The Korean Budget System
(& Economic Development)

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Overview
Scope of “Public Finance”

- “Public Finance” consists of 3 parts:
  - **Budgeting:** Decision making about government expenditures (resource allocation)
  - **Treasury:** Taking care of government liquidity issues (cash flow and debt composition)
  - **Revenue:** Securing resources that can be used by government (taxes, etc.)

- The current Korean budget system (including treasury) is the result of the Four Major Fiscal Reforms (2004 – 2006)
  1. Medium-term Planning and Budgeting (National Fiscal Management Plan)
  2. Top-down Budgeting
  3. Performance-based Budgeting
  4. Introducing an IFMIS (Digital Budget and Accounting System)

The Nature of the 4th Reform

- Actually originally conceived solely as an IFMIS project, before and independently of the others in the 4 Reforms
  - Later integrated into the 4 Reforms when the budget system reforms were proposed (4 Reforms = 3 + 1)
  - Upon which, the project subsumed the other issues indicated above

- In retrospect, what was the 4th reform?
  - More than just an IFMIS, it was the “treasury-issues” reform (TCOP)
    (but original conception of the DBAS project characterized it mainly as an IFMIS, the other tasks as just an auxiliary collection of related issues)
    - Program budget classification system
    - Introducing accrual accounting
    - Revising the scope of the government reporting entity
    - And integrating existing information systems into the new DBAS
  - The other 3 of the 4 Reforms: “budget system” reforms (BCOP)
    - Medium-term planning and budgeting
    - Top-down annual appropriations
    - Performance-based budgeting
A Different Look at the 4 Reforms

- **Budgeting**
  ... can be understood as the process of *allocative decision-making*

- **Budget Systems (BCOP)**
  ... are the *institutional infrastructure* (procedures, rules, etc.) that facilitate budgeting as an activity

- **Treasury-related issues (TCOP)**
  ... form the *infrastructure to that infrastructure* (budget systems), so that the latter can function effectively

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**Understanding Korea’s Four Reforms (2004 – 2006)**

**Budget System Issues**

Nordic Model of MTEF

1. MTEF (NFMP)  
2. Top-down Annual Appropriations  
3. Performance-based Budgeting

**Treasury Issues**

4. DBAS (IFMIS as designed by BSP)  
   - ISP (dBrain)  
   - ICT  
   - Financing  
   - BPR  
     - Program Classification  
     - Accruals  
     - Scope of Government  
     - Full cost accounting
BARO’s BSP as Originally Announced in November, 2004

<table>
<thead>
<tr>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007 &amp; 2008</th>
<th>2009 onward</th>
</tr>
</thead>
<tbody>
<tr>
<td>BSP</td>
<td>BPR &amp; ISP</td>
<td>Develop DBAS</td>
<td>Full Deployment</td>
<td>Beginning July 1, 2007</td>
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</tbody>
</table>

**BPR**
- Detailed business and process redesign
- Program classification

**ISP**
- Blueprint for building IFMIS
- Blueprint for central government budget
- Linkage with other systems

**Change Management**
(Training, etc.)
- Finished on schedule
- Partial implementation
- Postponed, later completed
- Postponed

Dependencies among Components of the Four Reforms

**Budget System Issues**

1. MTEF (NFMP)  
2. Top-down Annual Appropriations
3. Performance-based Budgeting

**Treasury Issues**

4. DBAS (IFMIS as designed by BSP)

**BPR**
- Program Classification
  - Accruals
  - Scope of Government
  - Full cost accounting

**ISP**
- ICT
- Financing
- ICT
- Financing

**Nordic Model of MTEF**
- 1. MTEF (NFMP)
- 2. Top-down Annual Appropriations
- 3. Performance-based Budgeting
- 4. DBAS (IFMIS as designed by BSP)
Tidying Up Loose Ends...

- Integration with sub-national government accounts
  - Full integration ruled out, but information from sub-national governments fed into central IFMIS at aggregated level
- Accruals
  - Full accrual reporting (financial statements) from 2012 (for FY2011)
- Adjust scope of government reporting entity
  - Updated to 2008 SNA standards, but still awaits official implementation
- Integrate performance management information
  - Performance management module added afterwards
- Full cost accounting
  - Study commissioned recently for allocating overhead to programs
- Advanced applications (analysis, etc.)
  - Later...

Further Details...

- Korean budget at a glance
- The role of fiscal policy
- Key lessons from the Korean case
- The Korean budget system
The Korean Budget at a Glance

Chart of Accounts* (FY2014, trillion Won)

- General Account: 201.6
- Special Accounts (18): 49.2
- Public Funds (54): 105.0

Total Consolidated Budget: 355.8 (4.0% increase)
Balance: 13.5 (1.0% GDP)
Adjusted Balance: -25.5 (-1.8% GDP)**
Government Debt: 514.8 (36.4% GDP)

* Gross amounts of accounts and funds are larger (figures above are net of inter-account transactions)
** Excludes social security funds surpluses

The Korean Budget at a Glance (2)

Budget Allocation (FY2014, trillion Won, % growth)

- R&D 17.7 5.1
- Industry, SME, Energy 15.4 -0.9
- SOC 23.7 -2.5
- Agriculture/Fisheries/Food 18.7 2.0
- Health/Welfare/Labor 106.4 9.3
- Education 50.7 1.9
- Culture/Sports/Tourism 5.4 7.7
- Environment 6.5 2.5
- Defense 35.7 4.0
- Foreign Affairs/Unification 4.2 2.3
- Security/Safety 15.8 5.1
- General Public Admin. 57.2 2.6

Total Spending Allocations: 355.8 4.0
**Budget Balance**

* Dark blue line shows consolidated budget balance in trillion won (left axis), light blue line shows same balance as % of GDP (right axis)

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**Government Debt**

[Graph showing government debt with key points and years indicated]
Composition of Key Expenditures (% of budget)

The Role of Fiscal Policy
Per capita GDP in the 1950s: about US$80 (among the poorest countries in the world)

$21,695 per capita in 2007

Growth in Per Capita GDP (US$)

13th largest economy in the world

Five Year Economic Development Plan

Asian Financial Crisis

Above 10%

Around 8%

10,307

6,742

Total Devastation after Korean War (1950 – 1953)
President Park Chung-Hee took power in a military coup in 1961. He immediately launched Korea’s economic growth drive as his most important mission. Implemented through a consecutive series of 5-year Economic Development Plans, government spending was the direct means of allocating scarce national resources (per capita GDP was around US$85) to key investment decisions.

The overall strategy was to have government lead the growth drive by

a) Planning/coordinating the economy’s growth
b) Provide crucial infrastructure and/or initiate large-scale projects
c) Encourage the private-sector agents to participate actively
Fiscal Policy in the 1960s

1st 5-year EDP: 1962 – 1966
Lay Foundation for Economic Autonomy
- Grow rural incomes through greater productivity
  ▶ Irrigation & waterways, better seeds, fertilizers, machinery
- Secure sources of energy (electricity, coal)
- Grow key industries and provide infrastructure
  ▶ Industrial complexes, highways, POSCO, shipyards
- Grow exports to improve trade balance
  ▶ From wigs, etc. to light industry (textiles, footwear)
- Foster technology
  ▶ Established KIST & other R&D institutes

Emphasis on results
- Systematically verified implementation / completion

2nd 5-year EDP: 1967 – 1971
Extend base for Economic Autonomy
- Food self-sufficiency, protecting forestry, growing fisheries
  ▶ SaeMaEul Campaign
- Invest in chemical, steel, machinery industries
- Grow exports to improve trade balance
- Foster technology
  ▶ Science & technology, plus management techniques
**Industrialization in the 1960s**

- From Agricultural products to Industrial Products,
- From Light industrial products to Heavy industrial products

**How Exports Changed**

- From Agricultural products to Industrial Products,
- From Light industrial products to Heavy industrial products

![Graph showing changes in exports from 1960 to 2005](image-url)
**Challenges & Responses in 1960s**

- Fiscal space?
  - Relied on US aid-in-kind up to early 1960s
  - Set up institutions for better fiscal management
    - Enacted Budget and Accounts Act and introduced Fiscal Financing Special Account (SA) and Econ Development SA
    - Founded National Tax Office to strengthen tax collection
  - “Diverting” funds to key projects
    - Kyungbu Expressway, POSCO, KIST

**Phases of Economic Development**

<table>
<thead>
<tr>
<th>Development Stage</th>
<th>1960s</th>
<th>1970s</th>
<th>1980s</th>
<th>1990s</th>
<th>2000s</th>
</tr>
</thead>
<tbody>
<tr>
<td>Source of Competition</td>
<td>Factor-Driven Stage</td>
<td>Investment-Driven Stage</td>
<td>Innovation-Driven Stage</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Direction of Industrial Policy</td>
<td>Exports-oriented light industries</td>
<td>Heavy and chemical industries</td>
<td>Technology-intensive industries</td>
<td>High-technology innovation</td>
<td>Transition to knowledge-based economy</td>
</tr>
<tr>
<td>Main contents</td>
<td>5-year Econ Plan - Export-led industrialization policy. Exported labor-intensive manufactured goods, with support from government policy.</td>
<td>5-year Econ Plan - Less focus on agriculture. Heavy and Petro-chemical Industry Development Plan: shipbuilding, automobiles, steel products.</td>
<td>5-year Econ Plan - Korea’s industries shifted to high-tech industries: Microelectronics, semi-conductors, mobile phones, nano-tech, and information industries.</td>
<td>5-year Econ Plan - Focusing on ITs (hardware, software). Fostering Biology industries - Liberalization of financial market.</td>
<td>MTEF and Long-term visions (5 strategies, 2 vehicles). Protect Intellectual Property Rights - Focus on building social safety-net</td>
</tr>
</tbody>
</table>
**Economic Growth, 1945 - 2010**

GNI per Capita (US$)

- Average growth rate during 1960-2010: 7.5%

**Fiscal Policy in the 1970s**

- **3rd 5-year EDP: 1972 – 1976**
  - Pursuit of Growth, Stability, and Balance (introduction of VAT)
    - Accelerate rural income growth
      - SaeMaEul Campaign
    - Accelerate export growth
    - Build heavy and chemical industries
- **4th 5-year EDP: 1977 – 1981**
  - Pursuit of Growth, Equity, and Efficiency
    - Self-sustainable growth (improve trade balance and industry structure)
    - Social development (income distribution, living conditions)
    - Foster technology and efficiency (address various distortions)
Challenges after the 1970s

- The two oil shocks by OPEC and President Park’s death at the end of the 1970s left Korea facing a bleak situation
  - Chronic inflation, driven by high input cost of materials
  - Unemployment
  - Chronic trade deficit

- Park’s successors (Chun, Roe, YS Kim, 1981 – 1998) chose to move toward market principles and fiscal prudence, then later toward liberalization (finance and imports) and decentralization

As a result, fiscal balance improved dramatically
- New earmarked taxes, introduction of social insurance (1989)
- Controlled spending, plus Middle East construction and recycling of petro dollars brought trade surplus

But liberalization and decentralization eventually began to undermine stability, even as a government-led mentality still pervaded all walks of society
The Asian Financial Crisis and Its Aftermath

- The Asian Financial Crisis of 1997 served as a wake-up call, that Korea’s decades-old government-led economy needed to move decisively further toward modern institutions and systems

- President Kim Dae-jung (1998 – 2003) led a quick recovery from the crisis, utilizing massive fiscal input into restructuring (especially the banking sector) and expanding the social safety net

- President Roh Moo-Hyun (2003 – 2008) modernized the budget system and continued to expand spending in social policy

Responses to the World Financial Crisis

- The World Financial Crisis of 2008 asked for massive fiscal stimuli from all affected countries
  - President Lee (2008 – 2013) authorized tax cuts and temporary spending boosts (together coming to about 10% of GDP)
  - As a result, Korea’s economy had the best performance among OECD countries against the WFC
    - Full recovery, however, awaits the recovery of the world economy

- Future Challenges
  - Slowing growth and aging population
    - Rising welfare (pension, healthcare) costs
  - Greater inequality in income distribution
Key Lessons from the Korean Case

Good Planning & Implementation

- In many developed countries, the budget authority is part of (or closely integrated with) the government unit that is responsible for strategic planning,
  - Which facilitates realistic, properly-costed planning

- But, developing countries often have separate ministries for planning and budgeting
  - Annual budgeting will have a strong tendency to dominate longer-term planning, rendering the latter ineffective
The Korean Case

- In the Korean case, planning and budgeting were always in the same ministry
  - Korea’s EPB (Economic Planning Board) was in charge of the 5-year Economic Development Plans and also the annual budget during the economic development drive from the 1960s to the 1990s
  - In Korea the concept of planning itself includes “planning to secure the necessary funding”
  - (Planning, Budgeting, Revenues) were tightly integrated with one another

Structure of Government (1962-1997)

- 1962-1993
  - President
  - Economic Planning Board (planning + budget): Deputy Prime Minister for Economy
  - Ministry of Finance (Tax, Treasury, Finance)
  - Other 15 ministries

- 1994-1998
  - President
  - Prime Minister
  - Ministry of Finance: Deputy Prime Minister for Economy (Finance, Budget, Treasury, Economic Policy, Tax)
  - Other 15 ministries

1998-2008

President
Prime Minister
Ministry of Finance and Economy (Tax, Treasury, Finance)
Ministry of Planning and Budget (Budget, Planning)
Other 16 ministries

Key Lessons

- Even among developed countries, short-term annual budgeting can often influence long-term or medium-term plans, instead of the latter imposing discipline on annual budgeting.

- For planning to be effective (vis-à-vis annual budgeting), the Korean experience shows:
  1. The government needs to assign its best people to planning, which must be fully integrated with budgeting and revenue collection (taxes).
  2. Give them appropriate incentives (e.g., remuneration and promotions).
  3. Back them up with strong support from the top (President or Prime Minister).
The Korean Budget System

The Korean budget system can be difficult to grasp

- Probably closest to the French budget system, although the roots of the present system can actually be traced back to the Japanese Meiji government and von Bismarck’s Prussian/German model
  - Very long history of centralized government run by elite bureaucrats
  - Legalistic mindset that emphasizes ex ante logic and form
  - But no “court of audits”

- But emphasizes modern budget practices pioneered by Commonwealth and Nordic countries
  - Multi-year or medium-term expenditure frameworks (MTEF)
  - Prudent economic assumptions
  - Top-down budgeting techniques
  - Relaxing central input controls
  - Focus on performance and results
  - Accruals & modern financial management
  - Budget transparency
  “Budget Reforms in OECD Countries: Some Common Trends,”
  (Jon Blondal, OECD J. Budgeting, v2n4)

- And currently there’s some serious talk about moving closer to the US system
Some Background

- Political form of government
  - Semi-presidential system (France; US, Mexico, Finland)
    - Bills for legislation can be proposed by both the administration and the legislature
  - Uni-cameral legislature (National Assembly) ≠ parliamentary systems
    - Much weaker vis-à-vis the administration than the US, but this has been changing in the last decade or so

- Legal tradition: follows civil law system (German-Roman)
  - Need to have laws/rules/regulations defined before one can do anything
    - Generally less room for discretion and “common sense” in public administration than in common law systems
  - Need to revise them before one can change anything

Some Further Legal Aspects

- Budget system defined by Constitution and National Fiscal Act
  - 2-level hierarchy, like most countries (Constitutions + Laws of principally equal status)
    - Public Finance Act → Budget and Accounting Act → National Fiscal Act
  - US system: unique “patchwork” of laws
  - French and German systems: 3-level hierarchies (organic, framework)
  - “Unwritten” systems: UK and Commonwealth, Nordic

- The Constitution says that
  - The administration shall formulate, and the legislature shall review and approve
  - The legislature may not increase (only cut) the total, nor may it add new spending items to the administration’s proposed budget (same as France)

- The budget is not a law, only a government plan that is approved
  - Budget ≠ budget act only in Korea and Japan among OECD countries
  - This means laws pertaining to budgeting will be strongly binding

- The law used to define budgeting as strictly annual
  - Consequently, there was (and still is) no conceptual distinction between authorization and appropriation (there is only “budgeting”)
Odds and Ends

- Key actions and decisions take place almost entirely within the administration, especially between the budget office and line ministries during formulation
  - But the legislature has been steadily gaining in influence, especially after founding NABO (the only sizable congressional budget office besides CBO)

- The fiscal year coincides with the calendar year

- The budget proposal must be “submitted” to the NA 90 days before (Oct. 2) the start of the fiscal year

- If the NA fails to approved the budget by the start of the fiscal year, the administration may draw up and execute a “quasi-budget,” that allows spending at the previous year’s rate. This has never happened since independence in 1948 (though some budgets have been passed with just seconds left before the new year)

Odds and Ends, continued

- Budget cycle
  - FY-1
    - March: Budget preparation guidelines (like OMB’s A-11)
    - May: Resource Allocation Meeting (determine ceilings)
    - July – Sept: Budget requests / negotiations / Cabinet approval
    - Oct 2: Transmission to NA
    - Year-end: Approval by NA
  - FY: execution, with monthly/quarterly apportionment & allotment
  - FY+1
    - Closing reports submitted to NA by end-May
      (ministries → MoSF → B. Audit & Inspection → MoSF → NA)

- Chart of Accounts
  - General Account
  - Special Accounts (18): Post office, Environment improvement, etc.
  - Funds (54): National Pension, National Health Promotion, etc.
Evolution of the Korean budget system

- Korea's old system: reasonably good, but lacked virtually all modern/advanced features
  - System remained basically the same from 1948 to the Asian financial crisis of 1997
    - Very traditional line-item, annual, bottom-up budget
    - Zero-based budgeting attempted briefly in 1980s
    - Reforms usually meant consolidating special accounts and funds, which have a tendency to proliferate over time
- The 4 Fiscal Reforms (2002 – 2007) modernized Korea's budget system almost overnight
  - Medium-term framework coupled tightly to annual appropriations through top-down budgeting
  - Built performance-based system, adopted US PART
  - Switched to program budget structure
  - Accrual accounting for final reports

Multi-year Budgeting...

- ... is ensuring that multi-year considerations are adequately reflected in the annual appropriations process
  - Does one need a distinct, stand-alone multi-year budget or plan?
- Formal Frameworks for Multi-year Budgets
  - Sweden: Firm total ceiling fixed 3 years ahead, is binding ex post
  - UK: (Comprehensive) Spending Reviews (biennial budgeting)
  - France?: multi-year appropriations
- Multi-year budgeting as an integral part of annual appropriations
  - US system:
    - Legislature:
      - Budget resolution has multi-year envelopes, but not effective in controlling multi-year total expenditure
      - Employs various point-of-order resolutions to restrict increases in mandatory spending (direct spending)
    - OMB: requires 10-year projections in line-ministry budget requests
National Fiscal Management Plan
(Korea’s MTEF)

- 5-year plan to present national policy visions and directions
  - Fiscal management from a medium-term perspective
  - Rolling plan that is revised annually
  - Annual budget must respect sector ceilings set in NFMP

- Main contents
  - Total expenditure ceiling (multi-year)
  - Sectoral and ministerial resource allocation plans (multi-year sub-ceilings)
  - Also includes narrative discussions on:
    - National policy directions & priorities
    - Medium-term fiscal management outlook
    - Economic forecast & fiscal targets (budget size, balance, debt, etc.)

What is Top-down Budgeting?

- It is not: Bottom-up Budgeting
  - Traditional way of budgeting
  - Sum of ministry budgets ⇒ Total budget
    - Difficult to control aggregates (total budget, deficit)
    - Difficult to control allocation among major sectors
      - Defense vs. pollution control vs. infrastructure, etc.
  - Additional Problems
    - Focus on annual numbers (myopic)
    - Inefficient process
      - Iterative negotiations (game-playing & g for totals)
      - Inability to utilize ministries’ expertise
**What is Top-down Budgeting? (2)**

*It is: Budgeting in 2 Steps*

1. **Ceilings (aggregate numbers)**
   1) Decide total spending & deficit levels (agg. ceiling)
   2) Decide allocation among major policy areas (sectoral ceilings: about 30)
      - Defense vs. pollution control vs. infrastructure, etc.

2. **Intra-sectoral allocations (details)**
   1) Ministry/agency budgets

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**Purpose of Top-down Budgeting**

*Improve micro-efficiency*

1) Efficient in time and effort (no more over-bidding)
2) Utilizes ministries’ expertise (best use of limited resources)

*Better macro results*

1) Effective for fiscal consolidation
2) Ensures spending is aligned with priorities
3) A key tool for enforcing MTEF (NFMP) decisions
   (ceilings are usually multi-year limits: Korea, Sweden, Norway, UK)
### Example of linking multi-year plans to the annual budget (Sweden)

<table>
<thead>
<tr>
<th>Current Year (n)</th>
<th>Plans for Future Years</th>
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<tbody>
<tr>
<td></td>
<td>n+1</td>
</tr>
<tr>
<td>2014</td>
<td>FY 2015</td>
</tr>
<tr>
<td></td>
<td>• Total Ceiling Fixed</td>
</tr>
<tr>
<td></td>
<td>• Finalize 27 sect.</td>
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<tr>
<td></td>
<td>ceilings and annual</td>
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<tr>
<td>2015</td>
<td>FY 2016</td>
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<td></td>
<td>• Total Ceiling Fixed</td>
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<tr>
<td>2016</td>
<td>FY 2017</td>
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<td></td>
<td>• Total Ceiling Fixed</td>
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<td>budget</td>
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### Building a performance-based budgeting system

- **Performance Budgeting (Pilot Project)**:
  - Developed Strategic Goals, Performance Objectives and Performance Indicators
  - Designed after GPRA

- **Performance Management**:
  - Expanded "Performance Budgeting" to 26 Ministries/agencies
  - Annual performance plans and reports are required

- **Self-Assessment of Budgetary Program (K-PART)**:
  - 1/3 of major budgetary programs are evaluated every year
  - Designed after PART

- **In-Depth Evaluation**:
  - Selected programs are subject to program evaluation
**Program Budgeting**

- Uses “program classification,” which organizes budget classification hierarchy by purpose/function of spending.
- Hence basic unit is the “program,” defined as individually comprehensive and mutually exclusive set of all government activities that contribute to the same policy end.

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**Linking Planning and Budgeting**

- Long-term, medium-term, and annual budgeting must all use program classification:
  - Ties together purpose/objective and resource allocation.
  - Focuses on total available/allocated resources for a policy area, regardless of funding source or account.
  - Linkage between objective and resources also makes program budgeting a natural for performance management.
- Note that program classification may be more difficult than it seems, because existing organizational structures and “turfs” may actually take precedence:
  - Making the organizational budget classification the primary classification.
  - But, good program budgeting requires that the organizational structure should follow the program classification.
Accruals has begun...

- From FY 2009, government accounting and annual reports adopted accruals
  - After a 2-year pilot phase (FYs 2009 & 10),
  - FY 2011 financial reports (in 2012) to legislature will switch to full accruals
  - Recently “upgraded” reporting of pension superannuation provisions
- Budgeting (formulation) will remain on a cash basis
- This affects only part of the annual reports
  - “Closing reports” to legislature formally discharge government from duty to execute the budget (similar to Germany)
    - Closing Summary
    - Revenues and Expenditures (by account)
    - Financial Statements
      - Balance sheets, Income statements, Net asset value change statements
    - Performance Reports

This ends the presentation
Thank You!