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Reforming the Public Expenditure System in Korea

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ABSTRACT/RÉSUMÉ

Reforming the Public Expenditure System in Korea

Although Korea has the second-lowest level of public spending among OECD countries at 22½ per cent of GDP, it faces strong upward spending pressures over the medium and longer term, which could threaten fiscal sustainability. This paper analyses the main features of Korea's public expenditure system and reviews expenditure trends and the main forces behind them. The objective is to identify the major shortcomings in budget planning, management and control systems that have impeded better public sector performance. The paper concludes by proposing policy measures to enhance the effectiveness, efficiency and transparency of the public expenditure management system. These include managing public finance within a medium-term expenditure framework; making the budgetary system more comprehensive and transparent by consolidating special accounts and public funds and bringing extra-budgetary funds into the budget; introducing more flexible and results-focused public management to improve public service delivery and accountability for results within the public sector; enhancing the role of market mechanisms in publicly funded services; and improving fiscal relations across government levels.

JEL classification: E62, H1, H4, H5, H7, I22.

Keywords: Government expenditure, public sector efficiency, budget systems, intergovernmental relations, new public management, Korea.

Réformer le système de dépenses publiques

Bien que les dépenses publiques ne représentent que 22½ pour cent du PIB, ce qui place la Corée à l'avant-dernier rang des pays de l'OCDE, les fortes pressions pour un accroissement des dépenses à moyen et long terme pourraient menacer la viabilité budgétaire. Ce papier examine les spécificités du système de dépenses publiques en Corée et il passe en revue l'évolution des dépenses et ses principaux facteurs. Le but est d'identifier les faiblesses dans le système pour formuler, gérer et contrôler le budget, qui ont empêché un meilleur résultat dans le secteur public. On proposera en conclusion un programme de réformes pour améliorer l'efficacité, l'efficience et la transparence du système de gestion des dépenses publiques. Cela comprend ; gérer les finances publiques dans un cadrage des dépenses à moyen terme ; compléter le dispositif budgétaire et le rendre plus transparent en consolidant les comptes spéciaux et fonds publics et en intégrant les fonds hors budget dans le budget ; introduire une gestion publique plus souple et plus soucieuse de ses résultats afin d'améliorer leurs prestations de services publics et d'accroître la responsabilité à l'intérieur du secteur public ; développer le rôle des mécanismes de marché dans les services financés sur fonds publics ; et améliorer les relations budgétaires intergouvernementales.

Classification JEL : E62, H1, H4, H5, H7, I22.

Mots Clés : dépense gouvernementales ; l'efficience du secteur public ; système budgétaire ; système de dépenses publiques ; relations intergouvernementales ; nouveau système de gestion publique ; la Corée.

TABLE OF CONTENTS

Tables

Figures

Boxes

REFORMING THE PUBLIC EXPENDITURE SYSTEM IN KOREA

Young-Sook Nam and Randall Jones[1]

Introduction

1. Korea has a history of fiscal prudence, reflected in relatively small budget deficits and low public debt. In gross terms, public debt is around 22 per cent of GDP, ranking well below the average of 74 per cent in the OECD area. Korea also has one of the lowest ratios of government spending to GDP (Figure 1). The level of public spending also reflects the immaturity of the social welfare system as well as the relatively low level of public services. However, Korea's public finances are facing serious pressures for increased spending. *First*, population ageing is projected to be exceptionally rapid in Korea, boosting the demand for greater spending on pensions and health. *Second*, the state-provided social safety net will expand as Korea moves away from traditional family-provided social protection. *Third*, Korea needs to prepare for the cost of co-operation with the North and eventual reunification. Meeting these challenges will require dealing with structural shortcomings of the budgeting and public expenditure management system. While the public expenditure system has been successful in maintaining aggregate fiscal discipline, it is not geared toward attaining efficient allocation of resources and maximising value for money. Furthermore, maintaining fiscal discipline through the traditional budgetary tools will be increasingly difficult, given the spending pressures that will significantly increase the share of non-discretionary spending in the government budget.

2. Building upon earlier special chapters in the *Economic Survey of Korea* on the tax system (2000) and population ageing (2001), this chapter reviews the major issues involved in enhancing the effectiveness of public spending and identifies key areas for policy action.[2] After an overview of expenditure trends and the main forces behind them, it highlights features specific to Korea. The chapter then analyses some of the main challenges, in particular: improving the budgeting and expenditure management system; enhancing the efficiency and accountability of public service delivery; and boosting the effectiveness of public spending through better intergovernmental fiscal relations. The chapter concludes by proposing an agenda for future reform.

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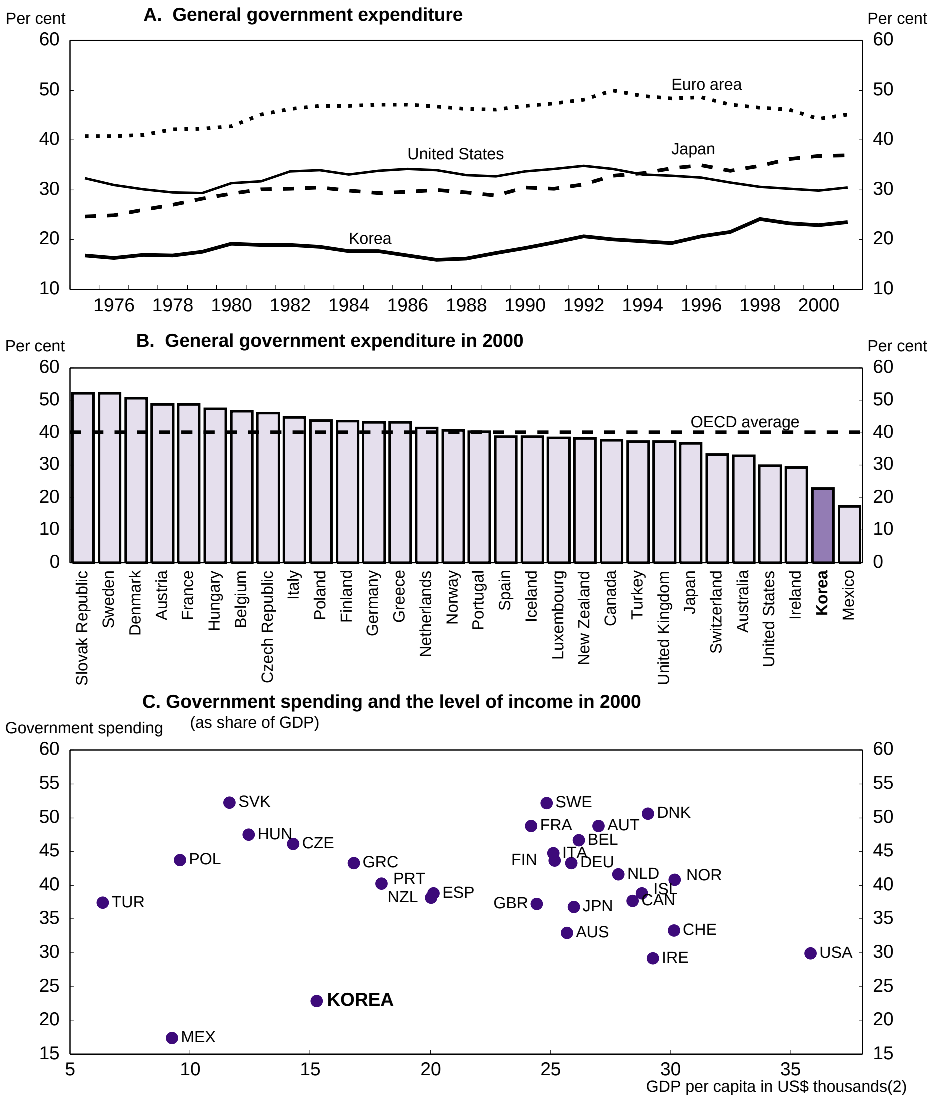
1 . This paper was originally prepared for the *OECD Economic Survey of Korea* published in March 2003 under the authority of the Economic and Development Review Committee of the OECD. Young-Sook Nam, who was then an economist in the Economics Department of the OECD, is currently a Research Fellow at the Korea Institute for International Economic Policy (KIEP). Randall Jones is head of the Japan/Korea Desk in the Economics Department of the OECD. They are indebted to Yutaka Imai, Michael Feiner, Jørgen Elmeskov, Val Koromzay, Andrew Dean and other colleagues in the OECD secretariat for valuable comments and drafting suggestions. The paper has also benefited from discussions with numerous Korean experts, in both academia and in ministries and government agencies responsible for policy-making in this area. Special thanks go to Brooke Malkin and Chantal Nicq for technical assistance and to Nadine Dufour and Jeanette Dargaville for preparing the document.

2. For an overview of public expenditure management issues in OECD countries, see Atkinson and Van den Noord (2001).

Figure 1. **Public spending in international comparison**[1]
Per cent of GDP



1. Public spending is defined as the sum of current outlays and net capital outlays. Data are based on SNA93/ESA95.
2. Converted at purchasing power parity exchange rates.

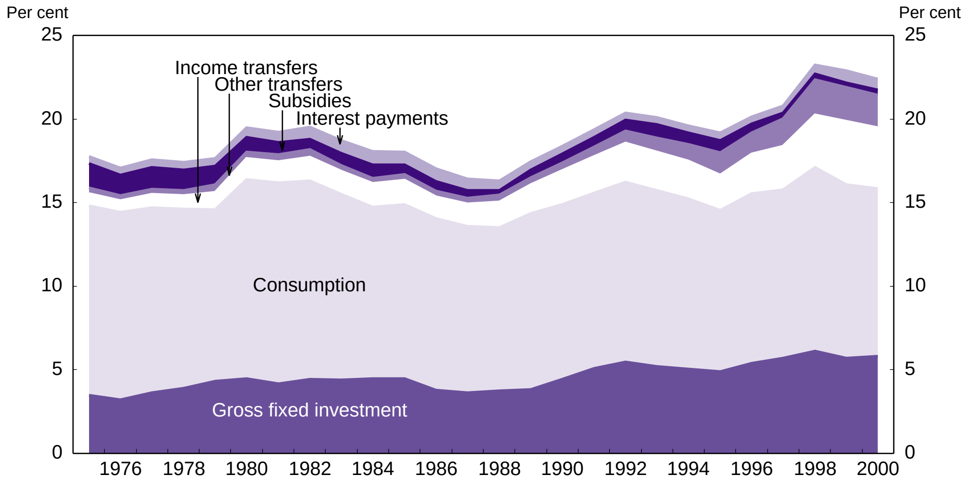
Source: OECD.

Main forces shaping public expenditure

Key features of public outlays

3. Public expenditure as a share of GDP is relatively low in Korea and its composition differs from that observed in other OECD countries. On a general government basis using national accounts, total public spending amounts to 22½ per cent of GDP, the lowest level apart from Mexico (Figure 1). While Korea's level of economic development explains this to some extent, Greece, Portugal and several central European countries with comparable or lower income levels have far higher spending levels (Panel C). The low level of spending at present is in part a result of fiscal consolidation during the mid-1980s, but also reflects longer-term trends. Traditionally, fiscal policy has aimed at promoting macroeconomic stability and maximising government saving to finance investment in public infrastructure and public corporations and to provide credit to targeted sectors. During the 1960s and 1970s, a number of special accounts and funds were set up to finance government investments and loans. New taxes were introduced to generate additional revenues for these expenditures. Large-scale public investments and loans boosted government spending to 19 per cent of GDP in the early 1980s (Figure 2), triggering budget deficits that averaged around 3 per cent of GDP (on a GFS basis) in the 1970s and peaked at 4.5 per cent of GDP in 1981. The rising deficit prompted active fiscal consolidation, which generated budget surpluses by the late 1980s. Since then, the government has maintained a very conservative fiscal policy, contributing to the currently low level of public debt and interest payments as a share of GDP.

Figure 2. **Trends in general government outlays**
Per cent of GDP



Source: OECD.

4. The breakdown of government outlays by economic category reveals that the characteristics of public outlays differ greatly from most other countries (Table 1). In particular, there are three major factors that underlie the comparatively low spending level in Korea. *First*, income transfers are limited by the lack of a well-developed social safety net. At 3.6 per cent of GDP, such spending is a quarter of the OECD average, although it is higher than that in Mexico. *Second*, government consumption, at around 10 per cent of GDP, is well below the OECD average of 17 per cent. *Third*, relatively low public debt translates into modest interest payments as a share of GDP. In contrast, public investment is exceptionally high, with net capital outlays exceeding 8 per cent of GDP.

Table 1. **General government spending by economic category**
Per cent of GDP in 2001

	Income transfers	Subsidies	Interest payments	Consumption	Net capital outlays	Total outlays
Korea (2000)	**3.6**	**0.3**	**0.7**	**10.1**	**8.3**	**23.0**
Australia	8.9	1.2	2.2	17.9	2.6	32.8
Austria	18.6	2.6	3.8	19.1	5.5	49.7
Belgium	14.4	1.6	6.6	21.7	2.2	46.5
Canada	11.0	1.5	6.7	18.7	0.2	38.0
Czech Republic	13.2	3.1	1.0	21.0	9.0	47.3
Denmark	17.0	2.0	4.1	25.5	2.1	50.7
Finland	12.5	1.5	2.7	21.0	6.6	44.3
France	17.8	1.2	3.2	23.3	3.3	48.8
Germany	18.9	1.6	3.3	19.0	3.0	45.7
Greece	15.9	0.2	6.2	15.5	4.3	42.1
Hungary	11.9	5.1	4.9	21.0	6.1	49.1
Iceland	4.2	1.8	3.7	23.6	6.4	39.6
Ireland	9.1	0.8	1.5	13.8	5.0	30.0
Italy	16.7	1.1	6.4	18.5	3.8	46.4
Japan (2000)	10.0	0.9	3.3	16.8	6.0	37.0
Luxembourg	14.9	1.7	0.3	17.3	4.4	38.6
Mexico (2000)	1.7	0.3	3.6	11.1	5.3	21.8
Netherlands	11.6	1.5	3.5	23.2	2.2	42.0
New Zealand (1997)	12.7	0.3	3.1	18.6	3.4	38.2
Norway	13.8	2.2	1.8	20.3	3.2	41.2
Poland (2000)	17.5	0.9	4.0	15.5	4.3	42.3
Portugal	12.5	1.4	3.1	20.7	4.4	42.0
Spain	12.2	1.1	3.1	17.5	3.6	37.5
Sweden	18.5	1.5	3.4	26.7	2.2	52.2
Switzerland (2000)	11.5	1.7	2.0	13.7	4.2	33.2
United Kingdom		0.5	2.4	19.4	2.2	38.2
United States	13.7	0.5	3.4	15.1	0.9	31.2
Euro area[1]	16.5	1.4	4.0	19.9	3.4	45.2
OECD[1] total	12.4	0.9	3.5	17.1	2.9	36.9

1. Weighted average.
Source: OECD.

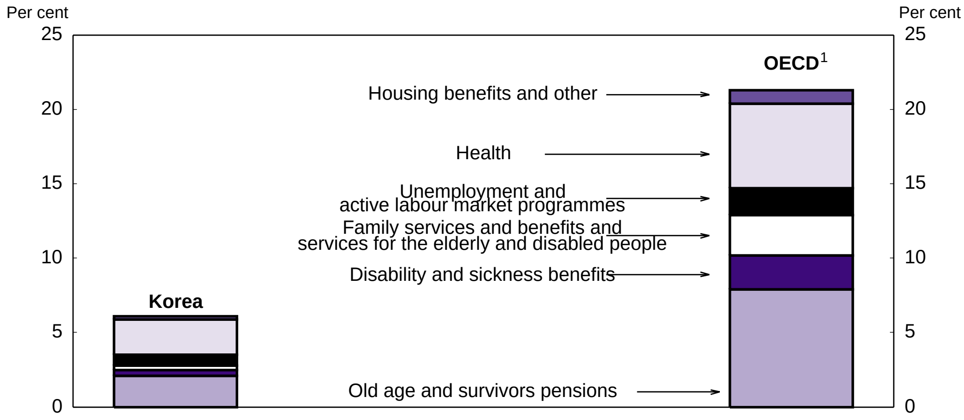
The low level of income transfers has limited the growth of government spending

5. The low, albeit rising, level of income transfers, reflects the fact that Korea's government-funded social safety net is at an early stage of development (Figure 3).[3] The low level is partially offset, though, by a relatively high level of privately funded social expenditure, both mandatory and voluntary (Table 2). Indeed, the proportion of privately funded social expenditures is the highest in the OECD area. This is largely due to the retirement allowance that firms are legally required to pay and voluntary social benefits, such as family allowances paid by many employers.[4] Even so, total social expenditure, public and private, is still only 8 per cent of GDP, compared with 15 per cent in Japan and 20 per cent or more in all the other OECD countries for which data are available. However, the level of support provided by the family, especially for the elderly, is likely to be higher in Korea than elsewhere.

3. The establishment of the social safety net reflected a widening of basic priorities to include social welfare as well as economic growth. This led to the establishment of a national pension system in 1988, national health insurance in 1992 and unemployment insurance in 1995. The current low level of publicly funded social expenditures reflects the immaturity of the pension system, which has few beneficiaries at present.

4. In most OECD countries, public social expenditure is lower on a *net* (after tax) than on a *gross* (before tax) basis since governments tend to claw back more money through taxation of public transfer income than the value of the tax advantages awarded for social purposes. In contrast, net public social expenditure is estimated to be higher in Korea and the United States. In 1997, net public social expenditure in Korea was 4.6 per cent of GDP, whereas gross public social expenditure was 4.4 per cent of GDP (Adema, 2001).

Figure 3. **Composition of publicly funded social expenditure**
Per cent of GDP



1. Unweighted average of 29 countries.
Source: OECD.

Table 2. **Social expenditures in OECD countries**
Per cent of GDP in 1997[1]

	Public	Private			Total	Share (%)	
		Mandatory	Voluntary	Total		Public	Private
Korea	**4.3**	**2.4**	**1.8**	**4.2**	**8.4**	**50.7**	**49.3**
Australia	17.4	1.1	3.2	4.3	21.7	80.2	19.8
Austria	25.4	0.8	0.8	1.6	27.0	94.1	5.9
Belgium	27.2	1.5	0.9	2.4	29.5	92.0	8.0
Canada	17.9	0.0	4.2	4.2	22.1	81.1	18.9
Czech Republic	19.4	0.0	0.0	0.0	19.4	100.0	0.0
Denmark	30.7	0.4	0.9	1.3	32.0	96.0	4.0
Finland	28.7	0.1	1.1	1.2	30.0	95.8	4.2
Germany	26.4	1.2	1.0	2.2	28.6	92.3	7.7
Ireland	17.6	0.0	1.6	1.6	19.2	91.6	8.4
Italy	26.4	1.3	0.1	1.4	27.8	94.8	5.2
Japan	14.0	0.5	0.4	0.9	14.9	94.0	6.0
Netherlands	24.2	0.7	4.2	4.9	29.1	83.1	16.9
New Zealand	20.7	0.0	0.5	0.5	21.3	97.6	2.4
Norway	26.1	1.1	0.0	1.1	27.2	96.1	3.9
Sweden	31.8	0.4	2.6	3.0	34.8	91.4	8.6
Switzerland	22.4	4.8	1.1	5.9	28.3	79.2	20.8
United Kingdom	21.2	0.4	3.4	3.8	24.9	85.0	15.0
United States	14.7	0.4	7.8	8.2	22.9	64.3	35.7
Average of above countries	21.9	0.9	1.9	2.8	24.7	87.3	12.7

1. Social expenditure includes: old-age cash benefits; disability cash benefits; occupational injury and disease benefits; sickness benefits; services for the elderly and disabled; survivor benefits; family cash benefits; family services; active labour market policies; unemployment compensation; housing benefits; public health expenditure; and other contingencies, *e.g.* cash benefits to those on low income.

Source: Adema (2001) and OECD, *Society at a Glance 2001*.

The small public sector has also contained government consumption

6. Government consumption is well below the OECD average, reflecting the small size of the public sector in Korea. Public-sector employment is relatively low by international standards, accounting for less than 5 per cent of total employment (Table 3). Moreover, it has been on a declining trend with a 7 per cent reduction between 1997 and 2001. The government has also tightly controlled its wage bill, although there have been significant increases in the past few years as part of the goal of boosting civil servant wages to parity with comparable private-sector levels by 2004. In addition, high co-payments by the private sector for many publicly provided services limit government spending. For example, although public spending on education is below the OECD average, public and private spending together total 7 per cent, one of the highest levels among member countries (Figure 4).[5] In the area of healthcare, private spending also accounts for almost half of total spending, as is the case in the United States and Mexico.

Table 3. **Public-sector employment in international comparison**[1]
Per cent of total employment

	1990	1995	1997	1999	2001
Korea[2]	**4.5**	**4.4**	**4.4**	**4.3**	**4.1**
Australia	22.0	19.3	17.5	16.6	16.2
Canada	20.3	19.8	18.4	17.3	16.9
Czech Republic	n.a.	n.a.	15.2	15.2	12.3
Finland	23.3	24.8	25.0	23.5	23.0
France	n.a.	n.a.	20.2	20.0	n.a.
Germany	n.a.	12.8	12.4	11.6	n.a.
Hungary	n.a.	n.a.	22.8	21.3	20.7
Ireland[2]	17.3	17.1	16.1	14.6	14.9
Italy	n.a.	n.a.	15.5	15.2	n.a.
New Zealand	n.a.	13.4	12.6	13.1	12.5
Spain	13.9	15.4	15.2	14.4	13.4
United States	15.0	14.9	14.6	14.5	n.a.

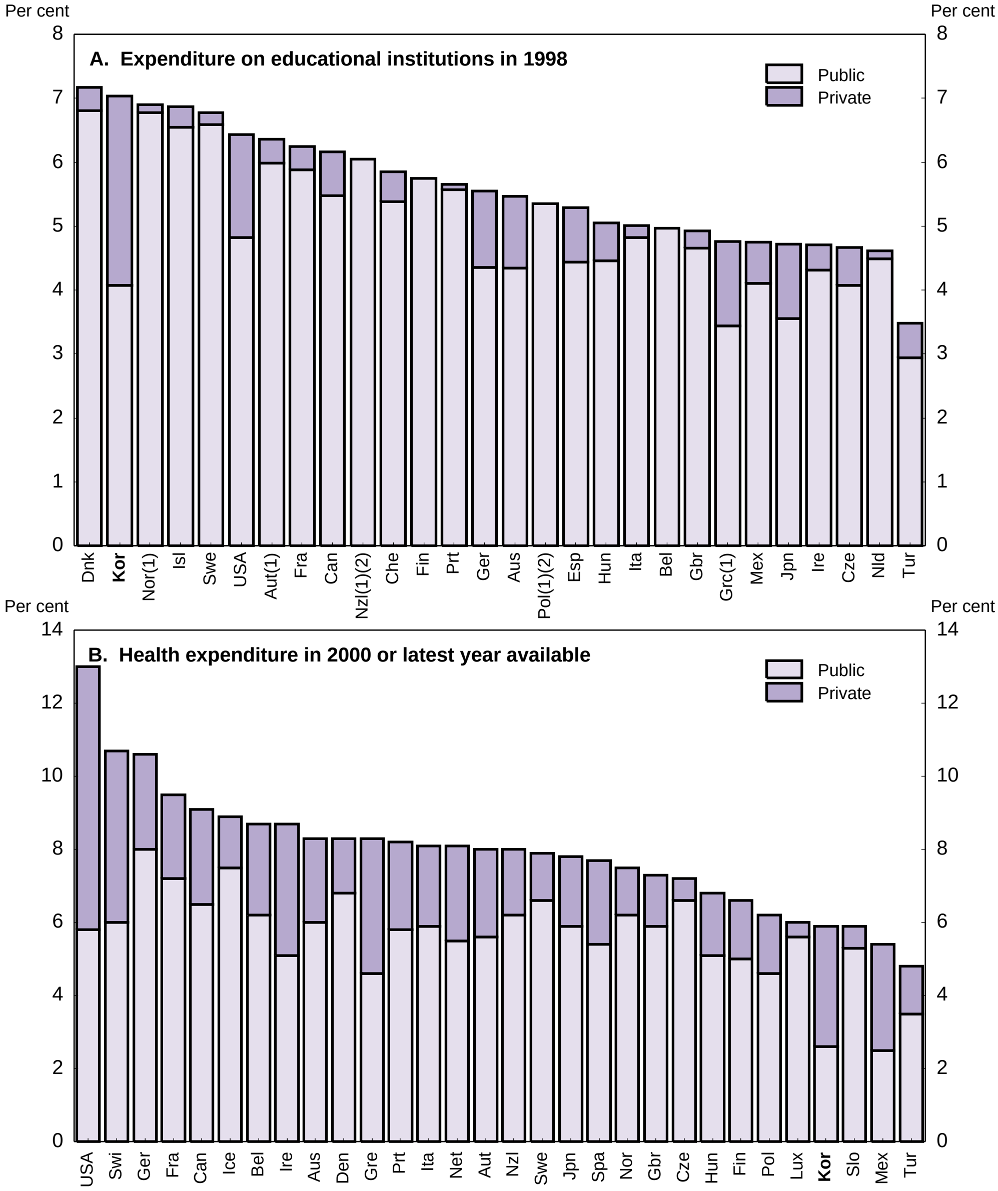
1. Public employment refers to the general government sector excluding social security administration and public enterprises.
2. Public-sector employment in full-time equivalent.

Source: OECD.

7. The structure of public expenditure broken down by government functions also shows large differences with other OECD countries (Table 4). In addition to the low level of publicly provided social protection noted above, defence spending, at around 3 per cent of GDP, is double the OECD average. Expenditure on economic affairs, such as transport infrastructure, agriculture and housing, is also significantly higher than the average.

5. When private spending on extra-curricular education – accounting for 5 per cent of total household income -- is added, spending on education in Korea might be the highest in the world.

Figure 4. **Education and healthcare expenditure in OECD countries**
As a per cent of GDP



1. Public subsidies included in private funds.
2. Public expenditure only.

Source: OECD Health Data 2002 and OECD, Education at a glance 2001.

Table 4. **Main components of primary government spending by function**[1]
Per cent of GDP in 2000

	Defence	General public services	Public order and safety	Education	Health	Social protection	Economic affairs
Korea							
1990	3.9	2.5	1.2	3.4	1.7	2.5	3.8
1998	3.1	3.2	1.5	4.1	2.4	3.9	5.6
Austria	1.0	8.0	1.5	6.0	8.0	21.2	4.4
Belgium	1.2	9.7	1.6	6.1	6.5	17.2	4.3
Canada	1.2	8.0	2.1	6.2	6.5	13.4	3.5
Denmark	1.6	4.4	0.9	8.0	5.1	23.4	3.8
Finland	1.5	6.1	1.4	6.3	5.8	20.5	4.8
Germany	1.2	3.9	1.6	4.3	6.3	21.9	4.2
Greece	3.3	10.0	1.1	4.2	3.9	19.6	0.2
Iceland	0	2.0	1.4	5.8	7.0	8.1	5.7
Ireland	0.8	4.6	1.4	4.0	5.4	6.6	6.9
Italy	1.2	9.6	2.0	4.9	5.9	17.7	2.6
Japan	1.0	2.9	1.5	4.2	6.2	10.7	4.7
Luxembourg	0.3	4.5	0.9	4.6	4.2	17.2	4.4
Netherlands	1.5	8.5	1.4	4.7	4.0	17.4	4.4
Norway	1.9	4.8	0.8	5.7	6.6	15.6	3.8
Portugal	1.7	6.4	2.0	6.9	6.4	13.0	5.8
Sweden	2.2	10.2	1.3	6.9	6.3	24.5	4.0
United Kingdom	2.8	2.0	2.2	4.5	5.5	15.2	2.5
United States	3.3	4.2	1.9	4.8	5.0	6.5	1.9
Average of above countries	1.6	6.1	1.5	5.4	5.8	16.1	4.0

1. Data are for 2001 for Belgium, 1999 for Canada, Portugal and the United Kingdom, and 1998 for Iceland.
Source: OECD.

Spending pressures over the medium and longer term

8. Upward pressure on spending is likely to gain further momentum in Korea. One factor is the 157 trillion won (27 per cent of GDP) programme on financial-sector restructuring. Two-thirds of this amount was financed by government-guaranteed bonds issued by two off-budget funds. As a result, such expenditures have not yet been incorporated into the public sector, except for the interest costs on the bonds. However, this has led to a sharp rise in government-guaranteed debt. As noted inthe 2003 *OECD Economic Survey of Korea*, 49 trillion won of the debt will be transformed into public bonds starting from 2003, substantially boosting public debt and resulting in annual interest payments of about ½ per cent of GDP.

9. Pressure to increase spending will also arise from the expansion of the social safety net. Social welfare spending increased as a result of the financial crisis in 1997 in order to cope with the sharp rise in unemployment and to expand the safety net (Table 5).[6] In particular, to ensure minimum subsistence standards, the government launched in October 2000 the "productive welfare" system, which made social benefits under the Basic Livelihood Security Programme a right for those who qualify, rather than making them dependent on the availability of funds. At present, around 3 per cent of the population is covered by this programme. In addition, the high level of budgetary support for health insurance and for pension

6. To assist the unemployed, the authorities expanded the unemployment insurance programme, created temporary public works jobs, provided more vocational training opportunities and established a "Temporary Livelihood Protection Programme".

schemes for civil servants and military officers, which have been running large deficits, is expected to increase further. These medium-term pressures will make flexible management of public finances more difficult by further raising the share of mandatory spending in the budget. The experience of many OECD countries suggests that such pressures as Korea now faces can result in significant increases in spending.[7]

Table 5. **Government spending on the social safety net**
Billion won

	1997	1998	1999	2000	2001	2002
Unemployment insurance	170	1 191	1 697	1 135	1 730	2 101
Wage liability insurance	--	16	39	46	77	93
Support for minimum living cost	950	1 137	1 782	2 399	3 326	3 470
Occupational accident insurance	156	1 451	1 274	1 456	1 789	1 902
National Health Insurance[1]	5 813	6 884	7 921	9 032	13 245	13 331
National Pension Scheme[2]	1 500	2 426	3 891	1 588	1 569	2 261
Other	160	1 817	3 923	1 853	1 258	821
Public works jobs	--	1 044	2 493	1 321	675	523
Vocational training	160	203	292	256	277	206
Living cost loans	--	570	1 138	276	356	92
Total	**10 148**	**14 921**	**20 526**	**17 509**	**22 993**	**23 980**
Per cent of GDP	2.2	3.4	4.3	3.4	4.2	4.0
Memorandum item:						
Spending related to the labour market[3]	329	3 024	5 658	3 033	3 064	3 016
Per cent of GDP	0.1	0.7	1.2	0.6	0.6	0.5

1. Payment for medical treatment.
2. Pension payment.
3. Includes unemployment insurance, wage liability insurance, public works jobs, vocational training and living cost loans.

Source: Ministry of Planning and Budget.

10. Over the longer term, spending pressure will likely accelerate as a result of population ageing and the consequent demands that this implies on social spending, notably on pensions, healthcare and associated personal services. After Mexico and Turkey, Korea has the youngest population among OECD members, but its population will age more rapidly. As discussed in the 2001 *Survey*, the increase in pension expenditures as a share of GDP is projected to be among the largest in the OECD area over the next fifty years, rising from 2.4 per cent of GDP to 10.5 per cent under the current system. While systemic reform of the pension system is crucial to limit the impact on public expenditures, a significant increase appears unavoidable in any case.

11. Furthermore, Korea faces the uncertain cost of co-operation with North Korea as its economic reforms will require increased support. The experience of Germany suggests that the eventual unification with North Korea will entail a significant burden on Korea's public finances. Moreover, the cost is likely to be significantly greater than in Germany because the share of Korean population in the north is far greater than the share of German population that was in the east and the per capita income differential in the two parts of Korea is greater than it was in Germany.

7. In most OECD countries, the establishment and expansion of programmes and provision of services in the social policy domain and the increasing debt interest payments led to a persistent rise in general government expenditure until the 1980s. For a review of trends in public expenditure in OECD countries, see Tanzi and Schuknecht (2000) and Atkinson and Van den Noord (2001).

12. These spending pressures will necessitate a rise in the tax burden, which is among the lowest in the OECD, with total revenues amounting to only 22½ per cent of GDP. But given the negative effect on growth with which tax increases are associated, a prudent approach will be needed. The 2000 *Survey* suggested that the priority should be to broaden the tax bases and streamline the highly complicated tax structure. But a more fundamental issue is how to achieve the best value for money from expenditures. There is also strong demand from both public opinion and international investors for more transparency of public expenditure management.

Budgeting and public expenditure management

13. The ability to deal with future spending pressures and to improve the efficiency of spending relies critically on the effectiveness of the budgeting and public expenditure management system. A range of reforms to improve the efficiency of the public expenditure system were attempted in the 1980s and the 1990s. Nonetheless, the administration taking power in 1998 felt that serious problems still existed in the public expenditure system and launched a series of reform measures for the modernisation of administrative and budgetary processes. Much progress has been made, but the pace of change has been uneven across different areas and there is a need for a comprehensive reform strategy. This section reviews the institutional arrangements for budgeting and public expenditure management, the progress in reforms and the major weaknesses that will need to be addressed as Korea faces future challenges.

Overview of the budgetary system: the institutional set-up

14. Korea is a unitary state with a central government and two tiers of local government: there are 16 “upper-level” local governments for seven metropolitan cities and nine provinces and 232 “lower-level” local governments for cities (Shi), counties (Gun) and districts (Gu). Expenditures of the local governments, which include transfers from the central government, comprise some 40 per cent of overall spending. The concept of general government is, however, not yet used in discussing fiscal policy and government spending. Indeed, the government consolidated budget based on Government Finance Statistics (GFS) standards -- the key fiscal measure in Korea -- includes only the central government budget.

Structure and coverage of the budget

15. Korea’s budget lacks transparency because it is highly fragmented and suffers from excessive earmarking. The national budget presented to the National Assembly for 2003 was comprised of one general account, 22 special accounts and 47 public funds (Table 6). The general account comprises about half of central government spending on a consolidated basis. The proliferation of special accounts and public funds reflects the legacy of the economic policies of the 1960s and 1970s when a range of earmarked taxes -- amounting to nearly 15 per cent of total central government tax revenue (about 3 per cent of GDP) -- and so-called quasi-taxes[8] were created to finance public investments and loans to achieve specific policy objectives. While these accounts and funds have separate budgets and are managed independently, there are very complicated financial transfers among them, thus hindering transparency and accountability.

8. Quasi-taxes refer to a wide range of fees, charges and contributions that are not imposed by the tax laws. The amount of quasi-taxes is estimated at around 1 per cent of GDP.

Table 6. **Structure of the consolidated budget**

	Number (in 2002)	Outlays in 2001 (trillion won)	Main revenue sources	Linkage between revenue source and expenditure
General account	1	72.3	Tax revenues	None
Special accounts[1]	22	38.1	Earmarked tax; transfer from general account and public funds	Clear linkage
Public funds	47	26.0	Mandatory contributions; transfer from other accounts and funds	Clear linkage

1. Includes four public enterprise special accounts.
Source: Ministry of Planning and Budget and Koh (2000).

16. One of the major recent budgetary reforms has been the inclusion of public funds in the coverage of the national budget, thus making them subject to parliamentary oversight.[9] As discussed in the 2000 and 2001 *Surveys*, their exclusion from the annual budget had been a major weakness of the budget system. In addition to including them in the budget, the discretion of the responsible minister in boosting outlays -- without the consent of the National Assembly -- was reduced from 50 to 30 per cent. This reform will thus greatly enhance transparency and accountability.[10] Nonetheless, the fact that ministers still have the right to increase outlays by up to 30 per cent without the approval of the National Assembly limits effective oversight.[11] Furthermore, there remain a number of funds that perform quasi-fiscal activities as discussed below but are excluded from the national budget. At the central government level, there are ten extra-budgetary "financial" funds. The National Health Insurance also remains extra-budgetary, while all other social security funds are included in the budget as public funds. In addition, there are some 2 000 extra-budgetary funds set up by local governments for which there is very little published information.

17. The national budget is prepared, and its implementation monitored, on a Government Finance Statistics basis. The weakness in the coverage and methodology of the consolidated government budget, however, prevents it from playing its intended role as the principal tool of aggregate fiscal management. *First*, the GFS accounts do not include local governments, which hampers budget planning and monitoring at the general government level. *Second*, the budget is recorded on a cash-basis, which fails to deliver a fair and accurate picture of the impact of government's activities on its overall financial position and makes its long-term sustainability difficult to monitor.[12] Both of these problems are being addressed. The authorities currently plan to include local governments in the consolidated budget from 2003 and to move by 2005 at the latest from the present cash-based accounting to accrual accounting standards, a change that is in line with the latest update in GFS standards.[13] It is important to manage fiscal policy on a general government basis.

9. Revisions to the *Fund Management Act* in December 2001 require that the public funds be subject to parliamentary approval beginning in the 2003 budget. This reform also increased the coverage of public funds by transforming a number of "extra-budgetary" funds into public funds.

10. Until the 2002 budget, the total amount of government spending on a consolidated basis was unknown when the budget was passed.

11. Approval is only required from the Ministry of Planning and Budget.

12. Cash-based accounting provides little recognition of financial commitments because liabilities and receipts are accounted only in the year when they are realised.

13. Two major features of the new GFS standards set by the IMF are accrual-based accounting and harmonisation with the 1993 SNA system. The adoption of the new GFS standards will thus move the GFS-based government accounts closer to the SNA-based accounts (see Annex I).

The budget process

18. The national budget is prepared by the executive branch, which sets the overall fiscal stance and its underlying macroeconomic projections, and is submitted to the National Assembly for approval. Within the executive branch, the Ministry of Planning and Budget (MPB) plays a leading role in budget formulation, management and execution. However, responsibilities for budget management and control are shared with two other ministries, *i.e.* the Ministry of Finance and Economy which is responsible for preparing the macroeconomic outlook and revenue projections, and the Ministry of Government Administration and Home Affairs, which is responsible for local government finance and administration. The MPB initiates the drafting process and negotiates with line ministries and agencies their respective programmes, before presenting the draft budget to the National Assembly for approval (see Box 1).

Box 1. The budget process in Korea

The budget formulation process. Budget preparation begins in March when the Ministry of Planning and Budget (MPB) transmits the *Guide to Budget Compilation*, upon approval by the Council of Ministers, to line ministries and agencies. The budget guidelines contain forecasts of fiscal aggregates for the following year, spending priorities and more detailed guidelines on compiling budget requests. After negotiations between concerned parties, including ministers and political parties, and the budget co-ordination meeting with provinces and municipalities, the budget is approved by the Cabinet and the President and then presented to the National Assembly by 2 October. The operating plans of public funds are presented to the National Assembly by 12 October.

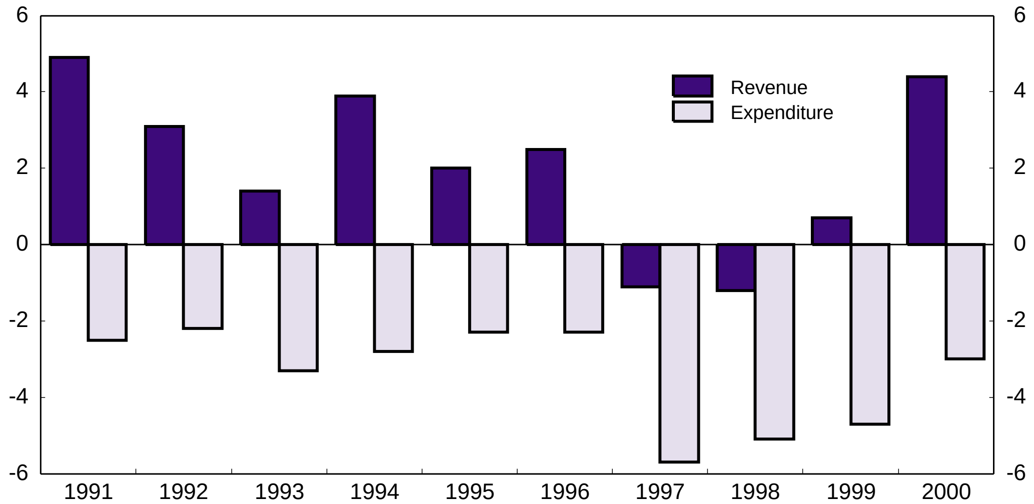
The approval process. The proposed budget is first reviewed by the Special Committee on Budget and Accounts of the National Assembly, which was made a permanent committee in 2000. After deliberations in the Adjustment Subcommittee, the budget is approved in the Special Committee plenary session by 2 December. After agreement by the Cabinet, the national budget is announced. There are restrictions on the right of the National Assembly to modify the budget proposal. In particular, it may not increase the budget or introduce a new budget item without the consent of the government. In practice, the National Assembly approves the budget as presented by the government with only minor changes since most of the political negotiations occur at the budget compilation stage. The role of the National Assembly has been strengthened as public funds have become subject to parliamentary oversight since 2002. The fact that each fund was created legislatively may help the National Assembly impose oversight on the funds. However, the capacity of the legislature to analyse these funds needs to be improved.

Budget execution and monitoring. The execution of the central government budget during the course of the year is controlled by the budget allocation set by MPB, while the treasury bureau of the Ministry of Finance and Economy (MOFE) is in charge of releasing the necessary funds. The quarterly plan for funding and execution compiled by MPB is sent to each agency with the President’s approval. The timing of spending during the year may be adjusted to accommodate or counter the business cycle. A newly established Committee on Budget Execution Management has actively sought to improve budget execution. In addition, a year-round regular monitoring system of fiscal execution has been set up for 300 major public projects. MOFE produces consolidated government finance statistics with a one-month delay, which are available on the Internet.

Conclusion of the budget. The budget is concluded when the National Assembly approves the budget settlement report. The Board of Audit and Inspection examines the final revenue and expenditure accounts of the government, which are compiled by the Ministry of Finance and Economy, before sending it to the National Assembly within nine months of the end of the year. However, the feedback effects from the examination of the budget settlement by the National Assembly into the next year’s budget tend to be limited. One problem is that there is little time between the conclusion of the previous year’s budget and the discussion of the new budget proposal. The government plans to address this problem by moving forward the date for submission of the budget settlement report.

19. There are no formal fiscal rules imposed on the central government by the Constitution or by the legislature concerning spending, the deficit or other fiscal objectives. The tradition of prudent budget management is probably explained by the culture of fiscal conservatism that prevails both within the administration and the public generally. In addition, the concentration of powers for both the drafting and execution of the budget in the hands of a single powerful ministry has helped impose an effective hard budget constraint on line ministries and agencies.[14] Moreover, budgets are prepared on the basis of deliberately conservative revenue forecasting, leading to a tendency for overshooting in revenues (Figure 5). On the spending side, line ministries also tend to take appropriations as the maximum authorised amount of expenditures, making spending overruns rare, in contrast to other OECD countries. However, the institutional environment has been changing significantly with the creation of a coalition government in the National Assembly and the democratisation of politics, resulting in greater pressure for spending increases in certain areas (Koh, 2000). The absence of a strong aggregate control framework in this new environment, together with future spending pressures, could pose a risk to aggregate fiscal discipline.

Figure 5. **Overshooting in government revenue and expenditure**
Out-turn less budget as a percent of budget[1]



1. Data refer to the general account.

Source: Board of Audit and Inspection.

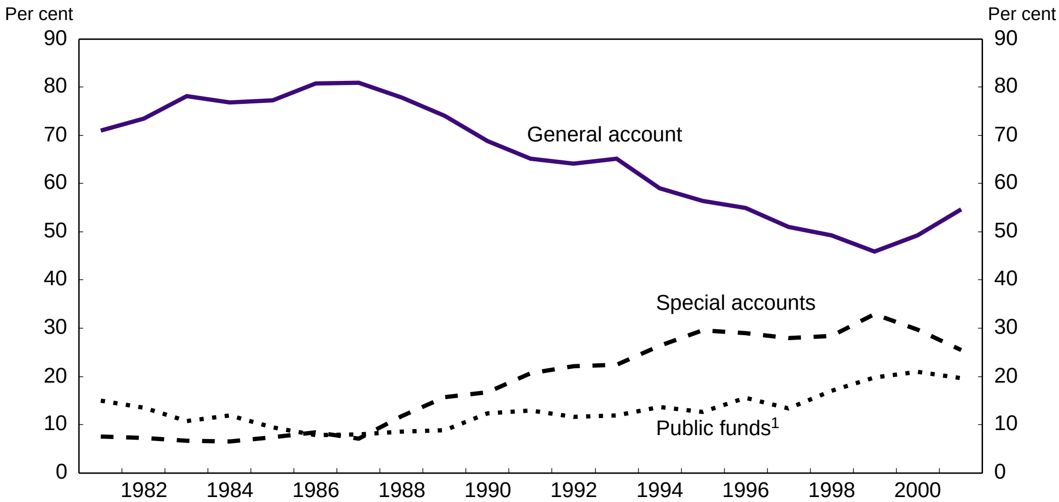
14. During the 1970s and 1980s, the Economic Planning Board (EPB) assumed the central role in budget drafting and execution, as well as in preparing and implementing economic development plans. In the early 1990s, EPB and the Ministry of Finance were merged into the Ministry of Finance and Economy (MOFE), which exercised the same degree of centralising power in budgeting as EPB.

Addressing the weaknesses in the budgetary system

Compartmentalised budget structure remains a fundamental weakness

20. The coherence of fiscal policy remains hampered by the highly fragmented and compartmentalised budget structure. While special accounts and public funds might provide the advantage of securing stable funding sources and operational flexibility for line ministries, this is outweighed by disadvantages, especially since its share in the overall budget is large and has been increasing until recently (Figure 6). *First*, the proliferation of these accounts and funds, with extensive earmarking of revenue sources, weakens fiscal planning because the budget authorities have little control over a significant share of public spending. As a result, both fiscal planning and parliamentary discussion are mainly focused on the general account, thus hampering allocative efficiency as a significant part of budgetary resources cannot be reallocated in response to changing strategic priorities.[15] *Second*, since most of these accounts and funds have been introduced without sunset clauses, some of them no longer serve the original policy objectives. Moreover, there is a considerable degree of overlap in the activities financed by the general account, special accounts and public funds. Consolidating special accounts and public funds has, however, proven to be difficult. While progress has been made in merging or eliminating some public funds, new funds have continued to be established.[16]

Figure 6. Government spending by type of account
Per cent of central government expenditure



1. Ten new funds were added to the category of public funds in 2000.
Source: Ministry of Finance and Economy.

15. This explains why the initial budget announced each year by MPB until 2002 was limited to the general account and one special account, the Fiscal Financing Special Account. For the 2003 budget, the MPB used only the general account.

16. Between 1999 and 2002, 19 funds were abolished and 14 funds were merged into six funds. But during the same period, ten new funds were created.

Strategic prioritisation in budgetary resource allocation is weak

21. A distinctive feature of the budget formulation process is the lack of strong strategic prioritisation in the allocation of budgetary resources. The annual budget guideline issued by the MPB lacks strategic foundation and is not backed by a visible and binding policy statement. It provides only indicative spending targets and compliance is generally weak.[17] The budget formulation is thus essentially characterised by a "bottom-up" approach. Line ministries bid for resources, while the MPB reviews their claims, compares their worth and decides on expenditure for over 2 200 appropriation accounts.[18] Given the excessive initial bids by line ministries, the MPB is forced to devote considerable time and energy on detailed budget analysis.

Annual budgeting is not explicitly linked to the medium-term fiscal framework

22. The current budget process is essentially geared to a single fiscal year. Since the 1980s, the budget authority had drafted medium-term fiscal plans but they were used only for internal reference. Greater emphasis has been given to medium-term fiscal planning after the financial crisis. In 1999, the government publicly announced a medium-term fiscal plan that included projections of fiscal aggregates and outlined priorities among the 12 broad spending categories between 1999 and 2002, which was subsequently revised (John M. Kim, 2001). However, the medium-term fiscal plan remains largely indicative and, in practice, there is little formal connection between the plan and the annual budgeting process. The budget documents currently contain fiscal data mainly for the budget year. In addition to aggregate expenditure control, the introduction of a medium-term framework is also important to encourage an efficient allocation of spending, particularly in the case of social overhead capital (SOC) projects, which typically require several years to reach fruition (see Box 2).

Box 2. Promoting efficiency in public infrastructure investment

The lack of multi-year planning horizons in the budget process is often associated with discontinuities and inefficiencies in public investment in many countries. The negative impact could be significant in Korea since, as noted above, the share of public investment in GDP in Korea is the highest in the OECD area, in part reflecting a high level of expenditure on social overhead capital (SOC).[1] In 2001, spending on SOC construction comprised about 15 per cent of the central government budget. There have been some criticisms in recent years concerning insufficient strategic prioritisation and transparency in SOC budgeting, resulting in inefficiency in large SOC projects.

Moving to multi-year budget appropriations approved by the National Assembly would enhance the efficiency and effectiveness of SOC investment by improving strategic prioritisation and transparency as well as strengthening fiscal discipline. While the current budget system allows for *multi-year expenses* that are aimed at providing stable financing for large projects through National Assembly authorisation for up to five years, this instrument has not been widely used in practice, except for national road projects. In 2001, less than 3 per cent of the national budget was allocated under the *multi-year expense* method. Instead, ministries have preferred to use the *long-term projects approval system*, which also allows for multi-year appropriations but requires only the approval of the MPB when changes are made to the original project or total construction costs. Because the total costs have not been approved by the National Assembly, however, stable financing is not guaranteed under this system.

17. For example, the 2003 budget guideline asked ministries to restrict their budget requests to one-digit growth from the 2002 budget. But the total budget requests amounted to an increase of 26 per cent.

18. This refers to the number of detailed appropriation accounts (S*e-Hang*) specified in the Budget and Accounts Act. In practice, however, the MPB negotiates with line ministries concerning over 6 000 appropriation accounts (*Se-Se-Hang*).

Box 2. Promoting efficiency in public infrastructure investment (continued)

A medium-term framework will need to be combined with transparent public evaluations, both *ex ante* and *ex post,* to enhance efficiency in the allocation of resources. An important reform has been the introduction of a preliminary feasibility study system aimed at strengthening the *ex ante* evaluation process. Since 1999, the Public Investment Management Centre (PIMA) has conducted preliminary feasibility studies for all new public investment projects exceeding 50 billion won ($42 million). PIMA has published a series of evaluation manuals for roads, railways, airports, seaports and cultural facilities. In most studies, public investment is evaluated from both social policy and economic perspectives. Between 1999 and 2001, PIMA examined 90 proposed projects, of which 49 were rejected.

1. The budget authorities classify SOC as transportation facilities (roads, railways, subways, airports and ports), multi-purpose dams, water control, irrigation and industrial complexes.

Transparency has been improved but weaknesses in some areas could pose fiscal risks

23. The authorities have made significant efforts to improve fiscal transparency. In addition to the budgetary reform that brought public funds into the national budget and timely dissemination of consolidated GFS accounts on the Internet, the National Fiscal Information System was established in 2002 as part of *e*-government, which is expected to increase efficiency and transparency of fiscal administration. Despite the progress made, further improvements are needed to better manage fiscal risks.

24. The use of extra-budgetary funds for quasi-fiscal activities continues to complicate the management of overall public finances, as noted in the 2000 and 2001 *Surveys*. Currently, ten government funds are considered "financial" and thus remain outside the budget. Nevertheless, they can have a substantial impact on the status of public finances, since any deficits will eventually have to be recognised by the budget. For example, a substantial portion of the cost of financial-sector restructuring was financed through two extra-budgetary funds. While this channel in general provides the advantage of flexibility, it reduces fiscal transparency and can be seen as a way of circumventing the normal budget process and parliamentary oversight, leading to a range of moral hazard problems. Other extra-budgetary "financial" funds are mainly credit guarantee funds, which have performed quasi-fiscal activities. For example, the Credit Guarantee Fund and Technology Credit Guarantee Fund, which have been heavily subsidised by transfers from the budget, provide loan guarantees to small and medium-sized enterprises (SMEs) with low credit ratings.[19] These funds are managed by non-governmental entities, which are responsible for internal personnel affairs, organisational changes, development of activities and the provision of guarantees. However, the funds' budgets, operational planning and the appointment and dismissal of board members are subject to approval by the relevant ministries to ensure that their activities fall under the relevant legal arrangements. Strengthening the accountability framework for these funds to the level applied to public funds will thus be necessary for the prudent management of fiscal risks.

19. The Credit Guarantee Fund was also used to provide guarantees for low-income households setting up businesses after the financial crisis in 1997.

25. There are other areas where budgetary transparency can be further enhanced by improving the budget documents presented to the National Assembly:

- The budget documents do not contain a statement of the major fiscal risks or a quantification of these risks. Although the total size of government guarantees is reported to the National Assembly on an annual basis, there is no estimate of the likely liability resulting from such guarantees. Given the sharp increase in guarantees since the financial crisis, the limited coverage in this area is a major weakness.
- Tax expenditures, which amounted to 2.5 per cent of GDP in 2000 (Table 7), are a fiscal instrument that has been frequently used as a substitute for direct expenditures. In 1999, the government started to report tax expenditures based on direct taxes to the National Assembly, and coverage was increased to include indirect taxes in 2000 and customs duties in 2001. These reports, however, are *ex post* -- budget documents do not include *ex ante* estimates of tax expenditure. Their exclusion from the budget documents shields them from the same scrutiny and evaluation accorded to direct expenditures and thus complicates trade-offs in setting spending priorities.
- Clear information on the macroeconomic framework underlying the forecasts for the budget and the key assumptions that influence the estimates of fiscal aggregates are not included in the budget documents.

Table 7. **Tax expenditures by purpose**
Billion won

	1999	2000
Support for employees and farmers	6 129	6 651
Savings	2 745	2 831
Employees	1 296	1 629
Farmers and fishermen	2 088	2 191
Economic development	2 571	4 246
SMEs	490	826
Investment stimulus	464	1 074
R&D	428	979
Public investment	518	499
Financial sector	168	274
Restructuring	300	439
Regional development	203	155
Social welfare	1 326	1 741
Education, culture and health	303	333
Environment	152	200
Social security	818	1 165
Housing	53	43
Defence	381	486
General public administration	109	128
Others	26	30
Total	**10 542**	**13 282**
Per cent of GDP	2.2	2.5

Note: The 1999 data include direct and indirect taxes, whereas the 2000 data include customs duties as well.
Source: Ministry of Finance and Economy.

26. The weakness of the current framework in disciplining fiscal policy became an increasing concern after the 1997 crisis. There was a consensus that it would be difficult to contain spending growth without appropriate budgetary and expenditure control mechanisms that bind the government to specific targets and spending priorities. To establish such mechanisms, a Fiscal Responsibility Bill was submitted to the National Assembly in June 2001 with five main provisions. *First*, it would require the government to

submit to the National Assembly a three-year fiscal plan, including targets for a consolidated budget balance and public debt. *Second*, it would restrict supplementary budgets to emergency situations. *Third*, it would establish public debt reduction as the priority in the allocation of any budget surpluses. *Fourth*, it would require that any proposals generating higher public spending or lower revenue include a plan on how to offset the negative financial impact. *Fifth*, it would create a National Debt Management Committee that reports to the MPB.[20] The failure to pass the Fiscal Responsibility Bill, essentially due to parliamentary feuding over whether to include government-guaranteed debt in the definition of national debt, was an important missed opportunity.

Introducing incentives and accountability for performance or results

27. The traditional budgeting system, which is largely characterised by detailed line item budgeting and control, is not geared to maximising operational efficiency. The budget implementation system focuses on compliance with legal and procedural rules, rather than on performance or programme outcomes. The responsibility of spending units is limited to keeping expenditures on inputs within the approved budget estimates and they thus have very limited freedom in shifting budget outlays from one budget category to another. While this is an important aspect of budget control, it has led to the neglect of efficient delivery of services or performance orientation.

Flexibility and performance orientation are being introduced…

28. The authorities have recently introduced some reforms to instil more managerial flexibility into the budgeting and management process. *First*, line ministries and agencies have been given more autonomy and discretion over an increasing proportion of their budgets that are designated as general running costs.[21] *Second*, the government has launched pilot projects for performance-oriented budgeting,[22] aimed at enhancing the efficiency of public service delivery. Initially, 16 organisations were selected for this programme in 2000, followed by another 23 in 2001 and 2002. *Third*, the government has introduced an "executive agency" system as a way to allow managerial flexibility in some organisations, while holding them responsible for performance. By 2001, 23 such agencies had been established and given greater flexibility in budget management.[23] The MPB also increased the number and size of lump-sum appropriation accounts, for which detailed planning is devolved to line ministries.[24] However, the number of such accounts was cut sharply from 49 in 2001 to 31 in 2002, due in part to criticism from the National Assembly concerning a lack of transparency and accountability.

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20. In addition, the bill would require the budget to include information on the costs of quasi-fiscal activities with a view to improving transparency. It would further provide details of contingent liabilities, including expected costs and likely beneficiaries.

21. The scope for the carry-over of unused operating costs was set at 5 per cent in 1999, in an effort to limit spending binges at the end of the year.

22. In Korea, the term "performance-oriented budgeting" refers to the practice of asking ministries or agencies participating in pilot projects to prepare and submit "performance plans" that specify strategies, objectives and indicators. The MPB, which is in charge of this project, may use this as input for the following year's budget for these ministries or agencies.

23. In practice, however, the flexibility and autonomy given to these agencies has been relatively limited, compared to the case in other countries that have adopted this system, such as the United Kingdom.

24. The number of these accounts increased from 18 in 1997 to 49 in 2001, boosting the amount of their outlays from 4.2 trillion won to 9.3 trillion won. In 2002, the size of these accounts fell to 4.3 trillion won.

…making it necessary to strengthen accountability for results

29. The steps to introduce managerial flexibility and performance orientation make it important to strengthen accountability for results. However, the Korean public expenditure management system does not provide for routine and systematic evaluations of value for money. There has been much effort to improve evaluation of programmes and activities, but systematic *ex ante*, intermediate and *ex post* spending reviews and evaluations are still limited.[25] In particular, the input-based budget classification system, combined with the lack of performance indicators, makes the evaluation of performance difficult.

30. The Constitution assigns the responsibility to improve the performance and assure the accountability of the government and other public-sector entities to the Board of Audit and Inspection (BAI), an independent agency under the President. The BAI has traditionally focused on financial audits, but has been broadening its scope to performance-oriented audits. It currently conducts between 70 to 80 performance audits, compared to 200 to 250 general audits, per year. In practice, though, broadening the scope of its work to performance-oriented audits has proven difficult for the BAI, given that its time and human resource allocation is geared more toward compliance audits. In addition to BAI, three other institutions are involved in performance evaluation: the Office of Government Policy Co-ordination under the Prime Minister's Office conducts evaluation of government policies; the MPB is in charge of the pilot projects on performance-oriented budgeting; and the Ministry of Government Administration and Home Affairs is responsible for the executive agency system. These institutions, however, have limited working-level relations with each other in carrying out their evaluations and an effective institutional framework for co-ordinating these efforts is yet to be developed (Jay-Hyung Kim, 2002).

Some further challenges in improving the effectiveness of public spending

Introducing competition and market mechanisms in publicly funded services

31. Many OECD countries have introduced market-based principles into the public sector with the aim of enhancing competition and efficiency in publicly funded services (Lundsgaard, 2000). Korea has also followed this trend, especially since the 1997 crisis. The government has increased its use of outsourcing and competitive tendering to improve the delivery of services, in particular, for support functions, such as cleaning, maintenance of buildings and equipment. This is part of the effort to consolidate public-sector activities in the core sector.[26] Local governments have also been encouraged to review and select activities that can be contracted out. The contracting out of local government functions has been most frequently used in the area of social welfare facilities and government building maintenance. The experience so far shows that cost-saving effects have been obtained in areas where competition among suppliers is well established. In contrast, where competition is not present, the total costs have tended to rise. At the local government level, in particular, the limited use of competitive tendering has limited the gains from this approach (Lee and Suh, 2000).

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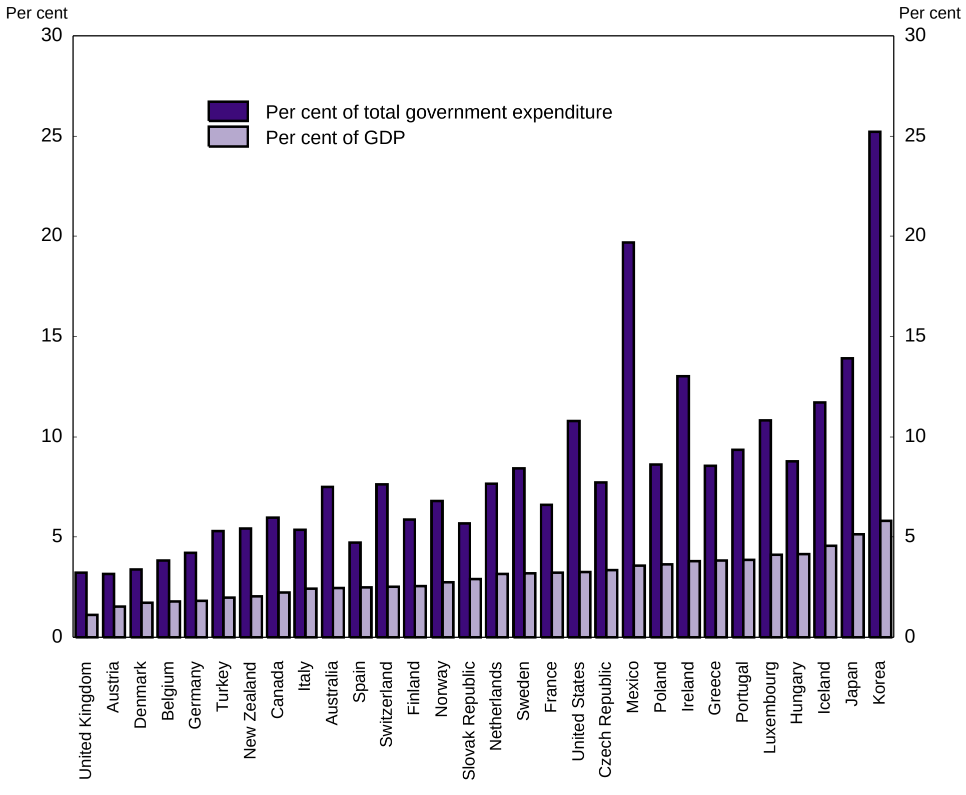
25. One major improvement in strengthening *ex ante* evaluation has been the introduction of pre-feasibility studies for large construction projects (see Box 2).

26. The government reports that between 1998 and 2002, 76 areas of the government sector have been contracted out, in addition to 209 activities of public enterprises and government-funded entities.

Contracting out in infrastructure is being pursued…

32. The government has also embarked on the strategy of optimising public-sector infrastructure investment by contracting out to the private sector.[27] As discussed before, Korea has one of the highest levels of government investment, both as a share of GDP and as a share of total government outlays (Figure 7). Although the government introduced the Private Participation in Infrastructure (PPI) programme in 1994, private-sector involvement did not increase owing to a number of problems, including the prospects of low profitability, unclear risk-sharing arrangements between the government and the private sector and limited competition among prospective partners. The financial constraints following the 1997 crisis prompted an initiative to overcome these problems in 1999. It included stronger financial incentives for private investors, including guaranteed minimum operation revenue, institutionalised buyout rights and an increase in the credit guarantee ceiling from 10 billion won to 100 billion won.[28] As of 2002, 31 projects had been completed under the PPI programme and 98 projects were being implemented or were under negotiation. By 2001, private-sector participation in the construction of roads, railways and ports reached between 3 to 5 per cent of total infrastructure investment.

Figure 7. **General government investment in OECD countries**
2000



Source: OECD.

27. One aspect has been the privatisation of state-owned enterprises.

28. In addition, it permits all types of participation including Build-Operate-Transfer, Build-Transfer-Operate and Build-Operate-Own and requires feasibility studies on projects open to private-sector firms. The Private Infrastructure Investment Centre of Korea (PICKO) was established to support the new initiative.

33. The PPI is still at an early stage and will need to follow international best practices to avoid potential problems. Indeed, results in other OECD countries have not been uniformly positive and it is unclear the extent to which PPI actually saves public money and/or increases efficiency and consumer satisfaction. Private-sector participation often involves many types of government support, including soft loans, equity investment, direct lending through banks and provident funds, and explicit and implicit guarantees. Consequently, the PPI is likely to increase the government's direct and contingent liabilities and put new demands on the management of off-budget expenditure. Minimising the fiscal risk will depend in part on the scope for prudent selection of projects and enhanced competition. It is also essential to have a transparent and credible regulatory system that provides incentives for cost minimisation and an efficient contracting process. The government has been making significant efforts to move in this direction by: implementing a preliminary feasibility study system as discussed above (see Box 2); selecting private partners through open competition; and establishing an accountability framework for private participants. The experience in other countries suggests that most efficiency gains stem from the permanent exposure of potential contractors to competition, rather than from the tender as such. Continued efforts will thus be needed to organise the process of tendering and contracting in such a way that they reduce the government's dependence on the incumbent franchise or concession holder. Using performance-based contracts might also be one way to enhance flexibility and accountability (Oak *et al.*, 2000).

34. Korea has also been experimenting with other forms of pubic-private partnerships, notably the formation of joint ventures in which the government secures a minority stake in the equity capital. A number of local governments have set up such "third-sector companies" to invest in various construction projects. Public-private joint ventures can have the advantage of spurring innovation and introduce private-sector management techniques, while providing a public-service ethos in an organisation that would not exist without government involvement. However, these companies in Korea have often run into problems due to weak business plans and management skills. In 2001, 18 of 33 third-sector companies were in deficit, while most of the remainder reported poor profitability. This disappointing performance, as well as the difficulty of closing such companies, suggests caution in creating such partnerships. The experience of some other OECD countries indicates that this approach can impose burdens on taxpayers.[29]

Competition among providers of publicly funded services is limited in secondary education…

35. Competition is very limited in some publicly funded services such as secondary education. Secondary education in Korea is provided not only through public schools but also through privately managed educational institutions that are predominantly publicly funded. This way of sub-contracting education to the private sector has been seen in many OECD countries as a cost-effective strategy for providing education. In these countries, governments pay most of the costs of education but leave the management of educational institutions to the private sector, to provide a wider range of learning opportunities without creating barriers to the participation of students from low-income families (OECD, 2002*b*). In Korea, however, school choice among students and parents is strictly limited, even for non-compulsory upper-secondary education, by the practice of allocating students to schools using a lottery system. Competition among schools is also largely limited as private schools are subject to the same rules and regulations as public schools, which leaves them with very little autonomy in school management, curriculum, tuition, and teacher hiring and pay. This has led to a situation in which the educational environment in private high schools, which enrol more than half of students, is inferior to that in public

29. The failure of the Millennium Dome in the United Kingdom is a good example in this regard (OECD, 2001*b*). In addition, local governments in Japan have created over 4 000 third-sector companies, many of which suffer from large deficits.

high schools[30] (Table 8). While this policy was introduced out of concern for equity, the lack of competition among service providers and the absence of school choice have significantly limited the potential gains from this way of funding and providing services (see the 2003 *OECD Economic Survey of Korea*). The government has been exploring ways to introduce competition and diversity by allowing "independent private high schools" on a pilot basis, which should help enhance the efficiency of public spending in education.

Table 8. **Comparison of public and private high schools**
In 1999

	Number of schools (Per cent share)	Number of students (Per cent share)	Number of students per teacher	Expenditure per student (in thousand won)
General public school	48	41	20.6	2 782
General private school	52	59	23.6	1 677
Vocational public school	58	48	17.9	--
Vocational private school	42	52	22.7	--

Source: Korea Educational Statistical Yearbook.

… but efficiency concerns will need to be balanced with equity objectives in areas with high user charges

36. User charges can be a means to reduce excessive demand for some publicly funded services by making households more cost aware. Although internationally comparable data are not available, user charges are relatively well established in Korea. However, the benefits of this market-based solution will need to be carefully weighed against its undesirable distributional effects. In particular, the high level of private co-payments in healthcare raises concerns about equity of access for low-income households. The high share of private financing is linked to substantial out-of-pocket payments, in contrast to the United States, where private financing is due to private health insurance arrangements (OECD, 2002*d*). The high private co-payments, together with high fees for uninsured services and the widespread practice of informal treatment charges, make financial barriers to access insurmountable for the bottom end of the income distribution. The Medical Aid Programme, which provides a safety net for the most destitute, has been expanding but currently covers only around 4 per cent of the population, which leaves many citizens relatively unprotected. Affordability and access has also been affected by the rapid rise in health costs and the relatively low priority given to primary healthcare. This suggests that while private-sector participation in healthcare is important, appropriate institutional mechanisms should be put in place to control costs and to provide affordable access to low-income groups (Yang, 2001). There is also more scope for central and local governments to provide support to public health centres to guarantee better access and to strengthen basic preventive health services mainly for low-income people.

30. The funding sources for private schools include tuition fees, government subsidies to cover the shortage of remuneration and operating costs, and resources from school foundations. In practice, private schools rely heavily on government subsidies, while transfers from school foundations remain very limited due to their generally weak financial capacity.

37. High user charges also characterise tertiary education in Korea, which can be justified given the fact that private returns exceed social returns at this level of schooling. In Korea, however, this raises an equity problem because low-income households' access to capital markets is limited. Despite the fact that close to 80 per cent of all expenditure on tertiary institutions are from private sources, the level of subsidies to support tuition payments is significantly lower than in other OECD countries, making Korea an exception (Table 9). This problem could be addressed through a higher level of scholarships or loans that are subsidised or income-contingent, policies that are widely-used in other OECD countries (Blöndal *et al.*, 2002). Any further measures to increase user charges in tertiary education will need to be balanced with the equity concern for low-income households.

Table 9. **Private co-payments and public subsidies in tertiary education**

	Private expenditure[1] (share of total expenditure)	Scholarships/other grants to households	Student loans	Total
		(Percentage of total public expenditure on education)		
Korea	**78.0**	**2.4**	**6.4**	**8.8**
Australia	46.5	14.6	17.7	32.3
Canada	38.3	12.2	6.4	18.6
France	12.0	8.0	a	8.0
Germany	8.2	10.1	1.9	12.0
Ireland	22.6	14.8	n	14.8
Italy	13.5	16.9	n	16.9
Mexico	25.5	2.8	2.9	5.7
Netherlands	20.3	18.4	6.2	24.6
Spain	22.6	9.3	n	9.3
United Kingdom	26.1	23.1	13.3	36.4
United States	53.1	11.1	8.1	19.2

1. Excluding subsidies to educational institutions received from public sources.
a = data not applicable because category does not exist.
n = negligible or zero.
Source: OECD, *Education at a Glance*, 2002.

Addressing the governance problems of public corporations and the wider public sector

38. The delegation of power to off-budget institutions, such as government-invested corporations and other government-funded entities, outside the traditional government sector provides opportunities to engage citizens in public service delivery and policy-making. However, it also poses the difficult challenge of protecting the public interest through appropriate accountability mechanisms. Indeed, inefficiency, lack of transparency and lax adherence to regulations in such institutions have often been identified as problems in Korea. Addressing the governance of these corporations is important as their performance has significant implications for public finances. For example, the funds managed by the National Pension Fund Corporation, which currently equal 14 per cent of GDP, may eventually rise to 100 per cent (see the 2003 *OECD Economic Survey of Korea*). Moreover, the performance of the National Health Insurance Corporation also has important implications for the national budget, as the size of the government subsidy is expected to increase significantly (see Box 3). The efficient oversight and governance of the wider public sector will be all the more important in light of recent moves to devolve managerial responsibility through the "executive agency" system discussed above.

39. The government has started to address the governance problems of public corporations and the wider public sector,[31] realising that managing from a distance has created accountability and control issues. The MPB has set up the Government-invested Institutions Operations Committee, which has been conducting management performance assessment. The results are to be reflected in employee bonus payments. Public corporations and government-funded entities have been advised to make their financial statements and audit reports accessible to the public and to recruit outside directors. The government has also submitted in October 2002 a draft Basic Law on the Management of Government-Affiliated Organisations to the National Assembly with the aim of enhancing managerial flexibility and accountability of government-affiliated organisations. Poor control mechanisms governing public funds and extra-budgetary funds have been of particular concern. In 1999, the MPB established a Public Funds Management Evaluation Team, comprising private-sector experts, and an Evaluation Committee on Public Funds Policy. The Evaluation Team has been producing annual reports reviewing fund management practices of both public funds and extra-budgetary funds. These reports have identified a number of problems including a lack of transparency, weak expertise of fund managers, inefficiency in asset management and inadequate oversight by the relevant ministries. For extra-budgetary funds, implicit government guarantees tend to generate moral hazard problems, weakening accountability for results.

40. The experience of other OECD countries suggests that certain conditions are necessary to ensure adequate public governance of diversified public bodies (OECD, 2002*a*). Most important is transparency in the governance system of autonomous bodies, including their nominations, remuneration and general accountability mechanisms. Most OECD countries have started to implement output- and even outcome-oriented reporting through activity-based costing, and some have started to establish multi-year agreements and monitoring mechanisms for their autonomous bodies. In many cases, national audit offices and parliament play an important role in monitoring these bodies.

Box 3. Controlling spending in healthcare

One long-term issue in nearly all OECD countries, including Korea, is the impact of population ageing on public spending for health and nursing care (see the 2001 *OECD Economic Survey of Korea*). Other challenges include satisfying the rising demand for quality care associated with higher income levels, while improving equity of access.

Korea has made significant progress in building a system that provides basic healthcare services at a relatively low cost. It spent 5.9 per cent of GDP on healthcare in 2000, the third lowest in the OECD area after Turkey and Mexico. Moreover, the public sector’s share of that -- at 44 per cent -- was the second lowest after the United States, largely due to high co-payments. The healthcare system is based on predominantly private service delivery and mixed public and private financing. Healthcare is funded mainly through mandatory insurance contributions and out-of-pocket payments by patients. Providers are typically paid on a fee-for-service basis. There have been two major initiatives during the past few years: the integration of insurers into a single payer (Integration Reform) and the separation of the roles of prescribing and dispensing drugs between doctors and pharmacists (Separation Reform). While the former reform has resulted in full integration of administration, financial integration has proceeded on two tracks -- one for employees and a second for the self-employed. Following the Separation Reform in 2000, the deficit of the National Health Insurance (NHI) increased from 1 trillion won to 2.4 trillion won in 2001. While the financial position of NHI had been deteriorating since the mid-1990s due in part to the relatively low contribution rate, the Separation Reform also contributed to the rise in the deficit as it was accompanied by three successive increases in medical fees by the government in 2001 due to prolonged strikes by doctors. The rising deficit of NHI required the government to increase its budgetary support to the NHI’s self-employed pool to around 2.5 trillion won in 2001.

31. The wider public sector includes all bodies that are part of local and national government and have been given some autonomy and/or independence from reporting ministries and/or are subject completely or partially to management and financial rules from vertically-integrated ministries. The governance problems of the wider public sector have been identified as systematic in OECD countries (OECD, 2002*a*).

Box 3. Controlling spending in healthcare (continued)

In 2001, the Ministry of Health and Welfare announced a plan to stabilise the financial status of NHI and move the reserve fund into surplus by 2006. The plan encompasses a range of measures to boost revenues and contain expenditure growth. On the revenue side, the plan calls for a 9 per cent annual increase in the contribution rate until 2006 and a larger government subsidy to the self-employed pool. In order to raise the budgetary subsidy, however, the government sharply increased the earmarked "health promotion charge" levied on tobacco starting in 2002, further expanding the already widespread use of earmarked quasi-taxes in Korea. On the expenditure side, the plan includes measures such as higher co-payments, more thorough mechanisms to detect fraud by providers and rationalisation of the payment system.

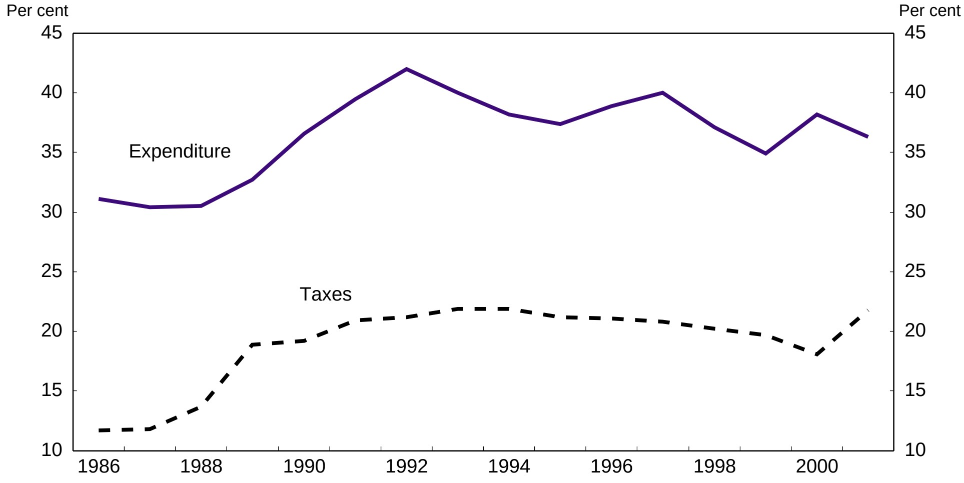
Given the rising levels of public and private health spending, a priority should be given to ensuring that the rising expenditures are used so as to achieve the best value for money in terms of quality, equity, efficiency and productivity. In particular, there is a great need to improve the governance of the health system, including the National Health Insurance Corporation (NHIC) and medical providers, in order to increase accountability and transparency. Concerted efforts will also be needed to achieve a more cost-effective utilisation of resources by improving providers' behavioural incentives. In this regard, the recent pilot programme of mixed payment systems for both physicians and hospitals should continue and their results should be carefully monitored, as discussed in the OECD's 2002 *Review of the Korean healthcare system*.

Enhancing the effectiveness of spending by sub-national governments

41. Korea has been taking steps since the late 1980s to decentralise public administration. The process has been largely motivated by the political objectives to revive and enhance local democracy and autonomy, which had been suppressed during the 1960s and 1970s. In 1988, the revised *Local Autonomy Act* and *Local Finance Act* prompted fiscal decentralisation and devolution of powers away from central government. Today, local governments' share of total public outlays oscillates around 35 to 40 per cent (Figure 8),[32] a level higher than in unitary countries such as France or Ireland but lower than federal Germany and the United States or the unitary Nordic countries. The local government share of national taxes rose to 20 per cent by the early 1990s. An increased use of user charges and fees has been another source of local government revenue. With the increased spending and revenue-raising powers, local governments should be able to design and tailor public services that better meet local needs and preferences. However, decentralisation has also resulted in new problems and tensions, including a perception that it has increased wasteful and inefficient spending by local governments, while hindering national or regional development. While some of these are only teething problems, others arise from deficiencies in the current intergovernmental fiscal design that has yet to find the right balance between autonomy and accountability for local governments.

32. This figure excludes education, which remains separate from the general budget of local governments in Korea. If education is included, this figure is increased to around 50 per cent.

Figure 8. Share of local governments in overall expenditure and taxes
As a percentage of national total



Source: Ministry of Government Administration and Home Affairs.

42. Perhaps surprisingly, given these complaints about decentralisation, the central government has maintained tight control over local government budgets. The *Local Autonomy Act* and the *Local Finance Act* require local governments to prepare balanced budgets. Moreover, the *Local Bond Approval System* requires that all local borrowing be approved by the central government, thus ensuring conservative financial practices at the local government level.[33] Local governments have also been subject to financial reviews conducted by the central government since 1996. In addition, the responsibility for evaluating the performance of local public corporations has been moved from the local to the central government level.

43. There is, however, a large degree of variation between local governments in fiscal capacity. For example, while the ratio of locally funded to total local government spending is more than 94 per cent for the Seoul Metropolitan Government, the ratio is below 50 per cent for more than 80 per cent (194 out of 248) of local governments (Table 10). A large portion of this fiscal gap is covered by central government transfers including tax sharing and grants (see Box 4). However, problems have been identified with both of these methods:

- The tax-sharing system, *Local Share Tax*, has been designed to redress horizontal as well as vertical fiscal imbalances. However, its equalisation function has had limited effectiveness in addressing horizontal imbalances, in particular, among cities and among districts within cities (Sung-Il Lim, 2002). The distribution formula is very complex and local governments, as well as the public, are not given information about its calculation. Furthermore, the distribution of the *special* Local Share Tax, which is to be used for unforeseeable circumstances, tends to be subject to central government discretion.[34]

33. Local borrowing is restricted to infrastructure projects, disaster relief and certain welfare enhancing projects. There are limits to the amount of debt and the shortfall allowed in tax revenues from the previous year. Local government debt was 17.8 trillion won (3.3 per cent of GDP) in 2001.

34. There is, however, a general distribution formula specified in the law.

- Conditional grants, *National Treasury Subsidies*, provide funds for very specific purposes, leaving little flexibility for local governments and resulting in large administrative costs (OECD, 2001*c*).[35] In principle, conditional grants should reflect nation-wide externalities and objectives, which would otherwise not be taken into account in local government decision-making. However, one study found that only one-fifth of the 344 projects financed by National Treasury Subsidies actually demonstrated such effects (Junghun Kim, 2000). The matching-funds mechanism of conditional grants also puts a financial burden on poorer rural governments, which rely heavily on conditional grants as a revenue source.[36]

Table 10. **Financial independence of local governments**
In 2000

Financial independence ratio[1]	Total	Per cent	Metropolitan cities and provinces	Cities	Counties	Autonomous districts
Less than 10%	5	2	-	-	5	-
10-30%	101	41	4	21	72	4
30-50%	88	35	4	22	10	52
50-70%	30	12	2	16	4	8
70-90%	19	8	5	12	-	2
90% and over	5	2	1	1	-	3
Total	248	100	16	72	91	69

1. The financial independence ratio is computed by dividing local tax and non-tax revenues by local expenditures.
Source: OECD (2001*c*).

Box 4. Local government funding

Local government expenditure is financed by local revenue and intergovernmental transfers (Table 11). Local revenue is composed of tax and non-tax revenue. In addition, local governments can finance themselves from local bond issues. Intergovernmental transfers consist of tax sharing (*Local Share Tax*), conditional grants (*National Treasury Subsidies*) and more broadly defined capital grants (*Local Transfer Fund*).

Tax revenue: Local tax revenue is provided by 17 taxes, with those related to property accounting for three-fifths of the total. The central government administers both the assessment rules and actual property tax rates, leaving local governments with limited discretion in practice. But the “flexible tax rate system” allows local government to vary rates by up to 50 per cent of the centrally determined tax rate for 11 local taxes, including the resident tax and the tobacco tax. However, local governments have rarely used this power to raise their tax revenues.

Non-tax revenues: Local governments receive revenue from their stakes in, and operation of, profit-oriented businesses, local public enterprises and public land development, as well as from various fees and charges.

35. The large number of central ministries -- 19 in 1999 -- involved in the grant system, together with the lack of inter-ministerial co-ordination, also hinders the efficiency of the system.

36. The average matching rate (paid by the central government) is around 60 per cent. The share of conditional grants is the highest for counties (Gun), where conditional grants comprise close to 30 per cent of total revenue. This puts a heavy burden on these poorer local governments.

Box 4. Local government funding (continued)

Tax sharing: *Local Share Tax* is a vertical tax-sharing system designed to equalise vertical and horizontal disparities with respect to tax-raising capacities and needs. It sets a fixed percentage (15 per cent) of the total national tax income that goes to the local level. The equalisation formula between local governments is based on the concept of "standardised fiscal deficiency", which is calculated as the difference between standardised fiscal needs and standardised fiscal revenue. The standardised fiscal need is calculated on the basis of a complicated formula taking into account demographic, geographic, and social and economic characteristics. The standardised fiscal revenue is calculated through a simpler formula, mostly reflecting 80 per cent of *actual* tax revenue and current non-tax revenues of a local government, which may discourage local government efforts to raise more revenue. While 10/11ths of the total amount is a general transfer, based on normal criteria, a small fraction (1/11th), called *Special Local Share Tax,* is earmarked, which functions more like conditional grants.

Conditional grants: *National Treasury Subsidies*, which are matching-grants, are provided to local governments for specific projects. They are allocated in line with national policy priorities for each economic sector based on annual evaluations of local needs by the central government. In 2001, National Treasury Subsidies accounted for 45 per cent of all central government transfers and 13 per cent of total local income.

Conditional capital grants: The *Local Transfer Fund* is somewhere between tax sharing and conditional grants in Korea and is often called "block" grants because of its relatively broad objectives. It was introduced in 1991 to stimulate local capital investment in infrastructure and is financed by specific shares of national taxes. Currently, all liquor tax, 15.3 per cent of the special agriculture tax and 14.2 per cent of transportation tax are transferred to local governments through this Fund. The revenues may be spent on road maintenance (70 per cent), farming and fishing development, water purification, regional development and youth education.

Other Funding: There are two tax-equalisation schemes between upper and lower-level local governments that resemble the Local Share Tax. These schemes aim to offset horizontal disparities among autonomous districts (*Metropolitan City Revenue Sharing*) and cities or counties (*Fiscal Compensation Fund*). In addition, the *Local Subsidy* is a conditional grant transferred from upper-level to lower-level local governments.

Table 11. **Intergovernmental fiscal transfers**
Billion won in 2002

Intergovernmental fiscal transfers		Amount	Per cent of total local revenue	Type	Matching	Ear-marked[1]
Central to local	Local Share Tax	10 307	15.3	Block	No	Yes
	National Treasury Subsidies	13 045	19.4	Conditional	Yes	No
	Local Transfer Fund	4 574	6.8	Conditional	Yes	Yes
Between local governments	MCRS[2]	1 968	2.9	Block	No	Yes
	Local Subsidy	3 406	5.1	Conditional	Yes	No
	Fiscal Compensation Fund	1 480	2.2	Block	No	-

1. Refers to whether the grant system is related to specific tax revenues.
2. MCRS = Metropolitan City Revenue Sharing.

Source: Sung-Il Lim (2002).

44. Concerns have also been raised about ill-defined spending and financing responsibilities across government layers. The decentralisation process has entailed a gradual devolution of government functions from the central to local level.[37] In particular, local governments have become increasingly responsible for social welfare functions. However, the functions of local governments have not been clearly defined and there is a large degree of overlap in spending and financing responsibilities between different levels of government.[38] This partly results from unclear assignments specified in laws and regulations,[39] but it also reflects the fact that upper-level local governments have often re-delegated to lower-level authorities the implementation of functions delegated to it by the central government, thus blurring responsibility.

45. Education has not been part of the growing responsibilities of local government. Although Korea’s education system is characterised by outstanding performances on international standardised tests of students (see the 2003 *OECD Economic Survey of Korea*), there is nonetheless widespread public discontent over large class sizes at all levels of schooling and insufficient capital investment. Educational funding is heavily dependent on the central government and indeed accounts for 20 per cent of its budget. In 2002, central government support for local education accounted for three-quarters of local education budgets. Education is administered separately by Boards of Education set up in upper-level local governments, which receive 13 per cent of total national tax revenue, thus guaranteeing their independence from the general local budget. As a result, lower-level local governments have little responsibility for education and hence limited incentive to invest in educational facilities. Furthermore, an increase in local government investment in education usually results in a cut in central government block grants for education, making it difficult to increase overall investment in schools at the local level. Recently, the central government has introduced some measures to encourage more investment by lower-level local governments.[40] However, more fundamental changes are needed to substantially increase local government’s involvement in education by increasing their financial and administrative responsibilities in this area.

37. Between 1991 and 1998, the central government devolved 2 008 out of 12 978 government functions to local levels. In 1998, the newly elected government set up the Presidential Commission on Promotion of Decentralisation, which devolved another 493 functions between 1999 and 2001.

38. The overlap in spending and financing responsibilities has also been identified as a problem in other OECD countries, for example, Switzerland, Italy, Germany and Greece.

39. The *Local Autonomy Act* assigns 87 functions to both upper-level and lower-level local governments. These overlapping functions represent 28 per cent of the upper-level local government functions and 25 per cent of lower-level local government functions (Hong, 1998).

40. For example, the regulation on lower-level governments’ investment in education -- requiring *ex ante* approval by the upper-level government -- has been relaxed. The central government has also allowed lower-level local governments to assess flexible tax rates for the education tax, and will not include those funds in the definition of local income used in the calculation of local government transfers.

Agenda for future reform

46. The previous sections suggest that there is considerable scope for improvement in the management of public expenditure in Korea. Given the future spending pressures, it is essential that Korea now launch a comprehensive reform programme to establish an effective public expenditure management system. The objective of reform should be to ensure fiscal sustainability and to enhance the transparency, effectiveness and efficiency of public spending. The key elements would be to manage public finance in a medium-term expenditure framework and to introduce modern public management tools to enhance flexibility and accountability for results within the public sector. The reforms should be implemented simultaneously in a transparent manner to gain public support. An agenda for such a programme is presented below and specific policy recommendations are summarised in Box 5.

Ensuring fiscal sustainability

47. Ensuring fiscal sustainability will require that the government consider its overall budgetary, taxation and expenditure priorities in a medium-term context. The reliance on an annual budgetary framework does not provide a strong anchor and discipline on policymakers. Combined with the absence of formal fiscal rules, this could significantly undermine fiscal discipline as Korea faces looming spending pressures. A key reform element is thus adopting a medium-term expenditure framework (MTEF) within which annual policy decisions can be made. Recent measures to present medium-term fiscal plans are a step in the right direction, but the authorities will now need to move to an explicit multi-year, medium-term budgetary process. Placing the annual budget process within a MTEF would increase fiscal discipline by showing the minimum costs of continuing existing policies and the medium-term consequences of decisions taken in following budgets, and by making clear to the public the degree of the government's commitment to fiscal discipline. At the same time, the government should also consider moving to a "top-down" approach to budget formulation, in which the fiscal authorities set a binding aggregate spending ceiling at the beginning of the process and divide it among individual spending ministries according to strategic priorities. This would allow the Ministry of Planning and Budget to largely withdraw from the details of budgetary allocations for each ministry and instead focus on providing strategic guidance on spending priorities to ministries. It will also allow each spending ministry to freely reallocate resources among its various agencies and programmes under a medium-term hard budget constraint. A top-down budgeting approach, together with a MTEF, would significantly boost the government's capacity for aggregate fiscal control and allocation of resources in line with medium-term strategic priorities.

48. Adopting a MTEF would involve preparing a rolling multi-annual budget for three or four years, based on medium-term macroeconomic forecasts, estimates of costs of ongoing programmes and estimates of the cost implications of changes in policies. Establishing a MTEF thus requires that the macroeconomic forecasting process be strengthened. In this context, it will be important to improve co-operation between key ministries, particularly the Ministry of Planning and Budget and the Ministry of Finance and Economy, during the forecasting process. It is also important that the assumptions underlying the macroeconomic forecasts are included in the budget documents. The experience of OECD countries suggests that the success of a MTEF requires strong political will. In this regard, legislation along the lines of the Fiscal Responsibility Bill should be enacted to underpin control of public expenditure and ensure fiscal sustainability, effectiveness and efficiency. Along with a MTEF, the government might also consider preparing indicative, long-term budget forecasts covering 30 to 40 years to capture the impact of population ageing and other demographic changes.

Making the budgetary system more comprehensive and transparent

49. The reforms to ensure fiscal sustainability should be complemented by measures to make the budget the principal instrument of aggregate fiscal control and management, which requires a more comprehensive and transparent budgetary system (OECD, 2002*c*). One of the reform priorities in this area should be to consolidate special accounts and public funds so as to reduce drastically their number as well as their share of expenditure. Accounts and funds that have overlapping functions should be merged, while those that no longer serve their original objectives should be abolished. Reducing the number of special accounts and public funds, however, requires a reform of the tax system aimed at abolishing earmarked taxes and various quasi-taxes, as recommended in the 2000 *Survey***.** For those public funds that remain, their administration should be upgraded, while providing more information to the public and strengthening the evaluation system. Control over expenditures by the public funds should also be strengthened, in part by further reducing, from the present 30 per cent, the amount by which ministers can increase outlays without the approval of the National Assembly. The introduction of any new special account or public fund should be subject to strict criteria, accompanied by sunset clauses. At the same time, the comprehensiveness of the budget also needs to be improved by bringing extra-budgetary funds and other spending, including National Health Insurance, into the budget.

50. The coverage of the budget documents should also be made more comprehensive and transparent. As the principal tool of fiscal control, it should contain complete information on government operations, including quasi-fiscal activities, tax expenditures, government guarantees and any other significant contingent liabilities and associated fiscal risks. Such a comprehensive coverage would facilitate the formulation of fiscal policy and the discussion, both within the government and the National Assembly, about the use of alternative fiscal instruments. Improving fiscal transparency also requires that budget planning and management be based on reliable and timely general government data. The current plan to include local governments in the consolidated government finance statistics by 2003 represents an important improvement, but it should be accompanied by more frequent and timely reporting of budgetary information on a consolidated general government basis. The objective of moving to accrual accounting by 2005 at the latest should be met, since the current method of cash accounting gives a misleading picture. Finally, transparency also requires providing reliable information about the government's fiscal policy intentions, forecasts and outcomes to the general public.

Moving toward more flexible and results-focused public management

51. Strengthening incentives at the central and local government level as well as in public-sector agencies for improved service delivery should be a key component of reform. The current efforts to provide more flexibility and autonomy to line ministries and agencies should be pursued. OECD country experience shows that entrusting spending agencies with flexibility in using resources, in exchange for holding them responsible for results, can lead to significant efficiency gains. The adoption of a MTEF and a top-down budgeting approach should help in this regard by providing spending ministries with greater flexibility to reallocate resources within the medium-term spending envelope. Korea can draw on OECD country experience in moving from its traditional system of input-focused management and budgeting toward one centred on outputs and outcomes. But countries have taken different roads to reform the public sector, with varying degrees of success. Korea will have to take a path that is compatible with its political and governmental conditions. In this sense, the recent experience of the pilot projects on performance-oriented budgeting and executive agency system should be evaluated systematically to draw lessons for deeper and wider reforms. However, progress requires the development of measurable performance indicators, which are critical for ensuring accountability.

52. Reducing the number of budget lines would allow the budget to be organised by programmes and activities. Such an approach would allow more scope for spending ministries to adjust their expenditures in line with changing circumstances and increase their freedom in operational decisions. Re-organising the budget classification so that programme areas match management responsibilities would increase transparency and allow the setting of effective expenditure ceilings and performance targets. A classification of expenditure by activity and programme would also allow performance indicators to be defined at an appropriate level.

Strengthening the accountability framework

53. The efforts to strengthen accountability for performance or results should accompany the move toward more flexible and results-focused budgeting and management. Greater weight should thus be given to developing effective value-for-money audits and systematic evaluations of programmes and projects. Korea can draw from the experience of other OECD countries which have used different instruments to assure accountability for performance (OECD, 1997). These include, for example, programme evaluation (Australia), annual reports that are audited for reliability of financial and performance statements (Sweden) and framework documents and performance targets to concentrate managerial attention on key objectives and results (United Kingdom). Moving from compliance to accountability for results, however, is not an easy task and it is necessary to ensure that basic audit functions do not suffer. Indeed, the traditional accountability based on legal and procedural compliance is still an important element of management and, without it, moving to the next step could pose significant risks (Schick, 1998). The rule-based governance will remain important in areas where it is difficult to introduce the new budgeting and management tools.

54. Within the Korean institutional context, strengthening the role and capacity of the Board of Audit and Inspection both in traditional auditing and in performance or value-for-money audits at both the central and local government level, could be most instrumental in strengthening the overall accountability framework. At the same time, the current effort to strengthen *ex ante* evaluation should be accompanied by systematic *ex post* evaluation of programmes and policies. Moreover, the feedback effects of *ex post* evaluation and audit findings into the policy formulation and budget processes should also be strengthened. It would also be particularly useful to undertake fundamental reviews of key sectors in a phased manner. This would not only rationalise the use of special accounts and public funds, but also address the current inefficiency and fiscal rigidities arising from vested interests in spending ministries. Finally, the current efforts to extend the accountability framework to public corporations and the wider public sector should be accelerated.

Enhancing the role of market mechanisms in publicly funded services

55. Enhancing the role of market mechanisms could boost the efficiency of publicly funded services. Government departments and agencies should make greater use of benchmarking, which could be a useful tool for improving value for money by establishing performance targets in reference to the best practices identified in comparable public or private organisations. The government could also explore a wider use of market instruments such as internal contracts, vouchers, and user charges: the experience of other OECD countries suggests that this can be done without compromising other policy goals, in particular equity objectives. However, reaping the full benefits of a market-oriented management approach partly depends on the strength of competitive pressures. In particular, competition in the process of contracting out of government functions and private participation in infrastructure construction will need to be strengthened. Expanding the current efforts to enhance competition in public administration should also be pursued.

Making decentralisation more effective

56. The on-going fiscal decentralisation and devolution of power offers an opportunity to improve the effectiveness of public spending. Making decentralisation more effective is thus a key component of reform. The basic direction of change in this area should be to provide more autonomy and flexibility, while strengthening accountability of local governments. The current intergovernmental fiscal design should be improved so as to strengthen incentives for local governments to be efficient and accountable in public spending. The rules for the central government's equalisation transfers to local governments need to be improved so as to make them the main instrument for ensuring horizontal equity between jurisdictions. The conditional portion of these transfers should be minimised, while the allocation criteria should be made more clear and objective. The use of small conditional grants should be drastically reduced by integrating small conditional grants into more general grants, as the central government is considering. This reform should be accompanied by a reduction in the share of conditional grants in central government transfers. For the remaining conditional grants, it is important to strengthen performance evaluation of projects financed by these grants. Along with the reforms at the central level discussed above, results-focused budgeting and management should also be pursued at the local government level.

57. The reform effort in this area should include reviewing the distribution of spending and funding responsibilities across levels of government and disentangling these responsibilities. More attention should be given to the principle that functions should be assigned according to competency in providing services. In the areas where responsibilities would still be shared, co-operation should be improved by setting clear objectives and rules for co-financing and service provision. Other reforms to enhance local accountability and fiscal responsibility include higher financial reporting standards, including accrual accounting and public release of results. The government's efforts to expand financial reviews of individual local governments since 1996 should be followed up through the development of new local standards and benchmarks, such as indicators for infrastructure services, health and education. Adequate norms and indicators will be critical to proper monitoring of local performance.

Box 5. Summary of recommendations

Ensure fiscal sustainability

- Adopt a medium-term expenditure framework within which annual budget needs are assessed.
- Strengthen the macroeconomic forecasting process underlying the budget.

Make the budget process more comprehensive and transparent

- Consolidate special accounts and public funds to reduce sharply their number and share of spending. Integrate extra-budgetary funds into the budget. Expand the comprehensiveness and transparency of the budget documents.
- Produce timely and reliable general government data that includes local governments and is based on accrual accounting. Provide adequate information on fiscal policy intentions, forecasts and outcomes to the general public.

Move toward more flexible and results-focused public management

- Expand incentives at the central and local government levels for improved public service delivery and accountability.
- Develop performance indicators to facilitate results-focused management and budgeting.
- Reduce the number of budget lines to encourage more focus on programmes and activities.

Strengthen the accountability framework

- Establish an effective institutional framework for expanding the number and usefulness of performance audits, in particular by increasing the role and the capacity of the Bureau of Audit and Inspection for value-for-money audits.
- Incorporate feedback from *ex post* evaluation and audit findings more fully into the budget process.
- Accelerate the current efforts to strengthen the governance of the wider public sector.

Enhance the role of market mechanisms in publicly funded services

- Encourage competition and extend market signals, including benchmarking, internal contracts, contracting out, vouchers, and user charges, without compromising social policy goals.
- Introduce more competition into upper-secondary education.

Make decentralisation more effective

- Increase the autonomy and flexibility of local governments while strengthening their accountability.
- Reform the intergovernmental fiscal transfer system: by improving the equalisation function of Local Share Tax and making the rules of equalisation transfers more clear and objective; and by drastically reducing the current reliance on conditional grants. Performance evaluation of the projects financed by these grants should be improved.
- Upgrade financial reporting standards and develop performance indicators for local governments.

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