

# The Korean Budget System (& Economic Development)

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**John M Kim, PhD**  
Head / PEMNA Center  
Korea Institute of Public Finance  
[jhrv@kipf.re.kr](mailto:jhrv@kipf.re.kr)

## 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)

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## The Nature of the 4<sup>th</sup> 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 4<sup>th</sup> 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

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## 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

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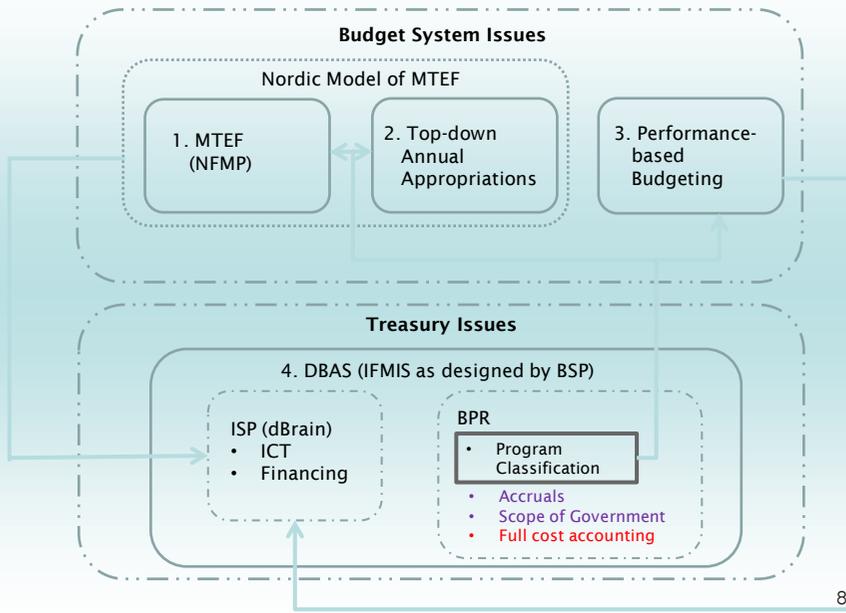
**BARO's BSP as Originally Announced in November, 2004**

2004	2005	2006	2007 & 2008	2009 onward
<b>BSP</b> Sept - Nov	<b>BPR &amp; ISP</b> Feb - Aug	<b>Develop DBAS</b> Oct 2005-Sept 2006	<b>Full Deployment</b> Beginning July 1, 2007	
Determine new budgeting and accounting framework  Come up with overall roadmap	<b>BPR</b> Detailed business and process redesign  <b>ISP</b> Blueprint for building IFMIS  Necessary legal reforms  <b>Change Management</b> (Training, etc.)	Info sys. for consolidated budget  Info sys. for central government budget  Linkage with other systems	<b>Test &amp; Train</b> Jun - Dec  Data conversion  Testing  User training	Program classification (from 2008)  <b>Accrual reports and audits</b> • Trial basis from 2007 • Full accruals from 2008 Adjust scope of government reporting
				Budget analysis  Integrate performance management  <b>Full cost accounting</b>  <b>Improved budget and accounting management</b>

- Finished on schedule
- Partial implementation
- Postponed, later completed
- Postponed

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**Dependencies among Components of the Four Reforms**



## **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...

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## **Further Details...**

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

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## 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

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## The Korean Budget at a Glance (2)

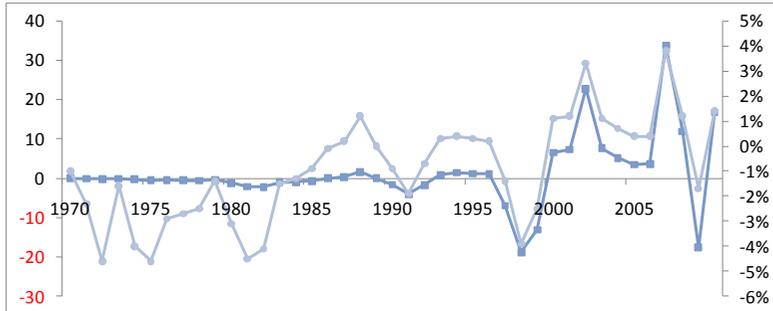
### Budget Allocation (FY2014, trillion Won, % growth)

- 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**

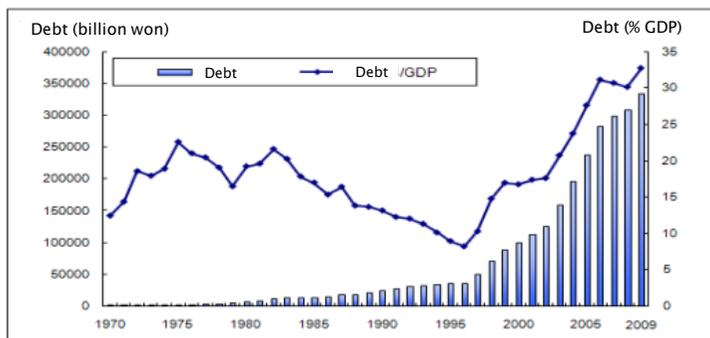
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## Budget Balance

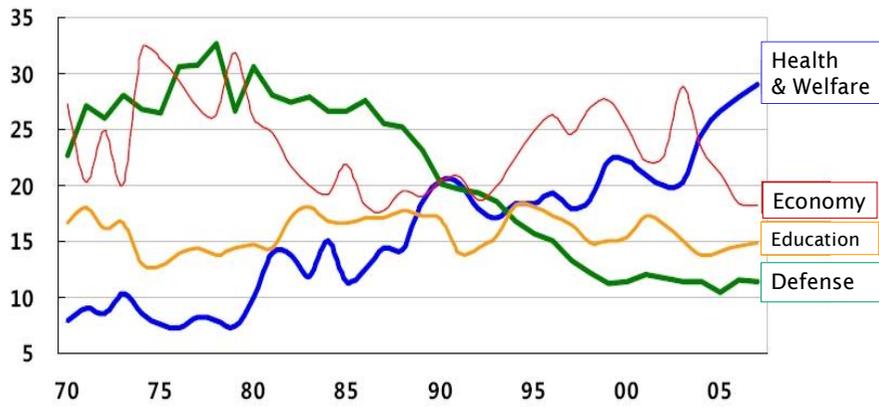


\* Dark blue line shows consolidated budget balance in trillion won (left axis),  
light blue line shows same balance as % of GDP (right axis)

## Government Debt



## Composition of Key Expenditures (% of budget)

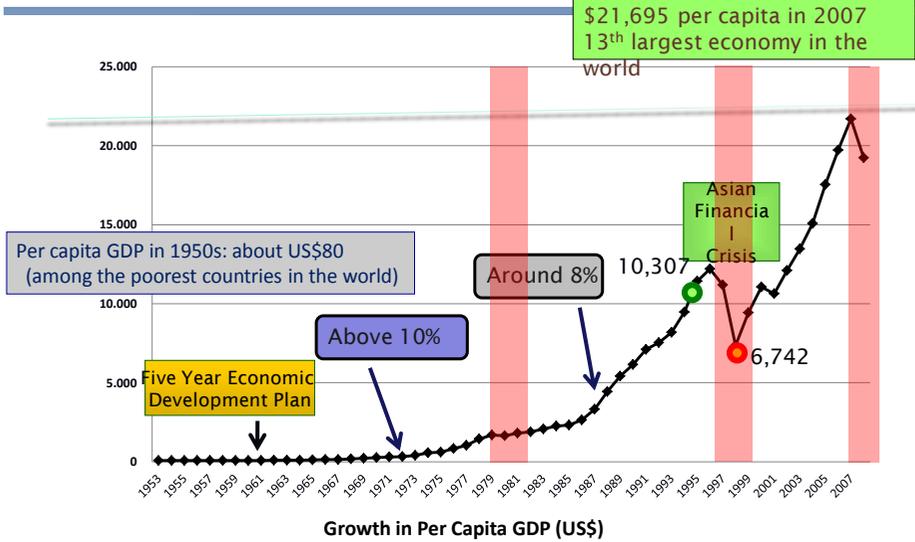


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## The Role of Fiscal Policy

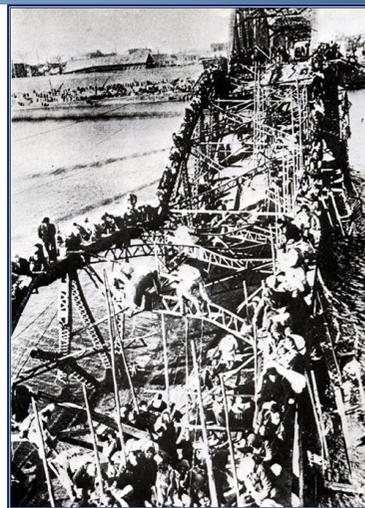
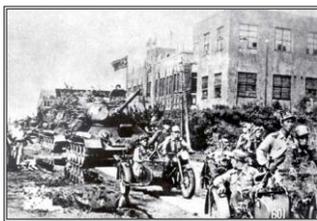
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## Building the Korean Miracle



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## Total Devastation after Korean War (1950 – 1953)



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# Firing up the Growth Drive (1960s)

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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



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## ***Fiscal Policy in the 1960s***

- **1<sup>st</sup> 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**

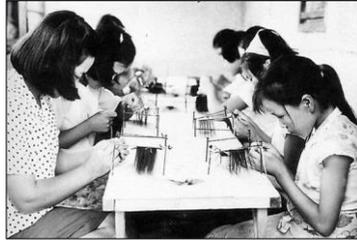
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## ***Fiscal Policy in the 1960s***

- **2<sup>nd</sup> 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

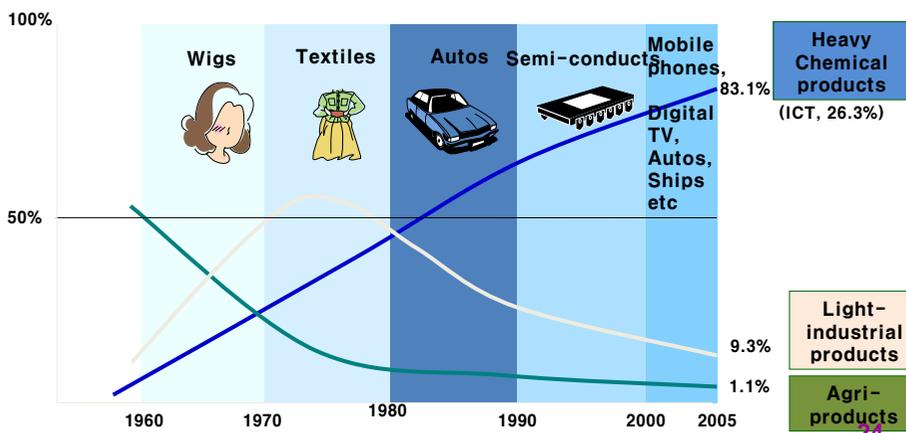
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# Industrialization in the 1960s



# How Exports Changed

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

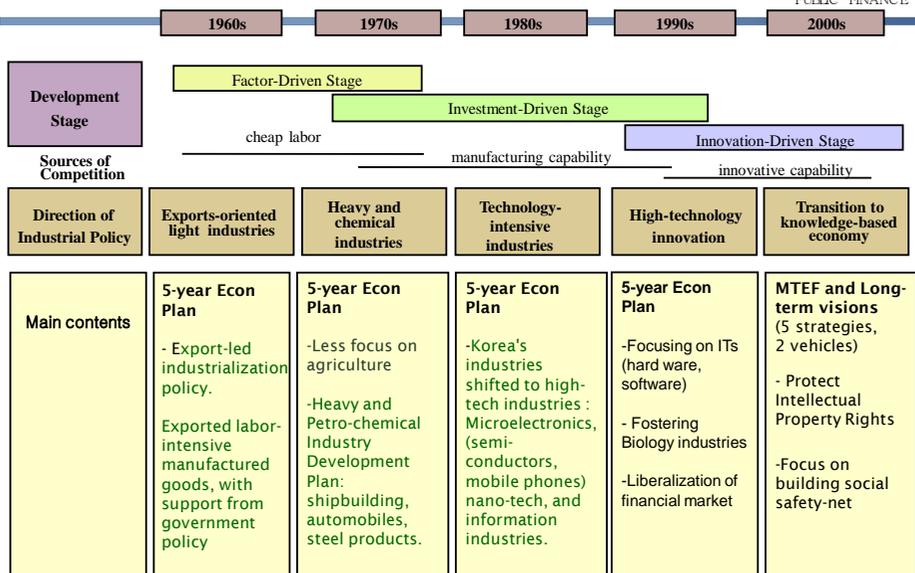


## Challenges & Responses in 1960s

- **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

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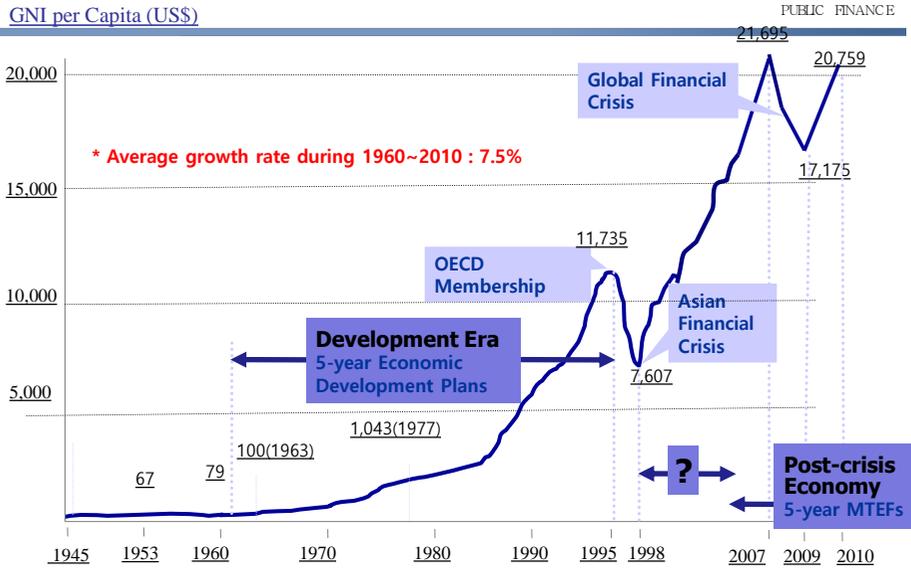
## Phases of Economic Development



## Economic Growth, 1945 - 2010



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## Fiscal Policy in the 1970s



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- **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)

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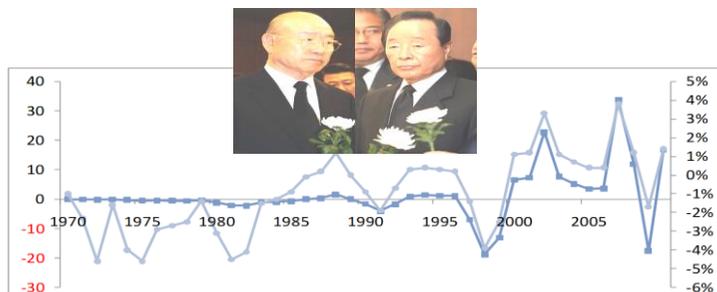
## Challenges after the 1970s

- **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**

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## Challenges after the 1970s

- **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**



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## ***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



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## ***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



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## Key Lessons from the Korean Case

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### *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

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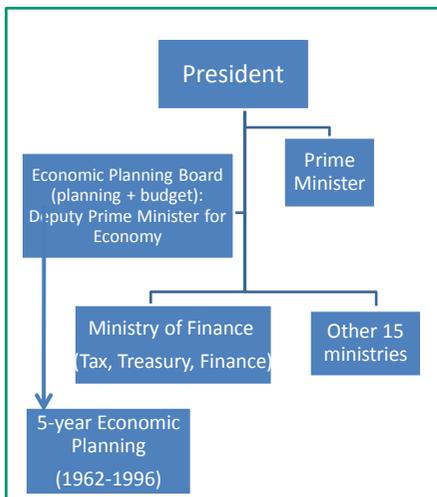
## The Korean Case

- 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

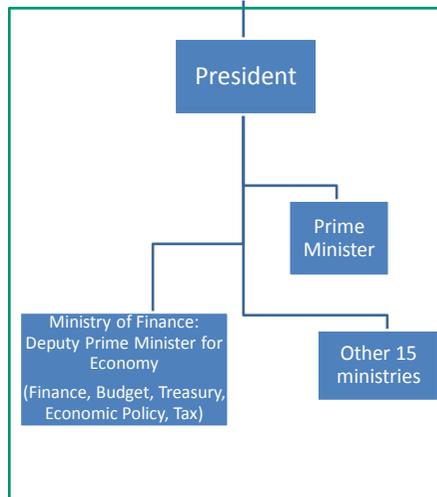
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## Structure of Government (1962-1997)

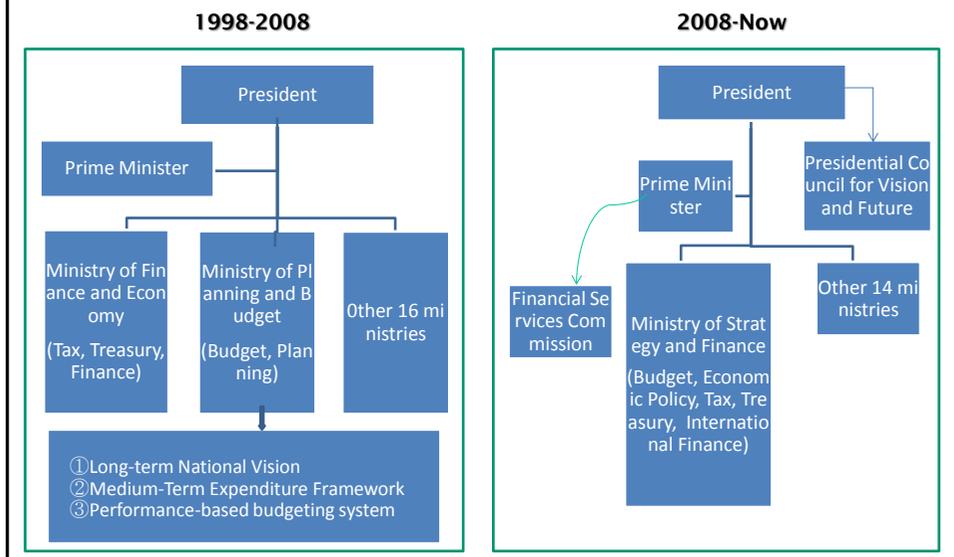
1962-1993



1994-1998



## Structure of Government (1998-2008)



## 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

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## *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**

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## *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**

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## *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”)**

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## 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)**

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## 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.**

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## ***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**

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## ***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**

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## ***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.)

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## ***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

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## ***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)

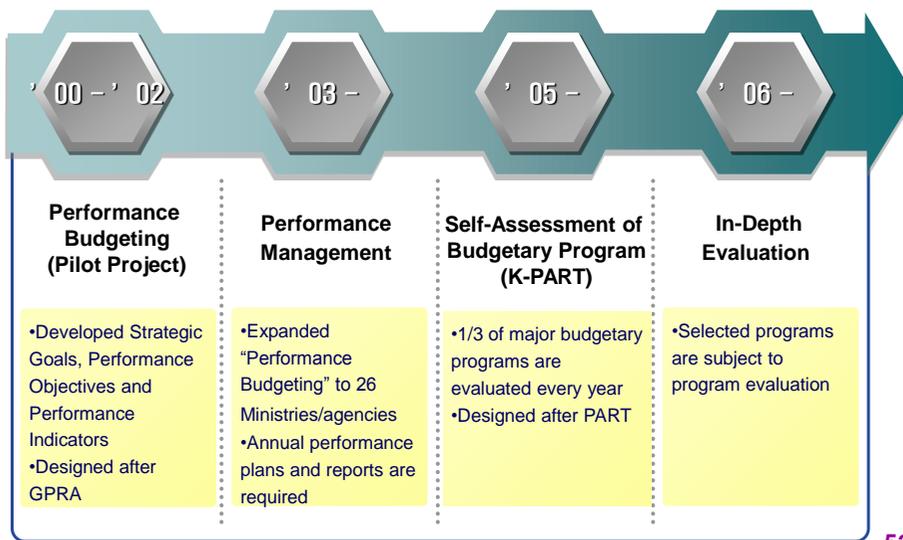
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## Example of linking multi-year plans to the annual budget (Sweden)

Current Year (n)	Plans for Future Years		
	n+1	n+2	n+3
2014	<b>FY 2015</b> •Total Ceiling Fixed •Finalize 27 sect. ceilings and annual budget	<b>FY 2016</b> •Total Ceiling Fixed •Adjust 27 sect. ceilings using budget margin	<b>FY 2017</b> •Total Ceiling Fixed •Set 27 Sect. Ceilings + budget margin
2015	<b>FY 2016</b> •Total Ceiling Fixed •Finalize 27 sect. ceilings and annual budget	<b>FY 2017</b> •Total Ceiling Fixed •Adjust 27 sect. ceilings using budget margin	<b>FY 2018</b> •Total Ceiling Fixed •Set 27 Sect. Ceilings + budget margin
2016	<b>FY 2017</b> •Total Ceiling Fixed •Finalize 27 sect. ceilings and annual budget	<b>FY 2018</b> •Total Ceiling Fixed •Adjust 27 sect. ceilings using budget margin	<b>FY 2019</b> •Total Ceiling Fixed •Set 27 Sect. Ceilings + budget margin

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## Building a performance-based budgeting system



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## ***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**

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## *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!**