

## 6 Fiscal Performance in South Korea (1970–2012)

### Budgetary Reforms with Growing Non-Budgetary Indiscipline

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#### Introduction

This chapter explores South Korea's<sup>1</sup> fiscal performance<sup>2</sup>—patterns of deficits and debt—in the historical and comparative contexts. During Korea's high economic growth period, lasting from the early 1960s to the late 1980s, Korea established a strong tradition of keeping a balanced budget. Fiscal discipline was also buttressed by an institutional arrangement that depoliticized the fiscal policy making process. Key to this was the dominance of the executive over the legislature in the budgetary process. Under Korea's presidential system, the powers of the legislature in budget drafting, execution, and oversight were very limited—unlike the United States (Lienert 2005; Stapenhurst et al. 2008). The strong presidency, which was established during the military dictatorship (1961–87), insulated the Korean economic bureaucracy, which was hierarchically organized with the Economic Planning Board (EPB) at the top (Choi 1991). The EPB, established in 1961, could influence every important economic policy making process by monopolizing the budget planning and implementation process. During the high economic growth period, the EPB developed the tradition of maintaining a balanced annual budget.

The situation changed with the democratic transition in 1987. Since the transition, the power balance in fiscal policy making gradually shifted from the executive to the legislature, with the shift accelerating in the 2000s, as Korean politics experienced repeated changes in government. The EPB was dismantled in 1994,<sup>3</sup> causing the fiscal bureaucracy to lose its policy autonomy gradually. This power shift coincided with a series of neo-liberal economic reforms, which the Korean government pursued since the early 1990s and then gained momentum after the Asian financial crisis of 1997. The series of neo-liberal reforms contributed to deepening the social and economic gaps of Korean society. Worsening socioeconomic polarization increased the demand for expanded social welfare programs.

With the 1987 democratic transition, the balanced budget tradition was gradually dismantled and the government consistently ran budget deficits, particularly after the Asian financial crisis of 1997. As a result, public debt has mounted over the past decade. But importantly, as non-budgetary fiscal indiscipline increased the government attempted to bypass the growing legislative oversight over the

budgetary process. The Korean government has used public corporations or extra-budgetary funds in response to the growing fiscal reforms to enhance the powers of the National Assembly on the budgetary process. By the end of 2013, the debt held by public corporations exceeded the debt held by the government.

This chapter is organized into five sections. The first section reviews the historical trends of fiscal performance from the early 1970s to 2012. The second looks at the distinctive features of Korea's tax and expenditure structure, and reviews how the balanced budget was institutionalized during the high economic growth period from the early 1960s to the early 1990s—specifically with the establishment of the EPB in 1962 and its abolition in 1994. The third section explores the budgetary politics, with special attention to the evolving relations between the executive and legislative branches of the government. The fourth section discusses fiscal challenges that the Korean government needs to tackle in the near future due to an aging population and dualistic employment structure. The chapter concludes with a discussion on comparative implications and policy lessons we can learn from the Korean case.

#### Trends in Fiscal Performance

##### Overview

Korea's fiscal performance has varied since the early 1970s. While the fiscal balance of the Korean government consistently fluctuated during the 1970s, it improved significantly from the early 1980s to 1996. Since then, primarily due to the Asian financial crisis of 1997–98, it has consistently worsened.

From the early 1970s to early 1980s, fiscal balance fluctuated as the Korean economy was hit by the shock of the collapse of the Bretton Woods system, in 1971, and two oil crises, from 1972 to 1974 and 1978 to 1981. During these periods, fiscal deficits ranged from 3.5 percent of Gross Domestic Product (GDP) to 4.5 percent. The Korean government launched the Heavy and Chemical Industrialization (HCI) strategy, which focused on developing steel, petrochemicals, automobiles, shipbuilding, machinery, and electronics. This HCI strategy required massive investments. The Korean government not only created various investment-related funds, but also a priority-loan program in which the government applied lower interest rates toward the loans for big companies (*chaebols*), which were engaged in developing those strategic industrial sectors (Cho and Kim 1997; Kim 2004). The HCI strategy decreased the savings-investment imbalances, and the expansionary fiscal spending for increasing investments aggravated the fiscal balance of the government (Bahl et al. 1986; Choi 1992).

It should also be noted that the two periods of 1972–74 and 1979–81 were periods of political instability. In 1972, a series of presidential emergency decrees were announced due to the mounting public demonstrations against the constitutional revision—the *Yushin* constitution, which gave permanent dictatorial power to Park Chung Hee (Lee 2005). But Park was assassinated in October 1979, followed quickly by a military coup. As a result, an interim military

government was established by Chun Doo-hwan, under martial law, which lasted until 1981. Massive demonstrations against Chun Doo-hwan's coup and his interim government intensified in early 1980. Chun's interim government tried to quell the demonstrations by using the special forces of the Korean military, which resulted in a massacre in the Kwangju area, the capital city of the Southwest province in May 1980 (Katsiaficas 2012). As a consequence of this social and political instability, exports plummeted and inflation mounted in the early 1980s.

The budget remained largely in balance from the early 1980s to 1996—as Figure 6.1 shows—while the savings–investment imbalance decreased. During this period, the Korean economy boomed, while accumulating current account surpluses. Furthermore, the Korean government tightened its monetary and fiscal policies. It attempted to slow down the annual growth rate of money supply to target the inflation caused by the oil crises and the subsequent political turmoil in 1979 and 1980, and restrain government spending. In 1982, the government set up the Budget Review Committee (BRC)—within the budget office—which reviewed the ministerial budget requests with the goal of containing spending increases and establishing fiscal discipline (Koh 2007).

In the late 1980s, the Korean economy reaped the economic benefits of low oil prices, low interest rates, and a weak dollar in international markets. From 1986 to 1988, Korea's exports and current account surpluses increased remarkably. Exports rose 28.3 percent in 1986, 36.4 percent in 1987, and 29.0 percent

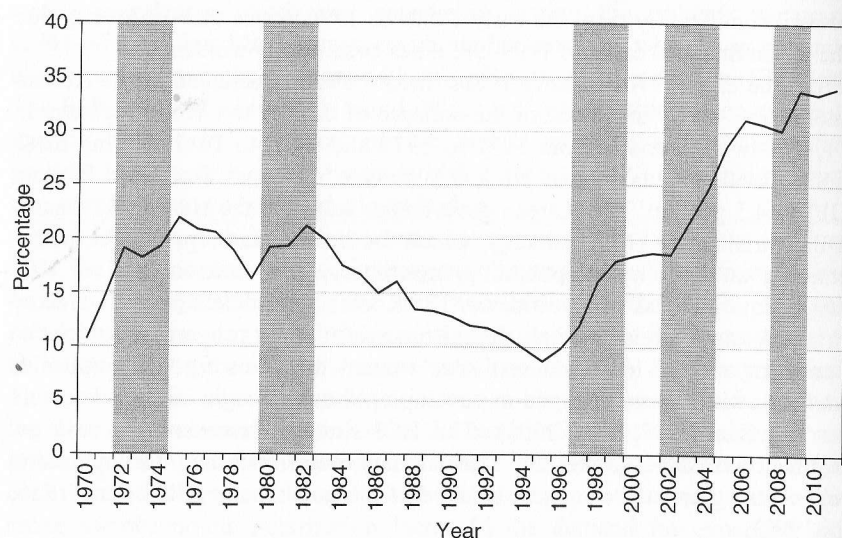


Figure 6.1 Percentage of government debt to GDP, 1970–2011 (source: MOSF, *Digital Budget and Accounting System portal* ([www.digitalbrain.go.kr](http://www.digitalbrain.go.kr))).

Note

1 The grey area highlights the period of economic or financial crises. Specifically, those periods are from 1972 to 1974; from 1979 to 1981; the Asian financial crisis from 1997 to 1999; the credit card companies crisis from 2002 to 2003; the global financial crisis of 2007 to 2009.

in 1988. Meanwhile, account surpluses increased from US\$4.6 billion in 1986 to US\$14.1 billion in 1988. As a result, the fiscal debt level decreased greatly. As Figure 6.1 highlights, from 1982 to 1996, the percentage of government debt-to-GDP fell continuously, going below 10 percent of GDP by the end of 1996. It can safely be said that until the mid-1990s, Korea's fiscal performance was positively balanced.

This trend, however, has changed since 1997. The Korean government has consistently had a budget deficit and its fiscal performance has continuously declined. The government debt level has increased from 10 percent of GDP in 1997 to 34 percent of GDP in 2012. During this period, the Korean economy went through three financial crises: the Asian financial crisis of 1997–98, the crisis of credit card companies in 2002–04, and the global financial crisis of 2007–09. These financial crises, and ensuing fiscal measures to cope with them, have contributed greatly to the sharp increase of Korean government debt. For instance, during the Asian financial crisis of 1997–98, the Korean government launched fiscal stimulus packages, including the usage of government money for financial restructuring. The government used a large amount of funds again to resolve the crisis of credit card companies in 2002–04. This pattern was repeated during the global financial crisis of 2007–09.

The fiscal balance worsened with the increasing demand for social protection as well. Since the Asian financial crisis, the Korean government has pushed several liberalization agendas in the financial, corporate, and labor sectors which have contributed to deepening socioeconomic polarization, reflected in the widening income gaps. To cope with the polarization, the Korean government tried to expand its spending for social security, specifically expanding the social safety net. However, despite the mounting demand for social welfare, the incumbent and opposition parties have not raised taxes to pay adequately for the expanding social welfare programs. Consequently, the increased rate of spending for social security has continuously exceeded the rate of tax revenue growth.

Despite the increase of government debt, Korea's debt level has been much lower than most Organization of Economic Cooperation and Development (OECD) countries for the past decade. As of the end of 2011, Korea's government debt-to-GDP ratio was less than 34 percent, while the average for OECD countries was 75 percent. Other fiscal indicators, such as structural budget deficits and net public debt, also suggest that Korea's fiscal condition is in much better shape than most OECD countries (OECD Economic Outlook No. 92).

It should be noted, however, that the data provided by the International Monetary Fund (IMF), OECD, and other international organizations, does not yet show comparable consolidated information<sup>4</sup> on public sector debt. In most cases, IMF or OECD data on public debt covers only the general government sector,<sup>5</sup> and does not include other subsectors of the public sector, such as nonfinancial public corporations and financial public corporations. As a result, we cannot capture the consolidated debt situation of the entire public sector. In this context, the World Bank and the IMF jointly launched in December 2010 the Public Sector Debt Statistics (PSD);<sup>6</sup> the quarterly PSD provides information covering both the general government sector and financial and nonfinancial public corporations.<sup>7</sup>

Because the Korean government has yet to provide the consolidated public sector debt to the PSD, we cannot do a real cross-country comparison on Korea's public sector debt level. Still, we get a sense of the recent trend by investigating the outstanding debt of nonfinancial public corporations in Korea. The level exceeded the outstanding general government debt, reaching more than 38.7 percent of GDP in 2013 (MOSF, April 9 2013), and it has increased 8.4 times since 1998, with particularly rapid growth during the last five years. Thus Korea's national debt level, including the debt in the public sector, may not be particularly low compared with that of other OECD countries, as is often believed.

### Tax Structure

Korea's tax revenues have increased greatly during the past decades; more than 430 times from KRW492 billion in 1971 to KRW212 trillion in 2008. In particular, from the 1970 to the late 1980s, the proportion of national taxes levied and operated by the central government was about 90 percent of total tax revenues. But with the growing fiscal decentralization since the late 1980s, the proportion of local taxes had grown gradually to more than 20 percent of the total tax revenues in the early 1990s. Since then the proportion of local taxes has continued to rise.

One of the more interesting aspects of Korea's tax structure is that the tax rate has been one of the lowest in the OECD area. Table 6.1 shows the ratio of the total tax revenue of major OECD countries to GDP. Korea's aggregate tax level was far lower than the OECD average from the 1970s to the 1990s. In particular, during the 1980s Korea's rate was about half the OECD average. But, with the increasing social security contributions, the rate increased to 25.1 percent by 2010, reaching a similar level as the United States and Japan.

Table 6.1 Total tax revenue<sup>1</sup> as percentage of GDP, selected countries, 1980–2010

|                               | 1975 | 1980 | 1985 | 1990 | 1995 | 2000 | 2005 | 2010 |
|-------------------------------|------|------|------|------|------|------|------|------|
| France <sup>2</sup>           | 35.5 | 40.2 | 42.8 | 42.0 | 42.9 | 44.4 | 44.1 | 42.9 |
| Germany <sup>3</sup>          | 34.3 | 36.4 | 36.1 | 34.8 | 37.2 | 37.5 | 35.0 | 36.3 |
| Italy                         | 25.4 | 29.7 | 33.6 | 37.8 | 40.1 | 42.2 | 40.8 | 43.0 |
| Japan                         | 20.7 | 25.1 | 27.1 | 29.0 | 26.8 | 27.0 | 27.4 | 27.6 |
| Korea                         | 14.9 | 17.1 | 16.1 | 19.5 | 20.0 | 22.6 | 24.0 | 25.1 |
| Korea without social security | 14.8 | 16.9 | 15.8 | 17.5 | 17.6 | 18.8 | 18.9 | 19.3 |
| United Kingdom                | 34.9 | 34.8 | 37.0 | 35.5 | 34.0 | 36.3 | 35.7 | 35.0 |
| United States                 | 25.6 | 26.4 | 25.6 | 27.4 | 27.8 | 29.5 | 27.1 | 24.8 |
| OECD (total)                  | 29.4 | 30.9 | 32.5 | 33.1 | 34.6 | 35.3 | 35.0 | 33.8 |

Source: OECD, *Revenue Statistics 1965–2011* (<http://dx.doi.org/10.1787/888932720302>).

#### Notes

1 Total tax revenue includes social security contributions.

2 Total tax revenues have been reduced by amount of any capital transfer that represents uncollected taxes.

3 Unified Germany beginning in 1991.

This lower level of tax burden reflects the long tradition of the benevolent state in Korea, resulting not only from a Confucian political culture, but also from the legacy of past authoritarianism. In Confucian tradition, the state was placed in the highest status of the hierarchical social order, and a good state—or a virtuous leader—was expected to be benevolent to the people. Moreover, due to the weak political foundation of legitimacy, authoritarian governments—lasting from 1961 to 1987—tried to compensate for coercive and oppressive rule by maintaining lenient tax policies. This prolonged history of lower taxes makes it more politically difficult to increase taxes to meet the growing demand for expanding social welfare.

By contrast, Korea's indirect tax proportion has been much higher than the OECD average, primarily because of a high proportion of consumption taxes. Of total tax revenues, the indirect tax to direct tax ratio declined from the early 1970s to the mid-1980s. It then began to rise in the mid-1980s, a trend that has continued. For the past decade, the indirect tax proportion has been consistently over 50 percent of total tax revenues. Of those indirect taxes, the value-added tax (VAT)—which was introduced in Korea in 1978—has been a primary source of indirect tax revenues, exceeding over 30 percent of the total tax revenue since its introduction.

Indeed, taxes on specific goods and services in Korea have been much higher than those in other OECD nations on average since 1980. For example, the proportion of taxes on goods and services was 62.6 percent in 1980, almost twice as high as the OECD average at the time. The proportion started to decline sharply under the Roh Tae Woo administration (1988–93)—as the Korean government began to introduce more social security taxes—and stayed around 40 percent of the total tax revenue from the early 1990s to the early 2000s. It has declined for the past decade, but was over 33 percent of total tax revenue in 2010 (OECD Revenue Statistics 2012). This high proportion of indirect taxes highlights how the Korean tax structure has been institutionalized favoring the rich or high income earners.

Meanwhile, Korea's social security contributions as a share of total taxation have been much lower than the OECD average. Social welfare programs were introduced in Korea far later than other European welfare states or Japan. For instance, the National Pension System was introduced in Korea in December 1973 under Park Chung Hee (1961–79). In the original pension plan, the contribution rate was low and mandatory coverage was narrow. Furthermore, the original pension scheme was introduced, not for improving the pension system per se, but for mobilizing domestic capital for investment in the heavy and chemical industries (Kim and Stewart 2011). The national pension scheme was not fully implemented until the enactment of the National Pension Act in 1988.

As Table 6.2 shows, in 1985, the proportion of social security contributions to total tax revenues was about 1.5 percent. But with the democratic transition in 1987, specifically during the Roh Tae-Woo administration (1988–93), additional social welfare programs were introduced. As a result, the proportion of social security contributions jumped to 10.1 percent in 1990, and grew continuously thereafter. By the end of 2010, it was at 22.8 percent of the total taxation, slightly

Table 6.2 Social security contributions as percentage of total taxation

|                           | 1975 | 1985 | 1990 | 1995 | 2000 | 2007 | 2010 |
|---------------------------|------|------|------|------|------|------|------|
| France                    | 40.6 | 43.3 | 44.1 | 43.0 | 36.1 | 37.1 | 38.7 |
| Germany                   | 34.0 | 36.5 | 37.5 | 39.0 | 39.0 | 36.6 | 39.0 |
| Italy                     | 45.9 | 34.7 | 32.9 | 31.5 | 28.5 | 29.9 | 31.3 |
| Japan                     | 29.0 | 30.3 | 26.4 | 33.5 | 35.2 | 36.5 | 41.1 |
| Korea                     | 0.9  | 1.5  | 10.1 | 12.1 | 16.7 | 20.7 | 22.8 |
| United Kingdom            | 17.5 | 17.8 | 17.0 | 17.8 | 17.0 | 18.4 | 19.0 |
| United States             | 20.5 | 25.2 | 25.2 | 24.9 | 23.4 | 23.3 | 25.7 |
| OECD (total) <sup>1</sup> | 22.0 | 22.1 | 22.0 | 25.1 | 24.6 | 24.6 | 26.4 |

Source: OECD, *Revenue Statistics, 2012 Edition* ([www.oecd.org/tax/taxpolicyanalysis/revenuestatistics2012edition.htm](http://www.oecd.org/tax/taxpolicyanalysis/revenuestatistics2012edition.htm)).

Note

1 Unweighted average.

lower than the OECD average of 26.4 percent. Considering the recent rate of increase in social security contributions, it looks obvious that social security contributions will continue their growth in Korea in the near future, converging with the general pattern of other advanced OECD countries.

### Expenditure Structure

The Korean government has traditionally used the majority of its spending on national defense and education. However, defense spending has been in steady decline since the early 1980s, while the spending for education has remained at the same proportion of total government spending, as Figure 6.2 shows.

It should also be noted that government spending for social protection has remained minimal until recently, unlike the advanced economies of Europe. Of the total government expenditure, spending for social protection has been below 7.5 percent until 2010. Indeed, Korea's public social spending has been the lowest among OECD countries. For instance, as of the end of 2009, the average gross public social expenditure in OECD countries was 22.4 percent of GDP. In Korea, however, it was only 9.4 percent of GDP. Mexico was the only OECD country whose public social expenditure was lower than Korea's (OECD, *Revenue Statistics* 2012). As noted in the previous section, the Confucian tradition remained strong in Korea and, in that context, family members were often socially expected to take care of individual family member's welfare necessities. Moreover, the public welfare system was introduced much later than in most OECD countries. As a result, Korea's public spending for social security has been an outlier among OECD countries (Yang 2013).

Government spending on healthcare, however, has increased remarkably over the past two decades. In 1988, the total spending for healthcare was only KRW1 trillion, but it increased to KRW38.1 trillion in 2010. In 2010, the proportion of the government spending for healthcare was larger than that of defense, education, and general public services, as Figure 6.2 shows. This increased government

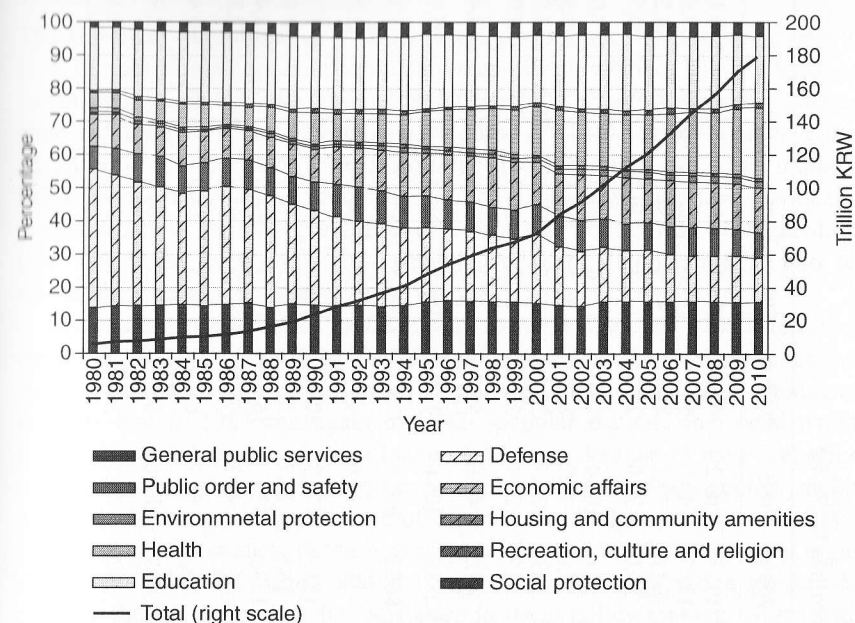


Figure 6.2 General government final consumption expenditure, 1980–2011 (source: Bank of Korea, *Economic Statistics System* (<https://ecos.bok.or.kr>)).

spending for healthcare was mobilized through social security funds, which are managed and operated by the government. Between 1990 and 2007, Korea's public social spending increased at an 11 percent annual rate in real terms, which was the fastest in the OECD (OECD 2012). Between 2007/08 and 2011/12, Korea's real social spending increased by 29 percent, the largest increase among OECD countries (OECD 2012, chart 2).

Meanwhile, fiscal spending by local governments grew rapidly. Local governments in Korea did not have any fiscal autonomy until 1995, as the military dictatorship suspended it from 1963. Local autonomy was restored only after a long political struggle following the democratic transition in 1987. However, even after the restoration of local autonomy in 1995, local governments had only a limited degree of fiscal autonomy.<sup>8</sup> Nonetheless, fiscal decentralization has gradually progressed over the recent decade. In 2003, the total budget of local governments was approximately 40 percent of the total budget of the central government, but it increased to about 53.4 percent by 2011 (see Table 6.3). For the past decade, the share of the local tax revenue in the local budget has declined, and the fiscal condition of local governments has worsened as spending of local government has often been swayed by local special interests.<sup>9</sup> To remedy this, the Korean government passed, in 2005, the Local Finance Act. With the Act, the Minister of Public Administration and Security came to be able to intervene in the operation of the budget by local governments (Article 5 of Local Finance Act).

Table 6.3 Budget of central and local governments, type of accounts, 2003–11 (unit: trillion KRW, %)

|   | 2003  | 2004  | 2005  | 2006  | 2007  | 2008    | 2009  | 2010    | 2011    |
|---|-------|-------|-------|-------|-------|---------|-------|---------|---------|
| Central government                                      |       |       |       |       |       |         |       |         |         |
| Subtotal (A)  | 191.9 | 187.9 | 195.8 | 204.2 | 201.0 | 228.2   | 256.5 | 255.3   | 264.1   |
| General account (a)                                     | 118.1 | 120.1 | 135.2 | 147.0 | 156.5 | 179.6   | 203.5 | 201.3   | 209.9   |
| Special accounts (b)                                    | 73.8  | 67.8  | 60.6  | 57.3  | 44.4  | 48.6    | 53.0  | 54.1    | 54.2    |
| (b)/(a) (%)   | 38.4  | 36.1  | 31.0  | 28.0  | 22.1  | 21.3    | 20.7  | 21.2    | 20.5    |
| Local government  |       |       |       |       |       |         |       |         |         |
| Subtotal (B)  | 78.1  | 87.3  | 92.4  | 101.4 | 112.0 | 125.0   | 137.5 | 139.9   | 141.0   |
| General account (c)                                     | 60.5  | 66.6  | 71.8  | 78.7  | 86.5  | 98.4    | 109.5 | 113.4   | 108.5   |
| Special accounts (d)                                    | 17.7  | 20.6  | 20.6  | 22.7  | 25.5  | 26.5    | 28.1  | 26.4    | 32.5    |
| (d)/(c) (%)   | 22.6  | 23.6  | 22.3  | 22.4  | 22.7  | 21.2    | 20.4  | 18.9    | 23.0    |
| Local budget to central budget: (B)/(A) (%)             | 40.7  | 46.5  | 47.2  | 49.6  | 55.7  | 54.8    | 53.6  | 54.8    | 53.4    |
| Total National Budget (C): (A) + (B)                    | 270.0 | 275.2 | 288.2 | 305.6 | 312.9 | 353.2   | 394.1 | 395.2   | 405.1   |
| Nominal GDP: (D)  | 767.1 | 826.9 | 865.2 | 908.7 | 975   | 1,026.5 | 1,065 | 1,173.3 | 1,237.1 |
| Total National Budget/GDP: (C)/(D) (%)                  | 35.2  | 33.3  | 33.3  | 33.6  | 32.1  | 34.4    | 37.0  | 33.7    | 32.7    |
| Tax revenue   |       |       |       |       |       |         |       |         |         |
| Subtotal (E)  | 147.8 | 152   | 163.4 | 179.3 | 205   | 212.8   | 209.7 | 226.9   | 244.7   |
| Tax burden ratio: (E)/(D)                               | 19.3  | 18.4  | 18.9  | 19.7  | 21    | 20.7    | 19.7  | 19.3    | 19.8    |
| National tax (F)  | 114.7 | 117.8 | 127.5 | 138   | 161.4 | 167.3   | 164.5 | 177.7   | 192.4   |
| Local tax (G)   | 33.1  | 34.2  | 36    | 41.3  | 43.4  | 45.5    | 45.2  | 49.2    | 52.3    |
| Total tax revenue to total National Budget: (E)/(C) (%) | 54.7  | 55.2  | 56.7  | 58.7  | 65.5  | 60.3    | 53.2  | 57.4    | 60.4    |
| National tax/central government budget: (F)/(A) (%)     | 59.8  | 62.7  | 65.1  | 67.6  | 80.3  | 73.3    | 64.1  | 69.6    | 72.9    |
| Local tax/local budget: (G)/(B) (%)                     | 42.4  | 39.2  | 39.0  | 40.7  | 38.8  | 36.4    | 32.9  | 35.2    | 37.1    |

Source: MOSF, KOSIS and Bank of Korea, *Statistics Portal*.

## Evolution of Budgetary Politics

The historical vicissitude of Korea's fiscal performance and its relatively low level of public debt beg some comparative questions; whether Korea's fiscal performance is an outlier case among OECD countries or only a transitory phenomenon resulting from an economic development that occurred later than other advanced economies. One interesting issue in the Korean case is the impact of fiscal institutions in the Korean context. To answer this question, we need to understand how the strong tradition of a balanced budget was established, and then how it has been gradually dismantled with the democratization and economic liberalization beginning in the early 1990s.

Korea's balanced budget tradition was founded upon the supremacy of the executive branch over the legislature in regards to the budgetary process. However, with the transition from a military dictatorship to a democratic regime—first in 1987 and again in 1992—popular demand for social welfare soared. Nonetheless, it took time for the increasing demand to have real effects on government's tax revenue and expenditure structure. Fiscal policy making was still under the heavy influence of the balanced budget principle until 1996. The turning point came with the Asian financial crisis and the subsequent regime change in 1998. The crisis and the regime change triggered a power shift between the executive and the legislature in fiscal policy making, with various fiscal reforms being taken to strengthen legislative power in budgetary planning and oversight.

## Weak Veto Power of the Legislature

Korea's fiscal policy making was long dominated by the executive branch of the government.

It reflects the long tradition of a strong presidency, which originated from the military dictatorship lasting from 1961 to 1987.<sup>10</sup> Park Chung Hee set up and consolidated this strong presidency during his dictatorial rule from 1961 to 1979. He claimed that “democracy should be established by administrative (fiat), not by political means (popularly determined)” (Park 1962, 208). He asserted that the state, especially the executive branch of the government, should “guide” democratization given the retarded social and economic conditions of the nation, calling it an “administrative democracy.” With the notion of “administrative democracy,” he laid out an institutional foundation that enabled the supremacy of the executive over the legislature and political parties in the national agenda-setting process in general, and in fiscal policy making in particular.

Park set up the Economic Planning Board (EPB) in July 1961. The EPB wielded monopolistic power on budget planning and allocation until 1994 when it was merged with the Ministry of Finance; it then was integrated into the Ministry of Finance and Economy. The EPB was placed at the top of the economic bureaucracy, and the head of the EPB, as a deputy prime minister, was in charge of orchestrating and coordinating the macroeconomic policies of the government. With the power of controlling the budget, as well as approval power for

foreign loans, the EPB, until 1993, was able to implement their five-year economic plans without hindrance (Choi 1991).

A "Planning and Control Office" (PCO) was established within the EPB from its creation in July 1961, a model that gradually extended to other ministries. Placed under the Office of Planning Coordination in the Prime Minister's office, the PCOs monitored and evaluated the status of the implementation of economic projects assigned to each ministry in quarterly reports. This controlling mechanism provided the Prime Minister, and ultimately the President, with an independent channel of information (Lee 1968, 144–145). As a result, during its existence the EPB's fiscal policy making process was fully insulated from any political interference from party politics. Without interference, the EPB was free to pursue their goal of an annual balanced budget (Kim 1992).

The supremacy of the executive in fiscal policy making continued even after the democratic transition, with multiple factors contributing to its sustenance. One key factor was the fiscal rules in the Constitution. According to the revised Constitution of 1987, "the legislative power is vested in the National Assembly" (Article 40) with the National Assembly holding final authority in deciding the government's budget. The president could not veto the budget bill, once it passed the National Assembly. However, the power of the National Assembly in the budgetary process was very limited by the fiscal rules stipulated in the Constitution.

One such rule was that the National Assembly could not increase the amount of fiscal money for any programs in the budget bill, submitted by the executive, without the consent of the executive (Article 57 of the Constitution).<sup>11</sup> The National Assembly was therefore only empowered to cut the budget for specific fiscal programs. Moreover, the Korean Constitution (Article 54) stipulates that:

(1) The National Assembly deliberates and decides upon the national budget bill, while (2) The Executive formulates the budget bill for each fiscal year and submits it to the National Assembly within ninety days before the beginning of a fiscal year.

As a result, only the executive can introduce budget bills to the National Assembly.

More importantly, the National Assembly had limited institutional capacity for budget audit and oversight. It did not have power to audit and oversee the operation of budgetary expenditure of executive agencies. Such functions belonged to the Board of Audit and Inspection (BAI), which served (and still does) as the government's principal auditing and evaluation agency.<sup>12</sup> This pattern is strikingly different from those countries in which the auditing functions and power belong to the legislature—often called the Westminster model—in which the legislature authorizes expenditure and revenue, and receives audit reports from an independent audit agency (Lienert 2005).<sup>13</sup> It was only after 2003, when the National Assembly Budget Office (NABO)<sup>14</sup> was established, that the National Assembly came to have a regular organizational structure for budget auditing and oversight.

Before the establishment of the NABO, annual budget reviews were done by the Special Committee for Budget and Accounts, which was composed of 50 National Assembly members. But the Committee was an ad hoc committee until 2000, and the turnover ratio of the Committee members was very high. In the Korean National Assembly, it is commonplace to reshuffle the Assembly members on the Special Committee for Budget and Accounts every year. As a result, those Special Committee members often suffered a lack of expertise on fiscal issues. Moreover, the total time for budget deliberation is limited to three months, curbing the budgetary review power of the National Assembly. In Korea, as the new fiscal year begins on January 1st, the budget must be passed before the end of the year. In practice, however, the real regular session for budgetary review often lasts less than a month.

Political party structure and practices, consolidated during the authoritarian regimes, also limited the power of the National Assembly against the executive. Until 2004, the president could dominate the legislative process in the National Assembly. The Korean president was not only the executive leader of the government, but also chairman of the ruling party. The president, as a ruling party boss, could wield almost absolute power over the nomination of district representatives for the National Assembly elections. Thus, personal loyalty to the president was a critical factor for politicians in being nominated and re-elected.<sup>15</sup> This institutional setting installed a president-centered, highly personalized and centralized structure in the ruling party, and it enabled the president to dominate in the legislative process in general, particularly in budgetary politics. With the exception of 1987 to 1989, the ruling party held majority status in the National Assembly, and the president could control the budgetary process without complications.

### *Shift in Executive–Legislature Relations and Budgetary Reforms*

Despite various institutional constraints, the power of the National Assembly has grown gradually with democratic consolidation. Since the democratic transition in 1987, there have been six presidential elections every five years, from the thirteenth in December 1987 to the eighteenth election in December 2012, and seven elections for the National Assembly members every four years, from the thirteenth in April 1988 to the nineteenth in April 2012. Of those six presidential elections, right-leaning conservative party candidates were elected four times, and conservatives parties won six out of seven legislative elections—the exception being the seventeenth legislative election in April 2004. These election results clearly demonstrate Korean voters have consistently supported right-leaning conservative parties.

It should be noted, however, that in the Korean political context, ideological positions of political parties have not usually aligned with their policy orientations (Kim 2000, 2002). Electoral politics are not typically determined by parties' ideological positions on certain economic policies or the role of the government in the economy. Likewise, political parties are not organized based on articulated interests of different social groups. Instead, most Korean parties are

catch-all parties, based on certain regional power bases. Until the regime change through the presidential election of December 1997, all incumbent ruling parties were based in *Kyungsang* (Southeastern) Province. During the military dictatorship, all three former dictatorial leaders—Park Chung Hee (1961–79), Chun Doo-hwan (1980–87), and Roh Tae-woo (1988–93)—were from the North *Kyungsang* Province, and the succeeding first civilian President, Kim Young-sam (1993–98), was from South *Kyungsang* Province.

Major opposition parties were also region-based. Indeed, in every election since the democratic transition in 1987, a region-oriented voting behavior pattern has determined the election results. This has prevented a policy or ideology-based party system from developing (Choi et al. 2014; Lee and Brunn 1996; Kwon 2004).

In a western political context, conservative parties prefer a smaller government. Partisan politics with diverging ideological orientations are one of the critical determinants in fiscal policy making (Ljungman 2009; Wehner 2009; Klarner et al. 2012). But in the Korean context, the conservative–liberal ideological divide has not been a guiding principle in determining political parties' fiscal policy orientations. Indeed, public debt increased at a much faster rate under the recent conservative Lee Myung-bak administration (2008–13). And in the presidential election of December 2012, both conservative and liberal candidates—Park Geun-hye from the conservative *Saenuri* Party and Moon Jae-in from the liberal Democratic United Party—commonly insisted that they should make every effort to improve, and increase public spending for, the social welfare system.<sup>16</sup>

A far more important factor in determining a government's fiscal policy orientation lies in the legislature–executive relationship. The first turning point came with presidential election of 1997. After a long-held dominance of conservative political parties, the victory of the left-leaning center-liberal political leader, Kim Dae-jung, paved way for a shift in fiscal policy. Former ruling parties from the military dictatorship put more emphasis on the growth of the economy than on redistribution or social welfare issues. But during the Kim Dae-jung administration, the focus of fiscal policy shifted from a growth-driven paradigm toward a more redistributory role. Indeed, Kim Dae-jung tried to spend more fiscal money on expanding social welfare and strengthening the social safety net.

However, a real tipping point of change in the legislature–executive relationship came with the establishment of a left-leaning liberal party, the Open Woori Party, and its victory in the presidential election of 2002. As a result of the election, the Roh Moo-hyun administration (2003–08) was inaugurated. Roh's ruling party, the Open Woori Party, shared a similar political orientation with Kim Dae-jung's New Millennium Democratic Party, but Roh's party was more progressive than that of Kim's in terms of making efforts to eradicate the institutional legacy from the past authoritarian regimes or strong presidency. In particular, Roh, as a presidential candidate, accepted his own party's request to introduce a division of power between the president (or presidential candidate) and chairpersonship of the party. As a result, for the first time in Korea's party

politics, Roh did not keep the chairpersonship of his incumbent ruling party while he was president. He felt that the dominance of the executive in policy making, and even in the legislation process, is a legacy from the past that had to be overcome in the course of consolidating democracy. From this, the incumbent Open Woori Party launched a series of reforms concerning the existing budgetary process with the aim to enhance the power of the National Assembly against the executive.

One such reform measure was to introduce a consolidated budget system. The Korean government traditionally maintained three fiscal categories—one general account, special accounts, and public funds (see Table 6.4). For example, as of 2001, about 31 percent of government spending was covered by 18 extra-budgetary funds. These funds were not included in the consolidated fiscal balance of the central government and were not subject to an ex-ante approval by the National Assembly, although they used tax revenues or just in case contingent liabilities should occur the government had to take fiscal responsibility (IMF 2001). As a result, it was difficult to identify the consolidated fiscal balance of the central government. To reform the situation, the ruling Open Woori Party initiated the National Finance Act, which came into effect in January 2007. With this Act, the government was required to manage all fiscal accounts by integrating them into the national finance account.

Furthermore, the Open Woori Party took measures to strengthen the budget oversight power of the National Assembly. One such measure was to make the Special Committee on Budget and Accounts—which was only an ad hoc committee until 2000—a standing committee, composed of 50 National Assembly members from the ruling and opposition parties. In 2008, the Special Committee organized the Adjustment Subcommittee, composed of 15 National Assembly members, for the purpose of deliberating the proposed budget plan.

Meanwhile, the Open Woori Party tried to enhance transparency in fiscal management by reforming the existing fiscal accounting system. The National Assembly enacted the National Accounting Act in October 2007 and changed the fiscal accounting system from a cash-based, single-entry bookkeeping practice into an accrual-based, double-entry bookkeeping one<sup>17</sup> for fiscal accounts, and this change came to be effective in 2009. As a result, from 2009, the government records every financial activity of the government (both central and local) at every stage of budget formulation, execution, and account settlement by applying double-entry bookkeeping and accrual accounting and reports it to the National Assembly. The government also came to be obligated to formulate and submit a medium-term (at least five years) Financial Management Plan to the National Assembly, in addition to the annual budget plan.

In short, the ascending power of the National Assembly against the executive has contributed to introducing more disciplinary measures in the budgetary policy making process. A series of fiscal reform measures were taken with an aim of enhancing transparency by integrating all fiscal processes including budget formulation, execution, account settlement, and performance management, while strengthening the power of the National Assembly in the budgetary process.

Table 6.4 Characteristics of general account, special accounts, and funds (end of 2011)

|  | General account   | Special accounts   | Funds   |
|--|---|--|---|
| Objective  | Supporting general fiscal activities  | Supporting specific programs   | Supporting specific programs  |
| Revenues   | General-purpose taxes <sup>1</sup> and nontax revenues  | Ear-marked taxes, mandatory contributions, transfers from other accounts and funds, etc. | Mandatory contributions, transfers from other accounts and funds, etc.                          |
| Expenditures                                     | Unrequited expenditures   | Unrequited expenditures and loans  | Unrequited expenditures and loans   |
| Linkages between revenues and expenditures       | None  | Clear linkages   | Clear linkages  |
| Authorization and execution of expenditure plans | Voted on in the National Assembly Controlled and monitored during execution as mandated by the Constitution | Same as general account  | Same as general account but with greater flexibility <sup>2</sup>                               |
| Items  |   | 18 accounts: corporate-related special accounts (5), others (13)                         | 65 funds: project funds (44), social security funds (6), finance-related funds (10), others (5) |
| Total Revenue (planned)                          | 209.9 trillion KRW  | 45.7 trillion KRW  | 369.3 trillion KRW  |

Sources: Koh (2007), table 9.6 and MOSF, *Fiscal Statistics Portal* ([www.mosf.go.kr/lib02.jsp](http://www.mosf.go.kr/lib02.jsp)).

Notes

1 Domestic taxes, composed of 14 taxes: customs, transportation–energy–environment tax, educational tax, and comprehensive real estate tax.

2 Central agencies which operate funds can change fund expenditures within 30 percent of the planned amount without notice to the budget authorities and the National Assembly. Cash flows are managed independently by the central agencies in charge and do not go through the treasury single account held in the Bank of Korea. Unlimited carry-overs of used cash are allowed.

Table 6.5 Debt trend of general government, 2007–12 (unit: trillion KRW, %)

|                                 | 2007  | 2008    | 2009    | 2010    | 2011    | 2012    |
|---------------------------------|-------|---------|---------|---------|---------|---------|
| GDP (a)                         | 975.0 | 1,026.5 | 1,065.0 | 1,173.3 | 1,235.1 | 1,272.5 |
| Total debt (b)                  | 299.2 | 309     | 359.2   | 392.2   | 420.5   | 443.1   |
| (b)/(a)                         | 30.7  | 30.1    | 33.8    | 33.4    | 34.0    | 34.8    |
| General Budget Account (c)      | 55.6  | 63      | 97      | 119.7   | 135.3   | 148.6   |
| (c)/(b)                         | 18.6  | 20.4    | 27.0    | 30.5    | 32.2    | 33.5    |
| Public funds                    | 52.7  | 49.2    | 49.5    | 47      | 45.7    | 45.7    |
| Monetary Stabilization Fund (d) | 89.7  | 94      | 104.9   | 120.6   | 136.7   | 153     |
| (d)/(b)                         | 30.0  | 30.4    | 29.2    | 30.7    | 32.5    | 34.5    |
| National Housing Fund           | 43.6  | 45.2    | 48.5    | 49.3    | 48.9    | 49.6    |
| Others                          | 57.6  | 57.6    | 59.7    | 55.6    | 53.9    | 46.2    |

Source: KOSIS Statistics Portal. (<http://kosis.kr>).

To date, however, budgetary discipline has not materialized, primarily because of the expansionary fiscal measures used to cope with the global financial crisis of 2008–10. As Table 6.5 shows, the total general account debt has been on the rise since 2007, reaching 34.8 percent of GDP at the end of 2012. During this period, there was no substantial change in the outstanding amount of public funds, national housing funds, or other categories of the general government account. However, the debt in the general budget account and monetary stabilization fund sharply increased. This sharp increase resulted from a variety of fiscal stimulus measures to reverse the economic downturn—which had a net effect on fiscal balance of minus 6.1 percent of GDP (OECD 2010, 50)—and from government intervention in the money and currency markets in an attempt to stabilize interest rates and foreign exchange rates (Tsutsumi et al. 2010).

Considering the effects of the global financial crisis and the short timeframe in which those reform measures have been implemented, it looks too early to identify the medium- or longer-term effects of these reform measures. Still, we are able to see a newly emerging feature in Korea's fiscal politics: non-budgetary government spending has sharply increased, as more reform measures have been taken to strengthen the government's budgetary discipline.

### Mounting Non-Budgetary Debts in Public Corporations

In response to growing oversight from the National Assembly, the government has tried to find an alternative way of increasing government spending, bypassing the approval and oversight of the National Assembly. For this purpose, the Korean government has mobilized public corporations—especially during the Lee Myung-bak administration (2008–13)—to carry out various social overhead capital (SOC)<sup>18</sup> projects over the past decade.

At the end of 2012, there were 295 public corporations, whose management and operations were controlled and supervised either by the central or local governments. As Table 6.6 shows, at the end of 2012, the total outstanding debt of the 295 public corporations was KRW493.3 trillion, which amounts to about

Table 6.6 Debt composition of public corporations, 2007–12 (trillion KRW, %)

|                         | 2007  | 2008    | 2009    | 2010    | 2011    | 2012               |
|-------------------------|-------|---------|---------|---------|---------|--------------------|
| GDP (a)                 | 975.0 | 1,026.5 | 1,065.0 | 1,173.3 | 1,235.1 | 1,272.5            |
| Total debt (b)          | 249.2 | 290.0   | 336.8   | 397.0   | 459.0   | 493.3 <sup>1</sup> |
| (b)/(a) (%)             | 25.6  | 28.3    | 31.6    | 33.8    | 37.2    | 44.5               |
| Top 12 corporations (c) | 186.9 | 227.7   | 267.4   | 324.4   | 378.7   | 412.3              |
| (c)/(b) (%)             | 75.0  | 78.5    | 79.4    | 81.7    | 82.5    | 83.6               |

Source: KIPF (December 2013).

Note

<sup>1</sup> This amount varies, depending on the scope of public corporations.

38.8 percent of GDP. This amount was larger than the total outstanding debt of the general government for the year (see Table 6.5). From 2007 to 2012, the outstanding debt amount of public corporations increased more than KRW244 trillion, which amounted to almost 50 percent of the total outstanding debt of all public corporations. Considering the fact that if public corporations cannot pay back their debt, all contingent financial liabilities are the government's responsibility, the growing debt of public corporations can result in a massive increase in public sector debt.

The debt of public corporations is concentrated in 12 major public corporations,<sup>19</sup> which primarily undertake government-directed economic activities such as SOC-related projects or energy development activities. As of the end of 2012, the share of those 12 major corporations was about 83.6 percent of the total outstanding debt of all 295 public corporations, reaching a total of about KRW412 trillion. The total debt of these major public corporations was only KRW59.4 trillion in 1997, but it increased roughly seven times in 15 years (KIPF 2013, 2). Moreover, the debt increase rate of these same public corporations grossly accelerated from 2007 to 2012, as Table 6.6 highlights. During this period, their total debt increased more than 2.2 times, from KRW186.9 trillion to KRW412.3 trillion. This increase rate of debt is much faster than the overall debt growth rate of the general government—as Table 6.5 shows—and the GDP growth rate.

While there might be other economic reasons for the mounting debt in the twelve major public corporations, one of the primary reasons is that the government has tried to use public corporations to bypass the approval or oversight of the National Assembly by launching various SOC projects. Indeed, according to an investigation by the BAI regarding the causes of mounting financial liabilities among public corporations from 2007 to 2011, more than half of the financial liabilities occurred as public corporations undertook government policy-related projects (mostly SOC projects), or the government repressed the public price levels for items—such as electricity and water—of public corporations despite the mounting prices of energy resources in the national markets (KIPF 2013).

The Four Major Rivers Restoration Project under the Lee Myung-bak administration represents one such case of bypassing the budgetary process. President Lee originally planned to build an inland canal, linking two major rivers—the

*Hankang* river and *Nakdong* river—but when he attempted to undertake the inland canal plan, many political opposition groups, including opposition political parties, and civic and environmental organizations united against the plan. Although President Lee was elected with a platform to build an inland canal, most popular polls<sup>20</sup> showed that the majority of the people opposed the inland canal project not only because of its cost or economic ineffectiveness, but also because of environmental concerns.

Under the continued popular protests and the overwhelming popular disapproval against the project, the Lee administration changed the original inland canal plan into the Four Major Rivers Restoration Project. The budget of about KRW22.2 trillion (approximately US\$17.3 billion), however, was not enough to carry out the project in four major rivers simultaneously. Under the circumstances, the Lee administration forced the Korea Water Resources Corporations (KWRC) to participate in the Restoration Project. Indeed, KWRC's debt was only KRW1.75 trillion in 1997, but increased to KRW13.8 trillion by 2012, with its debt growing by 62.4 percent annually, from 2008 to 2012 (KIPF 2013, 26).

The mounting debt of the Korea Land and Housing Corporation (LH) also highlights the government's attempts to avoid formal budgetary oversight from the National Assembly. For example, LH's debt was only KRW14.7 trillion in 1997, but it increased to KRW138.1 trillion by 2012, which was about 33.5 percent of the total debt of the 12 major public corporations. From 1997 to 2012, LH's debt increased about 8.4 times with a 17.2 percent annual growth rate (KIPF 2013, 28). One of the primary reasons for such a rapid growth of LH's debt lies in the fact that the government has used LH for massive SOC projects, such as constructing big rented houses and new city building projects, during both the Roh and Lee administrations. Such politicized investment can create losses that the government must bear, as the case of Japan's system of SOC—the Fiscal Investment Loan Program—illustrates (Park 2011).

The mounting debt in public corporations highlights a couple of distinctive features developing in Korea's fiscal politics. First, the leadership factor matters for fiscal discipline. As reviewed, since the early 2000s the National Assembly has introduced a series of reform measures to enhance fiscal transparency and discipline. But such efforts were not effective—they were even futile—in checking and balancing the top leader's decision of using public corporations for fiscal purposes, bypassing the oversight of the legislature. This pattern indicates that not only fiscal institutions or rules, but also political elite commitment to fiscal discipline, are essential elements for successful fiscal consolidation.

Second, rising non-budgetary debt highlights that it is necessary to focus fiscal consolidation on both general government and non-financial/financial public corporations. The fiscal consolidation efforts in Korea, which were reviewed in the above section, have primarily focused on consolidating the various budgetary accounts into one.

Conventional fiscal politics has also centered on the budgetary process. However, the debt level of public corporations has already become larger than the debt of the government. Considering the fact that debts in public corporations can ultimately be a fiscal liability for the government, inter-sectorial fiscal

consolidation is a necessary step for successful fiscal discipline, with more efforts needed to consolidate the entire public sector debt, covering both public corporations and the government.

### Future Fiscal Challenges

The Korean government has faced, or will confront, many fiscal challenges resulting from economic and demographic changes. Of the various challenges, two critical issues need to be emphasized: Korea's dualistic employment structure and the aging population—specifically issues of poverty among the elderly population and mounting healthcare costs. To cope with these fiscal challenges, the Korean government has relied more on issuing public bonds, and those public bonds have been issued especially related to special government fiscal accounts.

### Dualistic Employment and Industrial Structure

As of 2012, Korea's public spending on social security was the lowest among OECD countries. Likewise, employer contributions for social securities have been lower than those of other OECD countries. One of the primary reasons that makes it difficult to enhance employers' contributions is Korea's dualistic employment and industrial structure. In Korea, the proportion of irregular or part-time workers has sharply increased since the Asian financial crisis of 1997–98, as the Korean government has adopted aggressive labor market liberalization policies. Before the financial crisis it was difficult for employers to fire employees, but after the crisis regulations to preserve job security were lifted in the name of enhancing labor market flexibility. As a result, the number of irregular workers greatly increased.

As Table 6.7 shows, in 2004, out of a total 14.8 million wage and salary workers, more than five million workers (34.1 percent) were irregular workers, and 2.1 million workers were daily workers. This dualistic (or polarized) employment structure slightly improved between 2004 and 2011, but, due to a lack of job security, many irregular or daily workers could not participate in national pension, health insurance, or employment insurance through their companies. As a result, from 2004 to 2011, on average, only 40 percent of irregular workers could participate in these social insurance programs. Moreover, the percentage of self-employed workers is very high among Korea's economically active population. By 2011, of those 24.2 million economically active citizens, Korea's self-employment percentage was 28.8 percent, while the OECD average was 15.9 percent. Of those, 39.6 percent (9.6 million workers) were working in companies that have less than four employees (KOSIS portal). It is likely that this aggravating employment and industrial structure will increase pressures to expand social security programs for those who are not protected properly by the existing welfare programs.

Table 6.7 Social insurance subscribers, status of employed workers, 2004–11 (unit: %, 1,000 persons)

|                                      | Year <sup>1</sup> |        |        |        |        |        |        |        |  |
|--------------------------------------|-------------------|--------|--------|--------|--------|--------|--------|--------|--|
|                                      | 2004              | 2005   | 2006   | 2007   | 2008   | 2009   | 2010   | 2011   |  |
| National pension subscribers (%)     |                   |        |        |        |        |        |        |        |  |
| Regular                              | 72.5              | 75.7   | 76.1   | 76.3   | 77.3   | 78.9   | 78.4   | 79.1   |  |
| Irregular                            | 37.5              | 36.6   | 38.2   | 40.0   | 39.0   | 38.2   | 38.1   | 38.2   |  |
| Health insurance subscribers (%)     |                   |        |        |        |        |        |        |        |  |
| Regular                              | 73.8              | 75.9   | 76.1   | 76.7   | 78.0   | 79.8   | 79.5   | 80.9   |  |
| Irregular                            | 40.1              | 37.7   | 40.0   | 42.5   | 41.5   | 43.4   | 42.1   | 44.1   |  |
| Employment insurance subscribers (%) |                   |        |        |        |        |        |        |        |  |
| Regular                              | 61.5              | 63.8   | 64.7   | 64.3   | 65.8   | 67.6   | 75.7   | 77.4   |  |
| Irregular                            | 36.1              | 34.5   | 36.3   | 39.2   | 39.2   | 42.7   | 41.0   | 42.3   |  |
| Wage and salary workers (total)      | 14,894            | 15,185 | 15,551 | 15,970 | 16,206 | 16,454 | 16,971 | 17,397 |  |
| Regular employees                    | 7,625             | 7,917  | 8,204  | 8,620  | 9,006  | 9,390  | 10,086 | 10,661 |  |
| Temporary employees                  | 5,082             | 5,056  | 5,143  | 5,172  | 5,079  | 5,101  | 5,068  | 4,990  |  |
| Daily workers                        | 2,188             | 2,212  | 2,204  | 2,178  | 2,121  | 1,963  | 1,816  | 1,746  |  |
|                                      | 14.7%             | 14.6%  | 14.2%  | 13.6%  | 13.1%  | 11.9%  | 10.7%  | 10.0%  |  |

Source: KOSIS, Statistics Portal. (<http://kosis.kr>).

#### Notes

- 1 The figures for workers who participate in national pension, health insurance, and employment insurance are based on the census data of August of each year.
- 2 The number of regular, temporary, and daily workers is the end of the year figure.

### Aging Population: Poverty and Healthcare

An aging population is already posing a pronounced fiscal challenge to the Korean government. The proportion of the elderly population—people 65 years of age or over—in Korea reached 7.2 percent of the total population in 2000, and increased to 11.3 percent by the end of 2011. It is projected that the proportion will be over 20 percent by 2026, and close to 40 percent by 2050. As Table 6.8 shows, the aging index total dependency ratio, old-age dependency ratio, and working population to the old age group will grow rapidly in the coming decades. Indeed, as of the end of 2010, Korea's fertility rate—number of children born to women aged 15 to 49—was the lowest of all OECD countries, at 1.24, while the OECD average was 1.7 (OECD 2014, 17). In Korea's case, the demographic structure is being transformed too rapidly for social institutions to adjust. Population aging in Korea is projected to be faster than any other OECD nation. For instance, in Japan, it took 24 years for the elderly population to reach the level of 14 percent of total population, from 7 percent, and then took another 12 years to rise from 14 to 20 percent. However, in Korea, it took 18 years, and will take only 8 years, respectively, to make the same percentage jump.

The poverty rate among elderly people is much worse than that of other OECD countries—with the exception of Mexico and Chile—making fiscal management plans more challenging. As Figure 6.3 shows, in Korea, the Gini coefficient score—after taxes and transfers—in the working age group (18–65 years), is similar to the OECD average, 0.3, but the the Gini coefficient of the retirement age population (above 65 years) is 0.405. In other words, inequality is much worse in the retirement age population in Korea. More notably, the score gap

Table 6.8 Projection of aging population, 1980–2050

|  | Year |      |      |      |      |       |       |       |       |
|--|------|------|------|------|------|-------|-------|-------|-------|
|  | 1980 | 1990 | 2000 | 2010 | 2016 | 2020  | 2030  | 2040  | 2050  |
| Total dependency ratio <sup>1</sup>        | 60.7 | 44.3 | 39.5 | 37.3 | 37.2 | 40.7  | 58.6  | 77.0  | 89.8  |
| Old-age dependency ratio <sup>2</sup>      | 6.1  | 7.4  | 10.1 | 15.2 | 18.5 | 22.1  | 38.6  | 57.2  | 71.0  |
| Aging index <sup>3</sup>                   | 11.2 | 20.0 | 34.3 | 68.4 | 99.5 | 119.1 | 193.0 | 288.6 | 376.1 |
| Working population to old-age <sup>4</sup> | 16.3 | 13.5 | 9.9  | 6.6  | 5.4  | 4.5   | 2.6   | 1.7   | 1.4   |

Source: KOSTAT 2011.

#### Notes

1 The total dependency ratio is the number of persons under age 15 plus persons aged 65 or older per 100 persons 15 to 64 years old.

2 The old-age dependency ratio is the number of persons 65 years and over per one 100 persons 15 to 64 years.

3 The aging index is calculated as the number of persons 65 years old or over per 100 persons under age 15.

4 The working population ratio is the number of persons 15 to 64 years divided by the number of persons aged 65 or over.

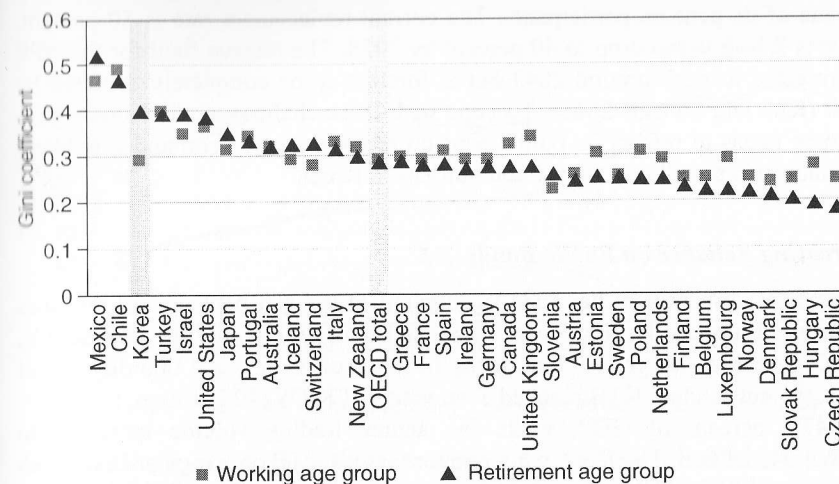


Figure 6.3 Gini coefficient (after taxes and transfers), OECD countries, late 2000s (source: OECD, *Database on Income Distribution Inequality* ([www.oecd.org/els/social/inequality](http://www.oecd.org/els/social/inequality))).

(inequality) between these two age groups is much worse than any other OECD country. It implies that many retirement age Koreans are not financially prepared for their retirement life. Nonetheless, as of 2010, of those people who are 65 years or over, only 28.7 percent had jobs, while 71.3 percent were unemployed (KOSTAT 2011). With that said, public spending on old-age benefits was 1.6 percent of GDP in 2007, a quarter of the OECD average, resulting in only one-fifth of the elderly receiving pensions (OECD 2012a).

The poverty rate among the elderly population is already a social and fiscal problem. One of the most serious fiscal challenges is increasing medical costs for the elderly. For instance, as of 2011, the total medical fees paid by the National Health Insurance Service was KRW460 trillion, which was larger than the total annual budget of both the central and local governments. Of these fees, the cost for the elderly (65 year or above) was KRW148 trillion (32.2 percent). Considering the alarming growth of the aging population in Korea, the social and political demand for public social spending—especially for healthcare—will increase greatly in the near future.

To tackle these challenges, the Korean government needs to improve its public pension programs. As of 2012, there were three occupational pension plans—Government Employees' Pension Plan (GEPP), Private School Teachers' Pension Plan (PSTPP), and Military Personnel Pension Plan (MPPP)—and one universal pension program—National Pension Plan (NPP). These pension plans are no longer sustainable, as two of them already have deficits; MPPS has posted a deficit for over 10 years and requires government support of about KRW1 trillion each year. GEPP posted a deficit in 2001. The pension benefits of NPP are a defined-benefit program, which is not influenced by the investment

performance of pension reserves, but by the level of inflation-adjusted monthly income of its pension participants. The current replacement rate is 50 percent, but it is scheduled to drop to 40 percent by 2028. The reserve fund for the NPP is projected to peak around 2043 but is forecast to be completely depleted by 2060 (Kim and Stewart 2011). To cope with these challenges, the Korean government needs to reform its public pension programs very soon and it is likely that such efforts will add more fiscal burdens to Korea.

### Increasing Reliance on Public Bonds

The Korean government has tried to supplement the gap between tax revenues and expenditures by issuing Korea Treasury Bonds (KTB). For the past decade, the KTB market has grown remarkably in terms of its size and liquidity. As of 2011, the outstanding KTB reached a net worth of KRW340.1 trillion, representing 47.7 percent of GDP, while the annual trading volume increased to KRW3,045 trillion. The Korean government issues KTB on a regular basis, with the approval of the National Assembly, in five fixed maturities—3, 5, 10, 20, and 30 years—at the market interest rate through public tender. The demand for KTB has been on the rise, as the bid-to-cover ratio—a ratio that compares the number of bids received in a Treasury security auction to the number of bids accepted—indicates, while the KTB financing rate has been in decline. Moreover, the average term to the maturity of KTB has become longer—from 4.04 years in 2004 to 5.56 in 2011—as the Korean government has recently increased the issuance of 10-year bonds (Baek 2012).

Indeed, the current status of the KTB market is in good shape. Its turnover ratio—which is often used as a measure of bond market liquidity—is higher than that of other Asian government bonds markets, except Japan. The percentage of the KTB market to GDP stood at only 47.7 percent as of June 2012, while Japan's ratio of government bonds to GDP is 194.1 percent. The KTB is the most actively traded bond in Korea, and it is used as the benchmark and base rate in formulating the interest rate policy in the financial markets as in advanced economies where public bonds markets are well developed. Considering the short history of the KTB market, this must be seen as a remarkable development.

It should be noted, however, that the Korean government has issued increasing volumes of KTB as various kinds of funds, whose management has more flexibility over general or special accounts. As Figure 6.4 shows, the government's bond issuance for the special account of budgets has been in decline since 2002, but issuance for funds has sharply increased during the past years. Originally, the Korean government issued various kinds of KTB in the course of restructuring the financial sector after the Asian financial crisis (Kang 2009). Financial restructuring was a driving motivation for the Korean government to launch a plan for stimulating the KTB market. However, the Korean government has issued more KTB recently, not to supplement the deficits in the general or special accounts—which are more tightly monitored and reviewed by the National Assembly—but to benefit various public funds, in which the government has far more flexibility regarding management and operation.

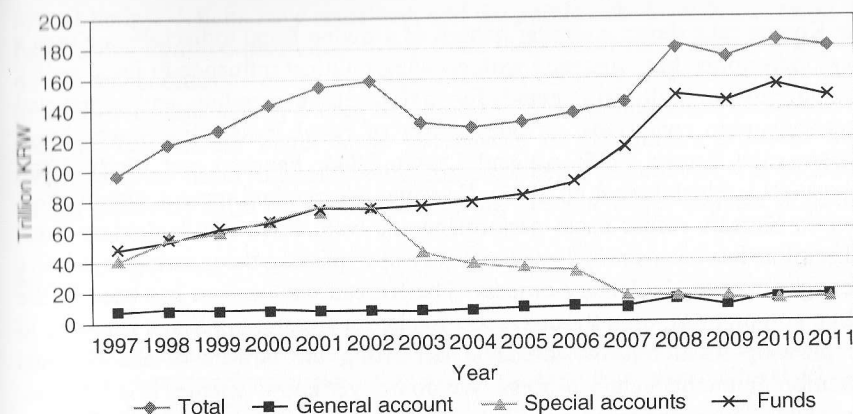


Figure 6.4 Government bonds issuance, type of fiscal accounts, 1997–2011 (source: MOSF, *A Report on the Gross Total of Government Bonds* (2012)).

Indeed, the National Finance Act (Article 70) allows the central agencies that operate funds to revise the amount of expenditures without submitting the revised expenditure plan to the National Assembly. They only need to get an approval from the National Assembly on their annual fund management plans, after which they can be far more flexible. As Figure 6.4 shows, the Korean government has sharply increased the issuance of funds-related government bonds from 2009 to 2012, but the detailed spending of those newly mobilized funds was beyond the oversight of the National Assembly. Despite the growing size of the KTB market, a “crowding out” effect—which drives down the spending/investment in the private sector—has yet to occur. However, the recent trend indicates that the Korean government may be tempted to use KTB to further meet the growing demand for social securities.

The new president, Park Guen-hye (2013–present), promised to aggressively increase social welfare spending as part of her campaign platform. She promised that her government would generate KRW27 trillion of tax revenue a year, or KRW135 trillion over the next five years, to expand various welfare programs. The political environment is favorable to the incumbent government—of which President Park is a member—as for the first time since the democratic transition in 1987, the ruling party gained the majority of seats in the legislative election in April 2012, and the president's popular vote exceeded 50 percent in the presidential election in December 2012. However, both the ruling party (*Saenuri* party) and the Park administration insisted that the government should expand more social welfare programs without increasing taxes. Under such circumstances, a viable option for the new government will be to issue more KTB. However, it is doubtful whether the Korean government can meet the mounting demand for public spending for social welfare programs without tax hikes, or undertaking substantive tax reforms.

## Conclusion

The Korean case shows a similar pattern of growing fiscal indiscipline. Korea's fiscal indiscipline has worsened with growing political influence in fiscal policy making, growing political demands for social welfare spending, and aggravated macroeconomic conditions, as other cases of fiscal indiscipline have shown (Alesina and Perotti 1995; Alt and Lassen 2006; Fabrizio and Mody 2006; Eslava 2011; Blöchliger et al. 2012). However, we can find some distinctive features in Korea's recent fiscal performance as well. First, non-budgetary fiscal indiscipline has been strengthened as a way of bypassing the growing legislative oversight over the budgetary process. The Korean government has tried to use public corporations, or extra-budgetary funds, for fiscal purposes in response to the growing fiscal reforms aimed at enhancing the powers of the National Assembly in the budgetary process. We do not yet know whether it is a temporary phenomenon occurring only during the Lee Myung-bak administration, but at the very least, this phenomenon highlights that it is necessary to consolidate the fiscal accounts and debts covering both the general government sector and both financial and non-financial public corporations. In particular, in a country where the share of public corporations are high in the national economy, such efforts look essential for fiscal consolidation. Enhancing transparency and discipline in the budgetary process is critical for successful fiscal consolidation, but non-budgetary fiscal venues should be properly monitored and included in the fiscal consolidation agenda.

Second, unlike advanced welfare states, the tax-welfare nexus has not been developed fully in Korean fiscal politics. As reviewed, Korea's tax rate is much lower than the OECD average, and the share of indirect tax in total tax revenue is lopsidedly high. But the demand for expanding social welfares has been noticeably on the rise. Nonetheless, fiscal politics have not been centered around tax reforms or broadening the tax revenue. Instead, political conflicts have focused on the expenditure side, concentrating on how to allocate government budgets. This reflects the shallow tradition of the welfare state, and the short history of partisan and ideological fights concerning fiscal sustainability and accountability, unlike cases in advanced economies where partisan politics with diverging ideological orientations determine the fiscal politics. But considering the fiscal challenges the country faces, it appears essential for Korea to create a new kind of social pact concerning taxes and social welfare. In particular, the Korean government needs to broaden the tax base in those areas where proper taxes have not been levied, such as capital gain taxes and social security contributions by employers.

Third, the Korean case shows that rigorous fiscal rules concerning ceilings on the deficits of the government's fiscal accounts, or the debt level, can be necessary for better fiscal discipline, while minimizing political discretions and indiscipline. As to achieving fiscal consolidation effectively, the debate remains, especially as to the European Union case, whether fiscal institutions or fiscal rules matter more (Wyplosz 2005, 2011). In the Korean case, fiscal institutions have gradually changed. From the dominance of the executive to the legislature,

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and other reform measures aimed at enhancing fiscal transparency. Nonetheless, annual budget deficits have remained, and the public debt level has been on the rise. In this context, institutionalizing more clear fiscal rules as to the government's expenditures—either by legislation or creating a more neutral independent oversight agency—may be helpful in maintaining fiscal discipline. In the end, reforms for better fiscal governance in expenditure practices need reforms in both fiscal rules and institutions, and better governance will be essential for achieving fiscal discipline and meeting Korea's longer-term social needs.

## Notes

- 1 Hereafter Korea/Korean will refer exclusively to South Korea.
- 2 For more details on the definition of fiscal performance and why we focus more on the long-term fiscal performance than overall short-run fluctuations of fiscal debt and consolidations, see the Introduction of this volume.
- 3 The EPB and the Ministry of Finance were merged and the Ministry of Finance and Economy was established in December 1994.
- 4 The IMF's manual for government finance statistics defines consolidation as "a method of presenting statistics for a set of units as if they constituted a single unit, and it involves the elimination of all transactions and debtor-creditor relationships that occur among the units being consolidated" (IMF 2001, 33).
- 5 The IMF's guide book on public sector statistics defines that "the general government sector comprises all government units and all nonmarket nonprofit institutions that are controlled by government units" (IMF 2013, 6).
- 6 For more details on the background of launching the PSD, see the official website (see following endnote 7).
- 7 Data are available at the PSD website (available at <http://web.worldbank.org/WBSITE/EXTERNAL/DATASTATISTICS/EXTQPUBSECDEBT/0,,contentMDK:22720531~menuPK:7409953~pagePK:64168445~piPK:64168309~theSitePK:7404473,00.html>) and the World Bank website.
- 8 Korea has adopted a two-tier local government system. There are 16 upper-level local governments (seven metropolitan and nine provincial governments) and 232 lower-level local governments: 91 counties (rural local bodies), 72 cities, and 69 urban districts.
- 9 All the local governments in Korea have chief executives (governors, mayors, county executives, and district executives) and local councils. Chief executives of both upper- and lower-level local governments are elected by direct popular vote for a four-year term. Lower-level council members are also elected by direct popular vote for a four-year term, and the upper-level council members are elected in a mixed form: While 10 out of 11 are elected by the popular vote, the remaining one is selected through a proportional representation system that was adopted just before the 1995 election. However, due to party nominations for those candidates for these elections, local elections have become an extension of the political struggle of political parties at the national stage.
- 10 The Roh Tae-woo administration (1988–93) is often treated as a continued regime of the past military dictatorship, as Roh Tae-woo himself was a general in the military and participated in the December 12 military coup. But it was established through a direct presidential election in December 1987 after the official democratic transition, so this chapter does not count it as a military dictatorship.
- 11 Article of 57 of the Constitution stipulates the changes in the budget bill as follows: "The National Assembly shall, without the consent of the Executive, neither increase the sum of any item of expenditure nor create any new items of expenditure in the budget submitted by the Executive."

12 Article 97 of the Constitution stipulates that:

The Board of Audit and Inspection shall be established under the direct jurisdiction of the President to inspect and examine the settlement of the revenues and expenditures of the State, the accounts of the State and other organizations specified by Act and the job performances of the executive agencies and public officials.

- 13 The Westminster model has been adopted by most Commonwealth countries, a few European countries like Ireland and Denmark, and some Latin American countries, such as Peru and Chile.
- 14 The organizational capacity of the NABO is still limited. For instance, as of 2011, the NABO has 116 full-time employees, and its Program Evaluation Bureau has only 28 full-time employees, while the BAI has 1,035 full-time employees (Kim 2012.)
- 15 An extreme example is the revised Constitution (*Yushin*) in 1972. According to the revised constitution, the President was empowered to nominate one-third of the National Assembly members.
- 16 The Saenuri Party claimed a tailored lifelong welfare system that encompasses both universalism and selectivism, while the Democratic United Party campaigned for a universal welfare system. But in terms of the scale of public spending for social welfare, there were no significant differences between the two parties. Both parties promised to offer free child-care services for children under five, free education for high-school students, regardless of income level, and half college tuition and others.
- 17 Accrual accounting provides better information about government assets and liabilities, and the full costs of a government's fiscal activities. For more details on the benefits of accrual-based accounting over cash-based accounting and those countries that have adopted a full accrual accounting standard, see Khan and Mayes (2009).
- 18 The concept of "social overhead capital" (SOC) refers to transportation, communication, and power facilities in a narrow sense, but it also refers to facilities for such things as education and health, for maintenance of law and order, and for research. For more details, see Bruton (1968).
- 19 They are Korea Gas Corporation, Korea National Oil Corporation, Korea Electric Power Corporation, Korea Coal Corporation, Korea Resources Corporation, Korea Expressway Corporation, Korea Water Resources Corporation, Korea Railroad Corporation, Korea Land and Housing Corporation (LH), Korea Rail Network Authority, Korea Deposit Insurance Corporation, Korea Student Aid Foundation.
- 20 The support rate for the Four Major Restoration Project was 50:50 when the Lee Myung-bak administration was established, but it decreased continuously, in opposition to the Project. For instance, only 5 percent of the people supported carrying out the Project as President Lee had campaigned during the presidential election, according to a public poll conducted 100 days after the establishment of the Lee administration (*Kukminilbo*, June 1, 2008).

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