be minimized. But the growing size and complexity of budget is making it necessary for MPB to deregulate the budgeting process, enhance autonomy and accountability of line ministries, and focus on the strategic management of public finance.

After the Introduction of the MTEF

With the introduction of the MTEF and the top-down budgeting, all these practices are changing. Now the annual budgeting exercise starts with a discussion on fiscal policy over a five-year period including the current year, the budget year, and three out-years. Following this discussion, MPB transmits spending ceilings for sectors and programs to line ministries.[22] These ceilings encompass the general and special accounts and funds. Line ministries are asked to prepare their budget requests within these ceilings. When reviewing the ministerial budget requests, MPB places less emphasis on the microscopic control of line items and more on the strategic alignment of budget requests with overall policy directions.

Key steps of the new budget process are explained in table 9.10. The budget cycle starts in January, earlier than in previous years. The workload of budget examiners are accordingly spread out over a year rather than concentrated in July and August. This is deemed another merit of the new system.

The new system is already producing tangible results. In fiscal year 2005, the budget requests by line ministries represented an increase of 11.7 percent over the previous year's budget. This was much smaller than the 30.8 percent increase in fiscal year 2004. Line ministries also voluntarily shuffled a larger portion of their spending across programs, cutting back 2.7 trillion won on existing ones and introducing new ones worth 3.0 trillion won. The corresponding figures for fiscal year 2004 were 1.6 and 1.5 trillion won, respectively.

Room to Improve

There is of course room to improve. The first three points explained in the following concern the behavioral changes that are needed in MPB and line ministries over the medium term. The next seven points concern the changes in the budgetary system and MTEF that need immediate attention.

22. Ceilings are set for 14 spending areas such as social infrastructure, agriculture, education, and environment and then disaggregated into 56 programs. For example, social infrastructure has 7 programs, including roads, railways, subways, seaports, airports, housing, and water resources. Separate ceilings are also set within each program for the general account and various special accounts and funds.

Table 9.10 **Key steps of the budget process after the introduction of the MTEF**

Action	
December	• The Ministry of Planning and Budget (MPB) sends to line ministries standard assumptions on macro-variables such as inflation, interest rates, exchange rates, etc. • Sectoral task forces are organized. They are composed of private-sector experts and government officials from MPB and relevant ministries.
January–April	• Line ministries submit to MPB their estimates of spending needs over the next 5 years by the end of January. • Sectoral task forces discuss major policy issues and present their recommendations in a series of public hearings held in March and April. • By the end of April, MPB prepares a draft National Fiscal Management Plan (NFMP) through discussions with line ministries. The draft NFMP contains major policy directions and fiscal aggregates (total spending, deficits, debts, etc.) for the next 5 years and tentative spending ceilings on sectors and programs for the budget year.
Cabinet meeting	• At the end of April, a cabinet meeting, chaired by the president, is held in a secluded place to discuss and finalize the ceilings. • Following the meeting, the ceilings are transmitted to line ministries in the Guide to Budget Preparation.
May–June	• Line ministries prepare their budget requests and send them to MPB.
July–August	• MPB prepares the draft budget. Less emphasis is placed on the microscopic control of line items and more on the strategic alignment of budget requests with overall policy directions.
August–December	• Goes through the same process as before the introduction of MTEF.

First, performance management in line ministries should be strengthened. In the discussion on policy directions and resource allocation, performance information can provide a valuable guide. There have been efforts in this direction, but none of them have yet succeeded in instilling performance orientation in line ministries. Details on the current reform efforts will be given in the next subsection.

Second, the planning and priority-setting capacity in line ministries should be enhanced. For example, line ministries should be required to publish long-term strategic plans, annual business plans, and annual performance reports. The planning and budget divisions of individual line ministries should play a greater role in the coordination of ministerial policies and budget requests unlike in previous years when they would simply compile budget requests from program divisions and send them to MPB with little modification.

Third, the role of MPB should also be changed. As a central coordinator of government policies, MPB should strengthen its capacity for policy analysis and long-term forecasts. It should stress less on input control and pay more attention to outputs and outcomes. It should act as a consultant for line ministries to enhance their program performance and strive to build mutual trust in a collective action game.

Fourth, the medium-term targets in the MTEF should be clarified. Presently, it is not clear which variable the government is targeting at in the medium term—the budget balance, the total spending, or the debt-to-GDP ratio. They are presented in NFMP merely as "projections" rather than as "targets." An ideal strategy would be targeting at a balanced budget over the business cycle.[23] Deficits are allowed in a period of slow growths but they are subsequently offset by surpluses in a period of high growths, and the accumulation of debt is held down over the cycle. The debt-to-GDP ratio declines slowly as the GDP expands. Examples of this strategy can be found in the Growth and Stability Pact (GSP) of the European Economic and Monetary Union (EMU), the *golden rule* of the British government, and the 2-percent structural surplus rule of the Swedish government.[24]

Fifth, it is necessary to set out the annual operational targets that can guarantee the achievement of the medium-term targets. There are two types of operational targets commonly employed, namely *budget balance* and *total spending.* A prime example of the former is the 3-percent deficit rule of the EMU. In contrast, the Swedish government imposes an expenditure ceiling on each of the three years ahead. The United Kingdom has adopted similar practices for expenditure control. The U.S. federal government experimented with both types of targets in the 1980s and 1990s (see box).

Between these types of targets, total spending is a superior choice because (a) it is less influenced by the cyclical position of the economy and therefore easier to control; and (b) it assists in a counter-cyclical management of fiscal policy by leaving the balance to fluctuate flexibly over the cycle. Presently, the Korean government intends to keep the annual spending totals unchanged in successive NFMPs, and thus appears to have the total spending as annual targets. But this point needs to be clearly communicated to the public.[25]

Sixth, it is desirable to introduce various risk analyses in the National Fiscal Management Plan. Such analyses would address such issues as (a)

23. Given the low level of debt-to-GDP ratio in Korea, it seems unnecessary to target at surpluses over the cycles.

24. The GSP commits the member countries to achieve and maintain a budget position of close to balance or in surplus over the cycle. The golden rule allows the British government to borrow only to invest and not to fund current spending over the cycle. The current Swedish government is targeting at an average surplus of 2 percent of GDP over the cycle (Gustafsson 2004).

25. With a fixed total spending, it may be difficult to cope with an unexpected surge of spending needs, for example in times of economic hardship. An escape clause may be needed that is not too lax to undermine fiscal discipline or too stringent to accommodate reasonable demands for increased spending.

Experience of the U.S. Federal Government on Deficit Control

The United States experimented with both types of annual operational targets explained in the text. In the 1980s, targets were set up for budget deficits. The Gramm-Rudman-Hollings Act of 1985 (GRH I) prescribed deficit ceilings in nominal dollars for the next five years. The strategy, however, did not work. The actual deficits exceeded the stipulated ceilings in all years covered by GRH I. In 1987, GRH II was enacted and the deficit ceilings were adjusted upward to accommodate this reality. But it did not take long before GRH II also proved to be a failure.

In 1990, a new strategy was adopted with the enactment of the Budget Enforcement Act (BEA). Instead of setting limits on deficits, the congress introduced separate rules for discretionary spending and mandatory spending. On discretionary spending, cash limits were imposed for the next five years. Except in special circumstances, these limits were not to be breached. For mandatory spending (interest payments, social security benefits, etc.), which depend on exogenous variables such as interest rates and the number of the elderly, the so-called "pay-as-you-go (PAYGO)" principle was introduced. In PAYGO, any increase in deficits resulting from policy changes should be offset by corresponding changes in revenues or mandatory spending.

The new strategy worked well. It was renewed in 1993 and 1997. Actual spending on discretionary programs turned out to be larger than stipulated in the law every year except in 1996 (see table 9.11). But the excess was always less than 1 percent of the stipulated amounts, and was mostly due to exception events such as the Gulf war and natural disasters.

Helped by the strong economy, the United States could attain budget surplus in 1999 for the first time since the mankind set foot on the moon. The unusually long period of boom in the 1990s boosted revenues above and contained the mandatory spending below the levels expected at the beginning. But it would be unfair to say that all surpluses were due to the strong economy. The rules introduced by BEA appear to have been quite effective in controlling expenditures and thereby reducing budget deficits.

First of all, these rules were aimed at controlling what could actually be controlled. Discretionary spending is by definition amenable to annual controls by the congress. Mandatory spending can also be controlled through the PAYGO rule by changing relevant laws. On the other hand, budget deficits are difficult to control because they are affected by business cycles as well as by government policies. When a target cannot be directly controlled by the authorities in charge, it is difficult to hold them responsible for the results, and we cannot be sure that they will make their best effort to achieve the target.

the deviation of medium-term growth rates and other macroeconomic variables from their projected levels; (b) explicit and implicit contingent liabilities of the government coming from loan guarantees, public corporations, local governments, and others; and (c) population aging.

Seventh, a mechanism for *baseline* projections should be established. MPB currently provides line ministries with standard assumptions on key macrovariables such as wage and price inflation. Based on these assumptions, line ministries project their spending needs for the next five years. But they should go further and distinguish between spending on existing programs (*baselines*), costs of new policy initiatives, and *savings options.* MPB would check the validity of ministerial projections and aggregate

Table 9.11 **Expenditures and revenues of the U.S. federal government (in billions of dollars)**

		1994	1995	1996	1997	1998
Total spending	BEA estimates	1,523	1,578	1,645	1,745	1,843
	Actuals	1,462	1,516	1,561	1,601	1,653
Discretionary spending	BEA limits	537	539	547	547	548
	Actuals	544	545	534	549	555
Mandatory spending	BEA estimates	765	795	843	920	996
	Actuals	715	738	785	809	855
Revenues	BEA estimates	1,230	1,306	1,379	1,440	1,523
	Actuals	1,259	1,352	1,453	1,579	1,723
Deficits/surpluses	BEA estimates	–270	–230	–266	–305	–320
	Actuals	–203	–164	–107	–22	70

Source: OECD (1999).

them to arrive at the government-wide baselines, costs of new policy initiatives, and savings options. Only then can the annual budgeting be closely linked with the National Fiscal Management Plan.

Eighth, a reconciliation process should be put in place to analyze the difference between projected levels of revenue, spending, balance, and debt and their outturns. This is a critical step to secure accountability and transparency of macrofiscal management. In case of the U.S. federal government, the deviation is decomposed into economic, policy, and technical factors.

Ninth, the internal auditing within line ministries and government agencies should be strengthened. An increased autonomy in financial management should be accompanied by an increased awareness of the possibility of fraud, waste, and abuse. In this regard, we can refer to the case of the U.S. federal government, where the independence of internal auditors is guaranteed by the inspector general system, and consider introducing a similar system.[26]

Tenth, *program budgeting* needs to be introduced. The Korean government is currently redesigning the structure of its budget accounts around functions, administrations, and programs. The effort is spearheaded by the

26. Under the Inspector General Act of 1978, the president appoints inspectors general (IGs) for certain specified federal establishments, by and with the consent of the Senate, without regard to political affiliation and solely on each individual's experience in specified areas. Under the Inspector General Amendments of 1988, the heads of designated federal entities appoint IGs, without the necessity of Senate confirmation. The IG Act identifies 26 federal establishments that are to have an IG appointed by the president with Senate confirmation and 30 designated federal entities that are to have an IG appointed by their agency heads. The IGs perform audits in accordance with generally accepted government auditing standards and report suspected violation of criminal law to the Attorney General. Each IG must prepare semiannual reports that summarize the IG's activities. The head of each agency transmits these reports unaltered to Congress and subsequently makes them available to the public (U.S. GAO 1998).

Budget and Accounting Reinvention Office (BARO).[27] The resulting program structure will make it easier to allocate resources according to the national priorities and set ceilings on sectoral spending. *Programs* will also act as the basic units of performance management in the future. More will be discussed on program budgeting shortly.

9.4.4 Performance Management

Overview

As noted previously, budgeting in Korea has traditionally been focused on the ex ante control of inputs. The authorities have little experience in performance management by such tools as performance monitoring and program evaluation. There is no established feedback mechanism that supplies performance information to those in charge of budget preparation and execution, which partly explains the continuation of some ineffective and inefficient programs.

Performance management becomes more important with the introduction of the MTEF and top-down budgeting. These changes will allow greater autonomy to line ministries and can lead to greater inefficiency unless complemented by a new mechanism to secure accountability on the part of line ministries.

Figure 9.20 describes the basic framework of performance management. Starting from the mission of an organization, we set up strategic goals, performance goals, and performance indicators (see table 9.12). Actual performance is assessed through performance monitoring, program evaluation, or program review. These works are documented in strategic plans, annual performance plans, and annual performance reports. Table 9.13 compares the three tools for performance assessment—monitoring, evaluation, and review. Key differences between evaluation and monitoring are listed in table 9.14.

In recent years, diverse efforts have been made to strengthen performance management in government. Some of them are listed in table 9.15. In the following, detailed explanation will be given on Performance Management of Budgetary Programs (PMBP), Self-Assessment of Budgetary Programs (SABP), and Evaluation of Budgetary Programs (EBP).

Performance Management of Budgetary Programs (PMBP)

Performance Management of Budgetary Programs corresponds to performance monitoring in the previous discussion. It is led by MPB, and its

27. BARO is a special task force organized in 2004 to lead reforms in the area of program budgeting, financial reporting, government financial statistics, and the IT system. It is officially part of MPB but composed of secondees from various organizations including MPB, MOFE, MOGAHA, and BAI.

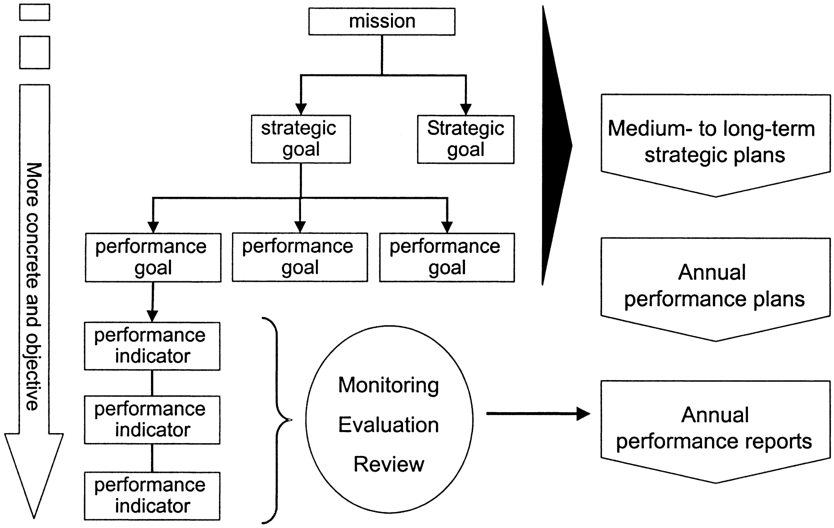

Fig. 9.20 Framework of performance management

Table 9.12 Meanings and requirements

Term	Meanings and requirements
Mission	Means . . . • Major results sought by the program or the organization as a whole. • Starting point for identifying the specific outcomes to be measured and the specific performance indicators that are needed. Should . . . • Focus on the program effect on customers and the public.
Strategic goals	Means . . . • Major policy goals that the organization pursues to complete its mission. Should . . . • Be value-free and avoid general or aspirational expressions. • Be stated clearly and succinctly. • Be minimal in number. • Be focused on the final results that the organization pursues.
Performance goals	Means . . . • Concrete goals that the organization pursues to attain its strategic goals Should . . . • Be specific enough to ascertain, with the help of performance indicators, whether the performance objectives have been achieved.

Table 9.13 **Tools of performance assessment**

Tool	Main characteristics
Performance monitoring	• Measures the program performance with a predetermined set of indicators. • Can produce information on outputs and outcomes in a frequent and timely manner at relatively low costs. • By itself, can rarely explain the causality between inputs and outputs or outcomes.
Program evaluation	• Addresses the question of why and how the program produced certain outputs and outcomes. • Employs analytical tools with varying degrees of sophistication. • Usually requires large amounts of money and time, and cannot be performed on all programs.
Program review	• Assesses the performance and other aspects of a given program with an explicit aim of helping budgetary decision-making. • Relies on information from various sources including monitoring and evaluation. • Is usually led by the central budget office (e.g., Ministry of Finance). • Requires a medium level of effort (in between monitoring and evaluation).

design follows the framework of the Government Performance and Results Act (GPRA) of the U.S. federal government. It is based on the pilot project on performance budgeting carried out in 1999 to 2002, which was not very successful in instilling performance orientation either in line ministries or in MPB.[28] Performance Management of Budgetary Programs requires line ministries to (a) set up performance goals and indicators, (b) prepare annual performance plans and reports, and (c) submit them to MPB at the start of the annual budget cycle (see figure 9.21).

A major drawback of PMBP lies in the fact that it covers only part of ministerial activities. Those activities not involving large sums of expenditure (such as pure policy making) are excluded from performance monitoring. Also, activities for which the benefits of performance monitoring are expected to be small (such as wages and salaries, *basic program* expenditures, and general administrative expenses) are excluded as well. This has the potential to lead line ministries to disregard those activities that are critical in achieving their overall mission but involve small expenditures or

28. In 2001, 39 organizations participated in the pilot. A survey of the pilot (Jun and Park 2002) found that over half of the indicators proposed in the performance reports were based on outputs and only one-fifth on outcomes. The rest were input indicators, and about two-thirds of all indicators were nonquantitative ones. The survey also found that many indicators changed from one year to another, making it difficult to trace program performance over time consistently. It subsequently proposed the government to applying performance indicators only to major large-sized expenditure programs for which quantitative indicators are easy to construct.

Table 9.14 **Key differences between evaluation and monitoring**

Monitoring	Evaluation
• Periodic • Assumes appropriateness of program, activities, and indicators • Tracks progress against small number of indicators • Usually quantitative • Use data routinely gathered or readily available • Cannot indicate causality • Difficult to use for impact assessment • Usually internal	• Usually episodic • Can address a wide range of potential questions about a policy, program, or project • Can identify what has happened as a result of an intervention and provide guidance for future directions • Can address "how" and "why" questions • Wide range of quantitative and qualitative research methods possible • Can use data from different sources • Can identify unintended as well as planned impacts and effects • Can involve internal, external, or self evaluation

Source: Perrin (2002).

Table 9.15 **Diverse initiatives for performance management**

Performance management initiatives	Organizations in charge
Performance Management of Budgetary Programs (PMBP)	Ministry of Planning and Budget (MPB)
Self-Assessment of Budgetary Programs (SABP)	MPB
Evaluation of Budgetary Programs (EBP)	MPB
Government Operations Assessment System (GOAS)	Office of Government Policy Coordination (OGPC)
Management by Objectives (MBO)	MOGAHA
Performance Audit	BAI

Fig. 9.21 Structure of PMBP

only wages and salaries, and to lose sight of the linkage between the overall mission, strategies, and performance goals.

Unlike GPRA, PMBP does not require strategic planning on the part of line ministries. This is understandable given the position of MPB within the government. MPB is only one of many ministries under the prime minister's office and cannot impose such a broad requirement as strategic planning on line ministries. But the lack of strategic planning renders it difficult to focus performance management exercises on the core values of the ministries and to derive performance indicators from ministerial missions in a systematic fashion.

Performance Management of Budgetary Programs, like its pilot project, has not been very successful. There appears to exist only a lukewarm support from the top management in MPB. Line ministries are also showing little enthusiasm for the PMBP. Most importantly, performance reports are not open to the public, giving little incentive for line ministries to think seriously about the exercise.

The general failure of PMBP can be explained in several ways. First, it has been and will be very difficult to set up quantitative indicators for many government activities, especially when the activity has diverse (and sometimes conflicting) objectives, takes many years to attain the desired objectives, is only one of many factors affecting the outcome, or does not lend its performance to quantitative measurement by its own nature. Second, and more importantly, PMBP is not attracting sufficient attention from major stakeholders such as the budget examiners in MPB, managers in line ministries, parliamentarians, and the general public. Performance information provided by PMBP is not detailed enough for budget examiners in MPB and parliamentarians involved in funding decisions on individual programs. Managers in line ministries do not find the information useful in managing their programs. And the general public cannot even access the information because the reports are not open to them. In short, it is hard to find real demands for PMBP.

Fortunately, efforts are being made to repair PMBP. According to MPB, from this year on, all activities (budgetary and nonbudgetary) will be covered by PMBP, and reports will be open to the public. Real demands for performance information are being created through SABP and EBP as will be explained in the following. But still there is no requirement for strategic planning. So long as strategic plans provide an overarching framework for results-oriented management, including PMBP, SABP, and EBP, the Korean government (to be specific, MPB in coordination with the prime minister's office) should seriously consider introducing strategic planning in ministries.

In the United States, federal agencies should prepare strategic plans, performance plans, and performance reports under the GPRA. Following these examples, prescribing more detailed requirements in Korea would help enrich the performance plans and reports prepared by line ministries. MPB or any other central agency[29] can also review them periodically, rate their quality, and propose best practices.

Self-Assessment of Budgetary Programs (SABP)

Self-Assessment of Budgetary Programs, a form of budget review, is also led by MPB. It was designed after the Program Assessment Rating Tool (PART) of the U.S. federal government. It requires line ministries to assess their own programs with spending levels above a certain threshold in a cycle of three years. The assessment is based on 16 questions common to all types of programs and a few additional questions specific to different types of programs.[30] Table 9.16 lists the common questions asked.

Answers to the questions take the form of "yes (1)" or "no (0)." In case of the questions regarding the achievement of program objectives and the customer satisfaction, 4-scale answers (1.00, 0.67, 0.33, 0.00) are given. A weight is assigned to each question and the overall assessment is based on the weighted sum of the answers. Programs are then classified as "effective (85–100)," "moderately effective (70–84)," "adequate (50–69)," and "not effective (0–50)." MPB reviews the results of ministerial self-assessments, and makes the final assessment.

In 2005, 555 programs were assessed (table 9.17). Among them, 87 (15.7 percent) were classified as *not effective,* and their funding was cut by 10 percent with some modifications. Such practice of directly linking performance to budgeting has been held as taboo by many experts mainly because decision making should be based not solely on a limited set of performance information but on broad considerations on, for example, the social needs for the programs. But MPB felt that without a direct linkage, it would be very difficult to invoke serious interest in SABP from line ministries. Certainly their strategy worked, and they plan to continue this exercise annually.

Even though SABP succeeded in creating *real demands* for performance information within MPB and also in line ministries, improvements are needed in several aspects. Just like PART, SABP increased the workload of budget examiners substantially. It will increase further in coming years as the assessed programs accumulate and the examiners need to reassess the old cases when necessary. To alleviate this problem, an arrangement was made this year with the small division in charge of coordinating SABP

29. The National Assembly Budget Office and the Evaluation Research Institute of the Board of Audit and Inspection can play the role of GAO in this respect.

30. Types of programs are infrastructure investment, procurement of large-scale facilities and equipment, provision of direct services, capital injection, subsidies to private entities, grants to local governments, and R&D.

Table 9.16 Common questions for the SABP

Section	Common questions
Program design	• Does the program have clear purposes and legal or other bases? • Can the government intervention be justified? • Is government spending necessary to achieve the objectives? • Is the program duplicative of other program? • Has the program been subjected to an objective feasibility study? • Is the proposed program design most cost-effective? • Are performance goals and indicators in place? • Do performance goals and indicators fully reflect program objectives? • Are the targets set at reasonable levels?
Program management	• Is the implementation being monitored regularly? • Is the program being implemented as planned? • Are efforts being made to reduce costs or increase efficiency?
Performance assessment and feedback	• Has an objective and comprehensive program evaluation been conducted? • Did the program achieve the intended objectives? • Are customers and stakeholders satisfied with the program performance? • Is the agency utilizing the assessment results for program improvement and budget planning?

Table 9.17 Results of 2005 SABP

Total	Effective	Moderately effective	Adequate	Not effective
555	28	99	341	87
100.0 (%)	5.0	17.9	61.4	15.7

efforts within MPB making a preliminary assessment of the documents prepared by line ministries, and then passing their opinions to budget examiners who make the final assessment. This arrangement is not necessarily optimal given the limited capacity of that division and the possible lack of ownership in SABP results by budget examiners. Greater resource for SABP is being called for.

In addition, efforts are needed to go beyond scoring the programs. The U.S. Office of Management and Budget (OMB) makes recommendations for line ministries to improve their program performance (figure 9.22). This year, MPB plans to start producing recommendations for line ministries. It remains to be seen how effective these recommendations will be to improve the program efficiency and effectiveness. In the United States, difficulties were encountered in communicating OMB's intentions to line ministries, prioritizing among many different recommendations, and securing adequate resources within OMB for the follow-up of recommendations. MPB should prepare themselves for similar difficulties.

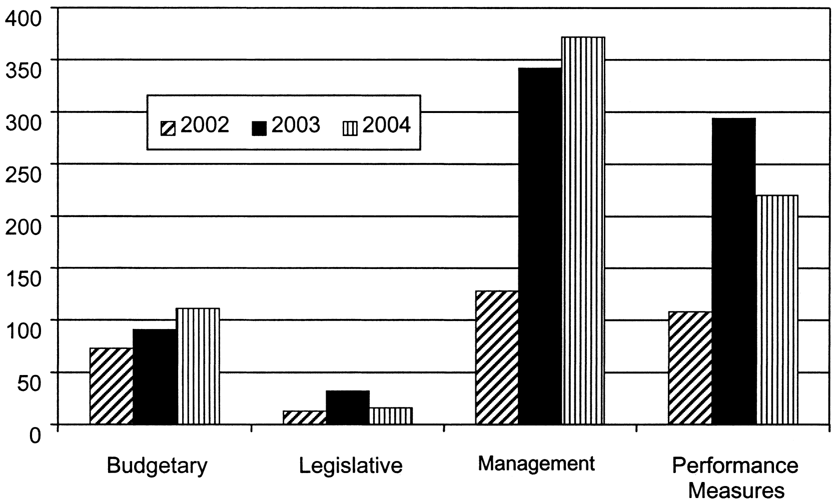

Fig. 9.22 Number of recommendations
Source: U.S. Office of Management and Budget.

Evaluation of Budgetary Programs

The last addition to the armory of performance management is Evaluation of Budgetary Programs (EBP), which is an effort led by MPB to set up a systematic approach to program evaluation in line ministries.

Each year, MPB would commission evaluation studies on programs that it considers need critical assessment. Korea Development Institute (KDI) organizes evaluation teams and oversees the studies. For this purpose, KDI has published a manual for program evaluation, which details the process and standards to be followed by evaluation teams.

Three programs were evaluated from late 2005 to early 2006 on a pilot basis. From 2006 on, around 10 programs will be evaluated each year. Pilot studies uncovered various difficulties in carrying out the evaluation. Most programs lacked clearly specified goals and necessary data to assess the achievement of goals. Evaluators found it difficult to understand the structure and context of individual programs and official documents were not of much help in this regard. MPB and line ministries often had different expectations on evaluation, with the former focusing on funding decisions and the latter on program management, which cannot be easily reconciled with each other.

To overcome these difficulties, KDI's evaluation manual stresses the importance of, at the start of evaluation studies, asking line ministries to provide sufficient details of the program, identifying the program structure and context, redefining the program objectives, describing the intervention logic of the program, setting up performance indicators and benchmarks for program success, and deciding on the purpose and scope of the evaluation. These steps should be taken in a transparent way and in full cooperation with relevant stakeholders including the ministries in charge of the program and MPB.

Perhaps the most difficult part would be describing the intervention logic and setting up performance indicators. The manual recommends the use of logic models for this purpose. Figure 9.23 gives an example of a logic model in the case of a road-safety campaign.

EBP is expected to provide information on program performance that can be used for SABP. In fact, the first question of the last section in table 9.16 asks whether an objective and comprehensive program evaluation has been conducted for a program. On the other hand, the information gathered through SABP can be used in the selection of candidate programs for EBP. In this sense, PMBP and SABP are complementary to each other. A similar relationship exists between EBP and PMBP. EBP can propose new and refined performance indicators for PMBP, as explained previously. At the same time, EBP can utilize the performance data collected through PMBP in conducting evaluation.

EBP has many challenges to overcome in the coming years. The ultimate aim is to set up a standard and provide examples for program evaluation, and to instill *evaluation culture* in line ministries, which, we hope, will conduct evaluation voluntarily on their own programs as part of their daily business.

9.4.5 Program Budgeting

Presently, the budget is classified first by the general and special accounts and funds. Then within these accounts and funds, it is further divided up by five levels of classification—chapters, sections, subsections, items, and subitems.[31] MPB usually examines the budget requests by line ministries at the level of subitems, which totaled 8,038 in fiscal year 2006. Such a detailed control of inputs by the central budget office produced many problems mentioned previously—weak linkages between budgeting and policy making, tiresome budget negotiation between MPB and line ministries, and limited accountability and autonomy of line ministries.

The present classification system has other drawbacks as well. Funding for a program is often scattered across various accounts and funds. For example, the development of fishing villages and ports is simultaneously funded by the general account, three special accounts (fiscal financing, agricultural and fisheries structural adjustment, balanced national devel-

31. The first three of these are controlled by the parliament, while the last two by MPB. For example, when a ministry wants to shift appropriation from a subsection to another, it needs an approval from MPB *and* the parliament. But when it wants to shift appropriation from an item to another, it needs an approval only from MPB.

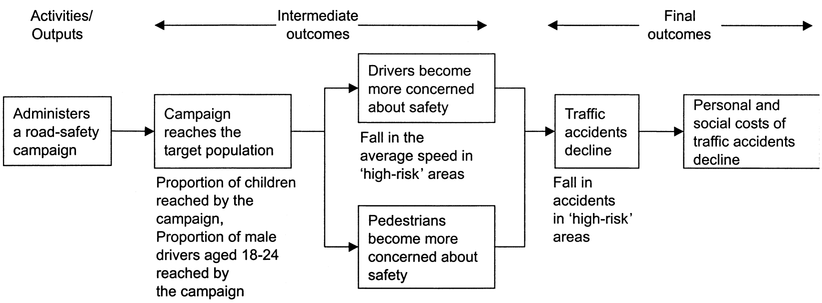

Fig. 9.23 Intervention logic of a road-safety campaign

opment), and one fund (fisheries development). This makes it difficult to identify the total amount of funding provided for a program, and manage its performance.

Inconsistency is another problem; some items or subitems cover a wide range of activities and involve a large amount of funding, while others are associated with very specific activities and a small amount of funding.

To remedy these problems and support other reform initiatives—medium-term expenditure framework and performance management—MPB set out to introduce *program budgeting*. In essence, four instead of five levels of classification are brought in, the input controls are drastically reduced, and the classification by accounts and funds is abolished. The new classification is shown in figure 9.24. The present 26 chapters, 79 sections, and 718 subsections are regrouped into 16 areas and 68 sectors; 718 subsections and 2,411 items into 1,043 programs; and 8,038 subitems into 3,594 projects. The control by MPB will be exercised at the level of projects, and that by the parliament at the level of programs. Line ministries will have full discretion on activities within each project.

9.4.6 Government Financial Statistics

The limited scope of the government financial statistics has been pointed out as one of the major drawbacks of the Korean fiscal management system. As explained previously, the consolidated central government covers the general and special accounts and funds. But it excludes some important fiscal activities of the government. For example, the National Health Insurance is excluded from the consolidated government even though it is a social insurance program that covers over 90 percent of the population. Also excluded are various quasi-government organizations and research institutions (such as KDI), which are mainly financed and whose activities are closely supervised by the government.

Even within the central government, the revenue and expenditure statistics on one hand and the government asset and liability statistics on the other hand have different coverage. The latter excludes some funds that are

Old Classification	New Classification	
Chapters (26) - Accounts (20) - Funds (26)	Areas (16) - Common for all accounts and funds	Chapters, sections, and sub-sections are reorganized into areas and sectors.
Sections (79) - Accounts (66) - Funds (79)	Sectors (68) - Common for all accounts and funds	
Sub-sections (718) - Accounts (366) - Funds (352)	Programs (1,043) - Accounts (793) - Funds (250)	Sub-sections and items are reorganized into programs
Items (2,411) - Accounts (1,419) - Funds (922)	Projects (3,594) - Accounts (3,044) - Funds (550)	Sub-items are aggregated into projects
Sub-items (8,038) - Accounts (6,291) - Funds (1,747)		

Fig. 9.24 Old and new budget classification systems

included in the former, with possible underreporting of the true size of government assets and liabilities. In addition, government assets are reported separately for credits (e.g., government loans), properties (e.g., securities and premises), cash holdings (e.g., deposits at the central bank), and supplies, making it impossible to get the overall picture of financial and nonfinancial assets.

Logical consistency is compromised also in the treatment of treasury bonds held by the National Pension Fund and other funds. These bond holdings are recorded simultaneously as government assets (as they are held by funds) and liabilities (as they are issued by the government). Ideally, such bond holdings should be netted out, and the asset and liability statistics should only reflect the transactions between the government and the private sector.

The consolidated central government also shows large discrepancies with the National Accounts in its coverage. The latter includes the National Health Insurance in the government sector but excludes some activities such as the credit programs of the National Housing Fund (NHF). As a result, the amount of government liabilities differs significantly between two statistical systems.

We have similar problems in the data for public financial and nonfinancial corporations. Together with the general government (the central and local governments and social security funds), public corporations constitute the public sector. In Korea, however, there does not exist a consistent definition of public corporations. For example, various financial funds such as the credit guarantee funds are not included in the public sector even though they have every aspect of public financial corporations. The government does not publish a comprehensive review on the financial status of individual public corporations, let alone consolidated financial statements.

This practice makes it difficult to assess the financial health of the public sector in general, and the implicit fiscal burden incurred through quasi-fiscal activities of financial funds in particular. Of particular concern are credit guarantee funds[32] that significantly expanded their activities after the recent economic crisis. At the end of 2003, the outstanding stock of guarantees amounted to 11 percent of GDP, far higher than in other countries where the public guarantees are usually less than 1 percent of GDP. Yet no reports exist that explain the future risks these funds may impose on government finance.

As a first step to address this problem, BARO is redefining the scope of the public sector. The starting point is the revised 2001 Government Finance Statistics Manual of IMF. BARO is also searching for ways to produce comprehensive, accurate, and timely information on the government financial position by introducing accrual accounting and building a new IT system. The IT system is expected to centralize an array of financial information from all organizations within the government sector. When BARO's work is completed by 2007, big improvements will have been made in financial reporting and government financial statistics.

9.5 Roads Ahead

The primary responsibilities of any fiscal management system lie in supporting aggregate fiscal discipline, allocative efficiency, and operational efficiency (Schiavo-Campo and Tommasi 1999). The Korean government had maintained aggregate fiscal discipline since the 1980s in a strategic dominance-based approach and pursued allocative and operational efficiency through a detailed input control on annual budgets. However, the changing environment after the financial crisis of 1997 necessitated a transition toward a target-based approach and a stronger emphasis on outputs and outcomes.

In response to these challenges, the government introduced the National Fiscal Management Plan, various performance management tools, program budgeting, and a new statistical system. These reforms are all in line with the *global standard* in fiscal management as espoused by international

32. These are the Infrastructure Credit Guarantee Funds; the Korea Technology Credit Guarantee Fund; the Credit Guarantee Fund for Agriculture, Forestry, and Fishery; the Korea Credit Guarantee Fund; and the Housing Finance Credit Guarantee Fund.

organizations. It is interesting to note that, unlike other developing countries where fiscal reforms are often imposed by these organizations as a string attached to the aids provided, the Korean government began the reform process on their own initiatives. Accordingly, the *ownership* of reform could be secured and genuine efforts guaranteed. The reforms could also be tailored to the specific needs of the Korean government because they were designed by *insiders* who had better knowledge on the institutional and historical context.

Even after the reform, there remain many improvements to be made in our fiscal management system as explained in the text. Consolidating the reforms will be the main challenge for the Korean government in coming years.

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Comment Gilberto M. Llanto

An observer like me can only look with envy at how the Korean government showed tight discipline in solving the persistent fiscal deficits of the 70s and 80s. Fiscal tightening in the 1980s was a delicate balancing act, but the principle of *expenditure within revenue*—or the balanced budget principle—produced wonderful results in terms of keeping the public debt at a minimal level and taming the fiscal deficit. The notable achievement of observing a balanced budget was that it was not formalized in either *law or a regulation.* It was the determined effort of the government that made the big difference. The self-discipline paid off because the Korean government could plan massive fiscal supports to troubled financial institutions when the Asian financial crisis hit the economy.

The amazing phenomenon was that the Korean government was able to reduce the ratio of government debt to GDP a few years after the financial crisis. The total public debt burden was 30 percent of GDP around 1998 to 1999 but the budget recorded a surplus of 1.1 percent of GDP in 2000. The surplus has remained in the following years. Strong economic growth and rapid increases in revenues no doubt made this possible.

Mr. Young-Sun Koh was, however, quick to point out that excluding the National Pension Fund from the consolidated balance indicates that there were "budget deficits since 1989, except in 2002."

Another indicator of fiscal health is the status of government liabilities.

Gilberto M. Llanto is a senior research fellow at the Philippine Institute for Development Studies.

I would like to thank Mr. Young-Sun Koh of the Korea Development Institute for sharing with us the very instructive experience of South Korea in addressing that country's fiscal problem and the future path of fiscal management from which developing countries such as the Philippines can draw lessons.